

Financial Economists Roundtable

Statement on Accounting Disclosure About Derivative Financial Instruments

November 21, 1995

The use of derivative financial instruments by financial institutions, other companies, investment funds, and individuals has grown rapidly in recent years. By transacting in exchange-traded instruments (such as futures and options) and "over-the-counter vehicles" (such as swaps, forwards, and other customized instruments), market participants are able to transform their risk exposures in anticipation of movements in interest rates, (currency) exchange rates, indices of stock prices or groups of commodities, and the prices of numerous specific commodities. Derivatives, properly employed, enhance overall economic welfare by making these risk transformations feasible and cost-effective.

Unfortunately, current external reporting requirements for financial assets and liabilities and for derivatives are incomplete and inconsistent. These reporting requirements often induce firms not to hedge important risk exposures and sometimes to hedge accounting rather than economic impacts.

At its 1995 annual meeting, the Financial Economists Roundtable examined the external reporting requirements for financial assets and liabilities as well as derivatives. We conclude that the informational content and comparability of financial statements would be enhanced by adoption of the following external reporting requirements:

1. All financial assets and liabilities should be recorded at "fair value", i.e. marked to market, except for derivative positions established to hedge cash flows related to nonfinancial assets or to future expenditures. When prices cannot be directly observed in the market by reference to liquid instruments, marking to market entails the use of models to infer fair value.
2. Hedges of nonfinancial assets or future expenditures should be reported in accordance with the matching principle of accounting, that is, the gain or loss on the hedging instrument should be recognized in the same period that the specified event or the hedged item is taken into income or expense, regardless of the nature of the hedged item.

- If the hedge instrument is not terminated when the hedged item is brought into income, it converts to an instrument to be marked to market.
- Gains on hedging instruments realized prior to the accounting recognition of the specified event should be deferred until they can be matched against the income or expense associated with the hedged item. In accordance with the accounting principle of conservatism, realized or measured losses on hedge instruments should be deferred only to the extent that they do not exceed the unrecorded gains to date associated with the hedged item.
- At the end of each accounting period, material unrealized and deferred gains or losses on hedging instruments, along with (offsetting) unrealized losses or gains on the hedged item, should be disclosed in a footnote.

3. External reporting must be supported by an adequate risk management/internal control system, which provides an immediate and continuous ex ante basis for establishing whether or not a derivative position is a hedge. Furthermore, such a control system provides an audit trail for the independent accountants (CPAs) who must give an opinion on the firm's financial statements.

The above measures would go a long way toward improving the informational content and comparability of financial statements with respect to transactions involving financial instruments in general and derivatives in particular.

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