A Survey of Corporate Risk Management: Too hot to handle? - Unaccounted for (part 8 of 9)

INDEX TERMS **Derivatives|accounting challenge; Accountancy|derivatives challenge;**

DATE **10-Feb-96**

WORDS **1702**

The case of the invisible derivative

MATTHEW BISHOP ACCOUNTANTS rarely set the world on fire, but their task is an important one. Without accurate and timely information about a firm's profits, assets and liabilities, shareholders cannot monitor the performance of management. And unless they do, corporate governance may fail.

The trouble is that company accounts, far from being the authoritative documents they seem, are a curious cocktail of hard facts (many of them out of date) and subjective judgments - an ambiguity arising in part from the dual role of accounts as both a historical record of a firm's performance and a guide to its short-term prospects. Now that derivatives are becoming widely used, accounts are struggling to fulfill either of these briefs satisfactorily.

Derivatives challenge traditional accounting in a number of ways. One of their appeals to a certain kind of manager has been that they allow loopholes in accounting rules to be exploited. In the late 1980s it became common for firms to use complex financial instruments that did not appear on the balance sheet, or which appeared as assets when they were liabilities, or as equity when they were debt. Although accountancy regulators in some countries have clamped down on this by rewriting the rules and requiring fuller disclosure of derivatives, in much of the world it is still possible to have read a company's accounts and yet be none the wiser about whether the firm has used derivatives and what for. Moreover, on past form it seems highly probable that financial wizards will continue to find innovative ways around accounting rules.

Fuller disclosure is certainly needed, but on its own it is not enough, and is anyway not as straightforward as it might appear. In most parts of the world, accounts record a firm's assets and liabilities at their historic cost - their value when they were acquired (albeit sometimes reduced gradually over time). This was always somewhat misleading, as the value of assets and liabilities rarely remains constant. In recognition of this, some countries provide scope for updating to current valuations. But the value of some derivatives can change many times faster and many times more than that of most traditional assets and liabilities. Whereas the historic value of, say, a factory might be acceptable as a rough guide to its current value, the same would not be true of a highly leveraged exotic derivative.

A growing band of accounting regulators, led by America's Securities and Exchange Commission and its Financial Accounting Standards Board, says the answer is to 'mark to market' (show at current market values) not only derivatives but all marketable financial assets and liabilities. This, too, raises tricky practical questions, such as whether to show the market value on the last day of

the financial year or as some kind of average. But it clearly makes sense, at least for the financial institutions (which already have to supply this information), where financial instruments make up the lion's share of both sides of the balance sheet.

Whether marking to market is as desirable for non-financial companies that use derivatives to hedge their normal business revenues and expenditures is less certain. For such firms, hedging often means matching a financial derivative to a future income or expenditure stream from an underlying business. By definition, if the hedge is working, the firm will incur a loss on the derivative if the value of the underlying asset or liability moves in the firm's favour. If the hedged asset or liability is not marked to market but the derivative is, which may be most of the time, the accounts will show the loss on the derivative but not the compensating gain on the other side of the hedge. According to Marti Subrahmanyam, a finance professor at New York University, this would be 'increasing information at the expense of accuracy.'

Given the current sensitivity of investors to losses on derivatives, managers may reckon it is easier not to hedge - and thus leave the firm exposed to greater risk - than to try to convince a sceptical public that the loss is actually a sign of success. A 1994 survey of chief financial officers of big American firms found that 41% thought that marking derivatives to market might cause them to do less hedging. Tom Jones, the treasurer of Union Carbide, puts it this way: 'We all have friends .. (who) say they would not hedge because derivatives are bad things to use. The irony, of course, is that by making that statement they have • opted) to accept the risk. But this hypocrisy, or at least confusion, persists in part because the two kinds of losses do not get accounted for in the same way. Unhedged losses do not show up anywhere. But hedging losses are reported separately - typically independently of the position they are being used to hedge - and they are now being held up for very strong public scrutiny.'

That problem could be avoided by showing derivatives used for hedging at their original cost in the accounts; but unless firms still marked their derivatives to market daily for internal-control purposes, they would have little idea whether or not their hedges were working properly. More logically, argues David Creed, the treasurer of Tate & Lyle, marking to market should be extended to all assets and liabilities that can be, not only derivatives or other financial instruments. This would include stocks of finished products and of raw materials, sales and purchase contracts yet to be delivered, property, employment contracts and so on. True, some assets - such as a firm's brands, or its products under development - are hard to value. However, these should be tightly defined and disclosed by the firm, says Mr Creed, so that shareholders and analysts are able to judge to what extent the marked-to-market accounts reflect reality.

A technique known as 'hedge accounting' might also be helpful, although this is hotly debated. The idea here is that firms can defer disclosing (fully) the hedge until it has been completed, so the losses and gains on either side of the coin cancel out. This should ease any pressure to unwind a hedge from boards or shareholders that look only at a marked-to-market derivative loss but not at any matching gain. The best method of hedge accounting has been under debate for some time in both America (where a formal set of rules already exists) and Britain (where hedge-accounting has been left to firms' discretion). A big problem is the difficulty of distinguishing between a hedge and a speculation. The American rules, and those being contemplated in Britain, get round this by restricting their definition of hedge accounting to derivatives tied to individual, contractually-certain, payments. But this may have the effect of encouraging transaction hedging at the expense of strategic hedging.

The future is another company

But there is a deeper problem too. Accounts have traditionally looked backwards, painting a picture of the firm at the end of the most recent financial year. Before derivatives, looking at that picture was a reasonable way to discover what kinds of opportunities and risks were likely to face the firm in the current year and beyond. That is no longer true, nor would it be even with full disclosure of a firm's marked-to-market derivatives. This is why the Securities and Exchange Commission in December 1995 issued proposals for firms to provide detailed information on the prospective values, on various financial-market assumptions, of the derivatives and other financial instruments they hold.

Banks are starting to deal with this problem by calculating their 'value at risk' (VAR). Whether this methodology is appropriate for non-financial firms is not clear, although BP publishes a VAR measure (as well as marked-to-market, gross and net positions, see table) for derivatives it holds for trading (speculative) purposes. However, as BP points out, 'where derivatives are used for risk management they do not expose the • firm) to market risk because gains and losses on the derivatives offset losses and gains on the asset, liability or transaction being hedged.' Thus, it does not publish a VAR measure for its portfolio of derivatives used for hedging, which dwarfs that used for speculation. Yet even if it did publish a VAR for all derivatives (and, indeed, other financial instruments), all would not be clear. Looking at all the firm's assets and liabilities, financial and real, might paint a very different picture.

In the end, though, however well accounts reflect a firm's assets and liabilities at the end of the latest financial year, they may prove useless to any shareholder worried about falling prey to a rogue trader like Baring's Nick Leeson. Richard Leftwich, a professor of accounting at the University of Chicago, points out that whereas a firm cannot shift a factory from Atlanta to Alabama overnight, with derivatives it can fundamentally transform its riskiness at the stroke of a computer key. The only possible safeguard against shocks - and that not foolproof - is for firms clearly to spell out the policies guiding their use of derivatives. Shareholders should be able to scrutinise these policies, and even debate them with management.

Setting out policies is no guarantee that they will be kept to. Good internal controls are essential. It was the lack of such controls, notably the failure to separate derivatives trading from settlement, that enabled Mr Leeson's losses to remain undiscovered for years. Such controls need to be vetted and approved by the firm's auditors and board. However, auditing firms may resist this fiercely, conscious of the growing fashion for firms to sue them at any hint of financial trouble.

BARING ALL

BP's gross contract amount of derivatives, end 1994, pounds m

Contract	Gross contract amount	Unmatched contract amount*	Value at risk	Current market value

---

Risk management				
Interest-rate	3,873	na	na	-121
Foreign-exchange	5,523	na	na	125
Oil-price	756	na	na	-1

Trading				
Interest-rate	429	208	-	-
Foreign-exchange	4,244	23	-1	7
Oil-price	635	272	-1	10

---

* Matched contracts have been eliminated. For traded derivatives, most of these positions have been neutralised, with trading initiatives being concluded by taking opposite positions to fix a gain or loss, thereby achieving a zero net market risk.

Source: British Petroleum annual report.
