

# *investment* GUIDES

## Editor's Letter

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# FAS 133

## *and the New Derivatives Accounting Landscape*

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### Editor's Letter

A decade in the making, hotly debated before congressional committees, and further modified to meet user needs since it was issued by the Financial Accounting Standards Board in June 1998, Statement of Financial Accounting Standards No. 133 is one of the most complex and controversial standards ever issued. It represents part of the FASB's long-term move toward fair value accounting; a steely determination by the Board to have derivatives reflected on the balance sheet and visible to financial statement users; and a substantial administrative task for financial statement preparers. The fall of 2001 is an opportune time for a snapshot of where FAS 133 implementation stands because by now every corporation has been fully involved with the process for more than a year but many still have a way to go toward what they would consider optimum systems and procedures. This book consists of 16 articles by experts from the FASB, major public accounting firms, consulting firms, and a corporate user, bank, dealer, law firm, and systems vendor. It is designed to be useful and current for those actively involved in Statement 133 implementation and understandable to those who want to learn more about the process and underlying issues.

We start with an overview of FASB's objectives by Melissa Probst and Rosemarie Sangiuolo and continue with the results of a corporate user survey conducted by Ira Kawaller, working with the Association for Financial Professionals, and then follow with advice on implementation issues beyond initial adoption efforts from Jim Rozsypal, John Woods, and Mike Dolan. Moving on to more corporate implementation issues, Keith Bergman comments on the current state of FAS 133 systems development from the vendor's point of view, Peter Connors gives us an overview of tax issues related to the standard, and Peter Marshall takes a new look at the role of the central treasury in light of FAS 133 requirements. We then devote three articles to what is perhaps the most onerous requirement of the standard, hedge effectiveness testing. John Althoff and John Finnerty start with an overview of three methods, the 80/125 test, the regression test, and the variance-reduction test, and then Rob Royall pursues regression analysis in further detail. Next, Andy Kalotay and Leslie Abreo demonstrate the use of statistical risk management methods to determine whether a hedge is not only highly effective but also reduces earnings volatility over the longer term.

We then address foreign exchange, interest-rate, and commodity price risk hedging issues and particular concerns related to warrants. We start with guidelines from Brian May and Steve Walter on hedging the FX risk of forecasted or anticipated sale and purchase transactions. Jeff Wallace then gives us a view of how Derivatives Implementation Group (DIG) Implementation Issue G20 opens the door for option hedging followed by a summary from David Kwun on how FAS 138 facilitates the use of cross-currency interest-rate swaps

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to hedge foreign-currency-denominated debt liabilities. Jeff Bauman, John Coleman, and Rob Powell show how Eurodollar futures can be used as an economical, FAS-133-compliant alternative to interest-rate swaps; David Dines discusses physical commodity contracts as an alternative to financial derivatives to hedge commodity price risk; and Deidre Schiela, David M. Lukach, Nora Dougherty, and J. Douglas Summa explain accounting and valuation considerations for issuers and holders of warrants. Finally, Walter Teets, emphasizing the need for continued hands-on training of staff members at all levels, concludes the book with three useful case studies that show journal entries for an interest-rate swap, a foreign exchange forward, and a commodity future.

The quality of a book of this nature reflects the willingness of top professionals in the field to take the time to share their views with their peers. As the editor, I have found working with every author to be a great pleasure. I also would like to thank Todd Miller for his excellent work in making initial contact with the authors and, as always, the Institutional Investor Journals staff for producing a smart-looking book under time pressure and tolerating the usual avalanche of additions and changes just before the printer's deadline.

**Henry A. Davis**  
**Editor**

*Henry A. Davis is a financial writer and consultant specializing in issues related to corporate finance and banking. Hal currently serves as Managing Editor of two Institutional Investor quarterly professional journals, Strategic Investor Relations and The Journal of Structured and Project Finance. In addition to business school case studies and articles for financial publications, he has written and co-authored 11 books for the Financial Executives Research Foundation, Euromoney Books, and Amacom Books on topics including project finance, financial turnarounds, financial performance measures, capital structure and dividend policy, financial risk management, intangibles, cash management, and the role of the finance function within the corporation. A former banker, Hal is a graduate of Princeton University and the Darden Graduate Business School at the University of Virginia.*