FAS 133: System Worries
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Nothing’s perfect - and an even larger measure of skepticism might be in order if we’re talking about FAS 133 systems. For the uninformed, FAS 133 is the new accounting standard that applied to derivative instruments. All banks that use derivatives will be affected, and one of the more critical concerns will likely be in connection with systems.

System providers have had a difficult charge. FAS 133 is complex and diverse, and a steady stream of DIG issues have required adjustments and modifications along the way. It would be tough enough if the standard had been finite and complete when it was initially released in June of 1998, but it’s been doubly-tough dealing with a moving target. The strategy of most system developers has been to put out a core product - ideally, one that appropriately processes data in a manner consistent with FAS 133 requirements - with the intent of expanding the system’s capabilities over time, in accordance with the needs of a (hopefully growing) client base. What this means is that users may end up doing something that is FAS 133 compliant, but not necessarily FAS 133 optimal.

Perhaps the biggest problem arises because the standard affords some measure of discretion for the user. In a host of situations, different choices on the part of the user will translate into different accounting. For example, in assessing hedge effectiveness, the user may - but is not required to -- exclude different components of hedge results. For forwards or futures, you may exclude the forward points and base the assessment of effectiveness on movements of the spot price for both the hedged item and the derivative. Alternatively, you could choose not to exclude these forward points. With this election you might compare changes of the forward price to changes of either the spot price or the forward price of the hedged item. Again, depending on which choice is made, different allocations of derivative gains or losses may be recorded in earnings, and different disclosures would certainly be required. In a similar vein, when the hedging derivative is an option, you may exclude either the time value of the option or the volatility value. Some systems may make these types of choices for you, and their choice may not be the best choice.

In the wrong hands, FASB systems can wreak quite a bit of havoc. A high level of user knowledge is necessary before these systems can be implemented. The human capital requirement is probably most significant in connection with hedge effectiveness testing. In a substantial number of situations, the way the hedge effectiveness test is constructed will determine whether or not hedge accounting will be permitted, and it’s not clear that a “one-size-fits-all” approach will generate a result that will necessarily qualify.

Ideally, a system user should have (a) an understanding of the economics of the derivative instruments and valuation methodologies, (b) a comfort level with statistics, and (c) an appreciation of the basic features of the FAS 133 accounting model. A deficit in any of the above areas leaves the user ill-prepared to assess whether the system’s solutions are optimal - or even if they have any merit whatsoever.

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He is currently a member of the Financial Accounting Standards Board’s Derivatives Implementation Group (DIG), and much of his work in recent years has related to aspects of FAS 133 – the U.S. accounting standard that pertains to derivative instruments. In prior years Kawaller was a trustee of both the Futures Industry Institute and the Securities Industry Institute, and he was a member of the board of directors of the International Association of Financial Engineers.

Mr. Kawaller received a Ph.D. in economics from Purdue University and has held adjunct professorships at Columbia University and Polytechnic University.