Microsoft (MSFT) recently warned investors that the application of new rules for accounting for derivatives and hedging transactions would result in a cumulative after-tax reduction in net income of approximately $350 million and other comprehensive income of approximately $50 million for the September 2000 quarter. The adoption would also affect assets and liabilities reported on the balance sheet.

- Why did the FASB change the way companies account for derivatives and hedging transactions?
- What are the new rules for accounting for derivatives and hedging transactions?
- How will the new rules affect the financial statements?

**Why did the FASB change the way companies account for derivatives and hedging transactions?**

Large derivative losses incurred at a few companies prompted the SEC, Congress, and financial statement users to urge the FASB to expedite development of a comprehensive, and consistent set of accounting rules for derivatives. The Board pushed accounting for derivatives to the front of its larger project on financial instruments. It identified specific problems with previous accounting and reporting practices that are addressed in SFAS No. 133 and 138. All firms must adopt the new rules for accounting for derivatives and hedging transactions for all fiscal quarters of all fiscal years beginning after June 15, 2000.

**What are the new rules for accounting for derivatives and hedging transactions?**

The FASB concluded that all financial instruments or contracts (such as futures, forwards, swaps, options, etc.) that embody three basic characteristics are assets or liabilities that should be reported on the balance sheet at “fair value”. Accounting for changes in the fair value of derivative instruments depends on whether or not the derivative qualifies as a part of a hedging relationship. Gains and losses on derivatives that are not a part of a hedging relationship - derivatives held for speculation - are reported directly on the income statement. The reporting method for gains and losses on derivatives that are part of a hedge is dictated by the nature of the hedge. The FASB describes two fundamental kinds of hedges - “Fair Value” and “Cash Flow” hedges. The standard also forces firms to “bifurcate” or separate embedded derivatives from host securities held for investment purposes.

**Derivatives Held for Speculation:** Derivatives held for speculation are treated in essentially the same manner as “trading securities”. They are reported at fair value on the balance sheet. Increases and decreases in their fair value are recognized currently in net income.

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**Fair Value Hedges:** A fair value hedge offsets the firm’s exposure to changes in the fair value of another asset or liability. An interest rate swap is a good example of this kind of hedge. The derivative instrument is reported at fair value on the balance sheet. The FASB also requires firms to value the hedged item at “fair value” even when historical cost would otherwise be used. Increases and decreases in both the fair value of the derivative instrument and the fair value of the hedged item are reported in net income. Gains and losses on the derivative are, therefore, offset by the opposite change in the fair value of the hedged item.

**Cash Flow Hedges:** A cash flow hedge reduces a firm’s exposure to variability in expected future cash flows related to an existing asset or liability or anticipated future transaction. For example, a futures or forward contract giving the firm the right to buy a commodity at a preset price protects the firm from possible price increases. The contract is a part of a cash flow hedge, as opposed to a speculative derivative, if the firm anticipates making the future purchase.

Derivative instruments providing effective cash flow hedges are measured and reported at fair value on the balance sheet. Gains and losses in fair value are recorded in equity as a part of other comprehensive income but are reclassified into earnings when the hedged forecasted transaction affects earnings. If a firm enters into a futures contract to buy a commodity, increases or decreases in fair value of the contract are reported in equity as part of comprehensive income until the commodity is sold or used up and becomes an expense. At that point the gain or loss accumulated in equity is reclassified into net income.

**Foreign Currency Hedges:** The FASB devotes special attention to foreign currency hedges. In general, however, these hedges are categorized as either fair value or cash flow hedges. The accounting is essentially the same as for hedges involving other kinds of assets and liabilities.

**Embedded Derivatives:** “Hybrid securities”, such as convertible bonds, are a combination of a traditional financial debt security (the host contract) and a conversion feature (the embedded derivative), which is essentially a stock option. In most cases, SFAS 133 requires investors to separate the embedded derivative from the host security (bifurcation). Each is then accounted for according to GAAP. This rule applies only to investments in hybrid securities. The FASB is dealing with accounting for issued hybrid securities in another project.

In our complex financial environment identification and classification of derivatives and types of hedges is far from simple. Embedded derivatives pose numerous conceptual and practical problems. The FASB established the Derivatives Implementation Group to identify and resolve significant questions. To date the task force has published responses to 114 different issues presented by firms struggling to apply this new set of rules.

**How do the new rules affect the financial statements?**

The new rules require recognition of all derivative instruments as either assets or liabilities. Derivative instruments always reported at “fair value” on the balance sheet.
Increases and decreases in the fair value of derivative instruments will be appear either on the income statement or as a component of comprehensive income. The rules differentiate between speculators and those who use derivatives for risk management. Firms that hold derivatives for speculation purposes report all gains and losses immediately on the income statement. Derivatives that are part of hedges are less likely to affect net income either because of offsetting changes in the value of the hedged item or because the rules allow the firms using them to report gains and losses as a part of comprehensive income.  (See Table 1)

Table 1: Accounting for Derivatives and Hedging Transactions on Financial Statements

<table>
<thead>
<tr>
<th>Derivative Purpose</th>
<th>Reported on Balance Sheet</th>
<th>Reported in Net Income</th>
<th>Reported in Comprehensive Income</th>
</tr>
</thead>
<tbody>
<tr>
<td>Speculation</td>
<td>Derivative: Asset or Liability at FV</td>
<td>Increase or decrease in Fair Value of derivative</td>
<td>NA</td>
</tr>
<tr>
<td>Fair Value Hedge</td>
<td>Derivative: Asset or Liability at FV</td>
<td>Increase or decrease in FV of derivative</td>
<td>NA</td>
</tr>
<tr>
<td></td>
<td>Hedged Item: Asset or Liability at FV</td>
<td>Offsetting increase or decrease in FV of Hedged Item</td>
<td></td>
</tr>
<tr>
<td>Cash Flow Hedge</td>
<td>Derivative: Asset or Liability at FV</td>
<td>Increase or decrease in FV of derivative, which is reclassified into net income when hedged forecasted transaction affects net income.</td>
<td></td>
</tr>
</tbody>
</table>

Initial application of the FASB statement begins with the first fiscal quarter of the first fiscal year after June 15, 2000. Firms with fiscal years ending on June 30th, such as MSFT, began applying the new rules in the September 2000 quarter. Upon initial application, the firm has to restate all freestanding derivative instruments to fair value and to recognize any offsetting gains and losses on hedged assets and liabilities. The cumulative effect of the change in accounting principle is reported in net income or other comprehensive income, as appropriate. Restatement for MSFT resulted in a $350 million charge to net income and a $50 million charge to comprehensive income. The restatement could, of course, result in increased net and/or comprehensive income.