DERIVATIVES IN THE CURRICULUM: WHO KNOWS WHERE OR WHEN?

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ABSTRACT

Statement of Financial Accounting Standards (SFAS) NO. 133, *Accounting for Derivative Instruments and Hedging Activities,* established new accounting requirements for derivative instruments and hedging activities effective June 15, 1999 (SFAS No. 137 changed the effective date to June 15, 2000). This statement requires that an entity recognize all derivatives as either assets or liabilities at fair value on the balance sheet. When certain conditions exist, a derivative may be specifically designated as: (1) a hedge of the exposure to changes in the fair value of a recognized asset or liability or an unrecognized firm commitment, (2) a hedge of the exposure to variable cash flows of a forecasted transaction, or (3) a hedge of the foreign currency exposure of a net investment in a foreign operation, an unrecognized firm commitment, an available-for-sale security or a foreign currency denominated forecasted transaction.

SFAS No. 133 has found its way into Intermediate Accounting texts. Most Intermediate Accounting instructors have probably thought " What, I have trouble covering the current material in the book and here's another 245 page pronouncement that's got to be squeezed into this course!" Paragraph 4 of the Statement " standardizes the accounting for derivative instruments, including instruments embedded in other contracts, by requiring that an entity recognize those items as assets or liabilities in the statement of financial position and measure them at fair value." This appears to be the same as the mark to market approach for an equity security. But should this standard be taught as part of an *Investments* chapter (for example, Chapter 18, Kieso & Weygandt, 8th ed.), mark to market adjusting journal entry [" Don't forget students, this is a balance sheet not an income statement approach"] or could it more easily and properly be taught somewhere else?

Paragraph 17 of the Statement indicates " all derivatives shall be measured at fair value" and paragraph 18 states that " accounting for changes in the fair value (that is, gains or losses) of a derivative depends on whether it has been designated as a hedge." For derivative *not* designated as a hedge, gains and losses are recognized currently in earnings. If a derivative *is* designated as a hedge, then, depending on the classification of hedge, the change in fair value is recognized in current earnings or as a component of other comprehensive income. This gain or loss treatment is similar to that of debt or equity investments, i.e., depending on the classification of the investment as trading or available for sale, gains and losses are recognized in current earnings or as a component of comprehensive income. So since the accounting for these transactions is similar, why not include the subject in the presentation of accounting for investments? This paper

argues that students could be misled by this approach and presents a rationale for including derivative in an advanced financial accounting course.