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THE COMPLIANCE OF CANADIAN AND AMERICAN FIRMS WITH DERIVATIVE REPORTING REQUIREMENTS

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ACCOUNTING FOR DERIVATIVES

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Résumé de l'article

Cet article traite de la conformité aux normes comptables en matière de divulgation des instruments financiers au Canada et aux États-Unis. L'analyse des états financiers réalisée par un échantillonnage révèle les endroits où la divulgation des compagnies est insuffisante et les endroits où celles-ci rencontrent des exigences en matière de normes comptables. À la lumière des conclusions de l'échantillonnage, les auteurs identifient certains problèmes potentiels dont les organismes de normalisation tâcheront de tenir compte au fil des développements à venir des normes comptables sur les instruments dérivés.

THE COMPLIANCE OF CANADIAN AND AMERICAN FIRMS WITH DERIVATIVE REPORTING REQUIREMENTS

by Charles Cheng and Paul Berry

ABSTRACT

This paper attempts to uncover possible compliance issues of derivative reporting in Canada and the United States. A financial statement survey is performed to reveal areas where companies demonstrate unsatisfactory reporting, and where they meet the requirements of the accounting standards. Through the findings of the survey, certain potential problems are identified that accounting bodies may attempt to address in the future development of derivative accounting standards.

Keywords: Derivative, compliance, survey.

RÉSUMÉ

Cet article traite de la conformité aux normes comptables en matière de divulgation des instruments financiers au Canada et aux États-Unis. L'analyse des états financiers réalisée par un échantillonnage révèle les endroits où la divulgation des compagnies est insuffisante et les endroits où celles-ci rencontrent des exigences en matière de normes comptables. À la lumière des conclusions de l'échantillonnage, les auteurs identifient certains problèmes potentiels dont les organismes de normalisation tâcheront de tenir compte au fil des développements à venir des normes comptables sur les instruments dérivés.

Mots clés : *Instrument dérivé, conformité, sondage.*

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DERIVATIVE ACCOUNTING STANDARDS IN CANADA AND THE UNITED STATES

In Canada, derivative reporting standards are outlined in section 3860, *Financial Instruments – Disclosure and Presentation*, of the *Handbook*. In its discussion of financial instrument reporting, section 3860 also addresses reporting issues of derivative financial instruments. It represents the product of the first phase of the Canadian Institute of Chartered Accountants' (CICA) project on financial instruments. It mainly deals with presentation and disclosure issues as opposed to measurement and recognition issues.

In the United States, derivative reporting standards are mainly outlined in four Statements of Financial Accounting Standards (SFAS): SFAS No. 105, *Disclosure of Information about Financial Instruments with Off-Balance-Sheet Risk and Financial Instruments with Concentration of Credit Risk (1990)*; SFAS No. 107, *Disclosure about Fair Values of Financial Instruments (1991)*; SFAS No. 119, *Disclosures about Derivative Financial Instruments and Fair Value of Financial Instruments (1994)*; and SFAS No. 133, *Accounting for Derivative Instruments and Hedging Activities (1998)*.

A FINANCIAL STATEMENT SURVEY ON DERIVATIVE REPORTING

The objective of the survey is to uncover possible compliance issues of derivative accounting standards and areas where reporting entities demonstrate unsatisfactory disclosure. This survey is of an exploratory nature and does not attempt provide a conclusion on the general level of compliance with derivative accounting standards. The population of the survey consists of thirty annual reports prepared by fifteen Canadian and fifteen U.S. corporations in 1996 or 1997. These preparation dates ensure that both the Canadian and the U.S. derivative disclosure standards were in effect during the preparation of these financial statements. Exhibit 1 provides a list of the annual reports included in this survey. These annual reports were selected by the use of Internet search engines. The population of the samples is comprised of the annual reports available on the Internet. Although the sample size of the survey restricts its ability to provide a general conclusion on the level of compliance with derivative accounting standards, the finding of the survey could

EXHIBIT 1
ANNUAL REPORTS INCLUDED IN THE FINANCIAL STATEMENT SURVEY

Canadian Companies		US Companies	
1. Alliance Forest Products Inc.	1996	1. Advanced Technologies Laboratories Inc.	1996
2. Bell Canada Inc.	1996	2. Chase Manhattan Corporation	1997
3. Bema Gold Corporation	1996	3. Chrysler Corporation	1996
4. Bombardier Inc.	1997	4. CIGNA Corporation	1996
5. Domtar Inc.	1996	5. Cisco Systems Inc.	1997
6. Inco Limited	1996	6. Compaq Computer Corporation	1997
7. MacMillan Bloedel Limited	1997	7. Dell Computer Corporation	1997
8. Northern Telecom Limited	1996	8. Digital Equipment Corporation	1997
9. Numac Energy Inc.	1996	9. E.I. du Pont de Nemours and Company	1997
10. Royal Bank of Canada	1997	10. PACCAR Inc.	1996
11. Shell Canada Limited	1996	11. PepsiCo Inc.	1996
12. Skyjack Inc.	1997	12. Quantum Corporation	1996
13. Suncor Energy Inc.	1996	13. Seagram Company Ltd.	1997
14. Talisman energy Inc.	1996	14. Silicon Graphics Inc.	1996
15. TransCanada PipeLines Limited	1997	15. The Goodyear Tire & Rubber Company	1996

suggest potential problems of existing and developing accounting standards.

In this survey, the Canadian and U.S. reports were evaluated separately based on the standards of their respective countries. Canadian reports were evaluated based the main disclosure requirements outlined in Section 3860: (1) 3860.52-56 Terms and conditions; (2) 3860.57-66 Interest rate risk; (3) 3860.67-77 Credit risk; (4) 3860.78-88 Fair value; and (5) 3860.92-94 Hedges of anticipated future transactions. The compliance with the disclosure requirement for financial assets carried at an amount in excess of fair value (3860.89-91) has not been examined in anticipation of the lack of applicability due to size of the survey sample.

As outlined in Section 3860, the terms and condition disclosure requirement requires the disclosure on significant terms and conditions affecting the amount, timing, and certainty of future cash flows. Concerning interest rate risk, reporting entities are required to disclose the contractual repricing or maturity dates, and the effective interest rates. Maximum credit risk exposure and significant concentrations of credit risk are required as credit risk disclosure. Reporting entities are also required to provide fair value of their derivative instruments as well as a discussion of their hedging instruments and (anticipated) hedged transactions. The Canadian annual reports were evaluated based on the reporting standards outlined in relevant paragraphs of Section 3860 of the *Handbook* as indicated in the preceding paragraph.

On the other hand, the derivative disclosure of the U.S. annual reports were compared to a summarized list of U.S. derivative disclosure requirements:[1]

1. Nature and amount;
2. Concentrations;
3. Fair values;
4. Derivatives for trading;
5. Derivatives for other than trading; and
6. Hedges of anticipated transactions.

This summarized list of reporting criteria represents the major disclosure requirements outlined in the three SFAS governing derivative reporting during the time which the survey was conducted (SFAS No. 105, SFAS No. 107, and SFAS No. 119). Since SFAS No. 133 was released subsequent to the preparation of the financial statements included in the U.S. survey, its release will bear no effect on the results generated from the survey.

During their examination, the annual reports were ranked based on their level of compliance with each of these individual reporting requirements. The reports were classified as having either:

1. Adequate disclosure (where most of the reporting requirements are met);
2. Insufficient but satisfactory disclosure (where some reporting requirements are not met); or
3. No prominent disclosure (where minimal disclosure exists).

For instance, paragraph 3860.92 of the handbook states that a reporting entity should provide a description of the anticipated transactions; a description of the hedging instruments; and the amount of any deferred or unrecognized gain or loss and the expected timing of recognition as income or expense pertaining to a hedge. During the evaluation of a Canadian annual report, if the reporting entity under examination has provided reasonable hedge disclosure on most of the items outlined above, it would have been ranked as having adequate disclosure. On the other hand, if the entity failed to provide disclosure on most of the reporting requirements, it would have been ranked as having no prominent disclosure. If the reporting entity provided discussion on some but not all of hedge disclosure requirement, or if the discussion provided is incomplete according to the reporting requirement, it would have been ranked

EXHIBIT 2
RESULTS OF FINANCIAL STATEMENT SURVEY ON CANADIAN COMPANIES

	Adequate Disclosure Based on CICA Recommendations		Insufficient but Satisfactory Disclosure Based on CICA Recommendations		No Prominent Disclosure	
	# firms	% population	# firms	% population	# firms	% population
Terms and conditions	11	73%	4	27%	0	0%
Interest rate risk	6	40%	3	20%	6	40%
Credit risk	4	27%	8	53%	3	20%
Fair value	13	87%	1	7%	1	7%
Hedges of anticipated future transactions	4	27%	9	60%	2	13%
	Explicitly Stated		Implied Within Statements		Not Stated	
	# firms	% population	# firms	% population	# firms	% population
Holding purpose of derivative instruments	10	67%	5	33%	0	0%
	Primarily for Hedging		Primarily for Trading		Both Hedging and Trading	
	# firms	% population	# firms	% population	# firms	% population
Holding purpose of derivative instruments	11	73%	1	7%	3	20%

EXHIBIT 3
RESULTS OF FINANCIAL STATEMENT SURVEY ON US COMPANIES

	Adequate Disclosure Based on CICA Recommendations		Insufficient but Satisfactory Disclosure Based on CICA Recommendations		No Prominent Disclosure	
	# firms	% population	# firms	% population	# firms	% population
Nature and amount	9	60%	5	33%	1	7%
Concentrations	5	33%	7	47%	3	20%
Fair values	11	73%	2	13%	2	13%
Derivatives for trading*	2	67%	1	33%	0	0%
Derivatives for other than trading	10	67%	5	33%	0	0%
Hedges of anticipated transactions	6	40%	7	47%	2	13%
	Explicitly Stated		Implied Within Statements		Not Stated	
	# firms	% population	# firms	% population	# firms	% population
Holding purpose of derivative instruments	10	67%	5	33%	0	0%
	Primarily for Hedging		Primarily for Trading		Both Hedging and Trading	
	# firms	% population	# firms	% population	# firms	% population
Holding purpose of derivative instruments	12	80%	0	0%	3	20%

* 12 entities reported no derivatives held for trading purpose.

as having insufficient but satisfactory disclosure. For instance, an annual report without adequate discussion on anticipated transaction would have been ranked as such despite having reasonable disclosure on its hedging instruments. The classification of annual reports in the appropriate category is a matter of professional judgement and all information disclosed in an annual report (including those in the Management Discussion & Analysis section) has been taken into consideration.

Exhibit 2 and Exhibit 3 summarize the results of this survey. The numerical representations denote the number of annual reports that fall under each category. The sum total of each row is the number of annual reports included in each survey (fifteen).

The result of the survey on Canadian annual reports indicates that there was insufficient disclosure with interest rate disclosure, credit risk disclosure, and hedge disclosure. Most companies did not have problems with fair value reporting. The results are similar in the U.S. survey. Companies were comfortable with fair value disclosure but not with concentration and hedging disclosures. Details of other findings and their interpretation will follow in subsequent sections.

Similar studies carried out previously suggest interesting findings which could be analyzed in parallel with the findings of this paper. Two studies which examine the compliance of U.S. firms with SFAS No. 119 are Herz, Elmy and Bushee (1995-96), and Mahoney and Kawamura (1995). Herz et al. discuss the degree of compliance and the nature of the compliance of 78 companies from 8 industries. The selection of the companies was based on their size. They concluded that the companies generally complied with SFAS No. 119, but that voluntary disclosures were typically not included. Mahoney and Kawamura sample the 1994 annual statements of 65 companies that were randomly selected and the 10 companies with the largest dollar amount of derivative trading revenues from among Fortune 500 industrial corporations and Fortune 500 service corporations. Their report concluded that most entities provided disclosures that were responsive to SFAS No. 119, but that some of the entities may have provided disclosures that were incomplete or less detailed than what was required.

■ THE FINDINGS

The findings of the Canadian financial statement survey will first be discussed followed by those of the U.S. survey.

Canadian Financial Statements Survey

In general, most Canadian reporting entities in the survey complied well with the standards set-forth in Section 3860 of the *Handbook*. It should be noted that although all fifteen of these companies prepared their financial statements in accordance with Canadian GAAP, some of them are cross listed on U.S. stock exchanges. In order to maintain their listing, these statements must comply with the U.S. standards. Since these standards require different disclosure from the Canadian equivalents, it may be that their reporting of derivative positions is driven primarily by U.S. standards rather than Canadian ones. Companies deal with these potential differences through a note to their financial statements, or by filing reconciled information with the appropriate securities commission. Some examples of these footno tes are appended in Exhibit 4.

EXHIBIT 4

1. Inco Limited 1996 Note 19:
The company's consolidated financial statements are prepared in accordance with accounting principles generally accepted in Canada. The most significant differences between Canadian and United States practices, insofar as they affect the Company's consolidated financial statements, relate to accounting for foreign currency translation, pension benefits, income and mining taxes, long-term investments and stock-based compensation.

Items discussed in detail: Foreign currency translation; Pension benefits; Income and mining taxes; Extraordinary item; Long-term investments; Stock-based compensation; Preferred shares. A reconciliation schedule showing earnings and balance sheet items translations is given.

2. MacMillan Bloedel Limited 1997 Note 19:
The Company's consolidated financial statements are prepared in accordance with Canadian generally accepted accounting principles (GAAP), which differ in some respects from US GAAP. Items discussed in detail: Proportionate consolidation; Post-retirement benefits; Deferred income taxes; Convertible subordinated debentures. A reconciliation schedule showing earnings and balance sheet item translations is given.

3. Royal Bank of Canada 1997 Note 19:
The consolidated financial statements of the bank are prepared in accordance with Canadian generally accepted accounting principles (GAAP), including the accounting requirements of the Superintendent of Financial Institutions Canada. As required by the United States Securities and Exchange Commission, material differences between Canadian and United States GAAP are described below. Items discussed in detail: Debt and equity securities; Post retirement benefits; Restructuring costs; Impaired loans.

4. Suncor Energy Inc. 1996 Note 19:
The consolidated financial statements have been prepared in accordance with Canadian generally accepted accounting principles (GAAP), which differ in some respects from GAAP in the United States. The significant differences in GAAP, as applicable to these consolidated financial statements and notes, are described in the company's Form 40-F report, which is filed with the United States Securities and Exchange Commission and is available on request.

5. TransCanada PipeLines Limited 1997 Note 1:
The consolidated financial statements of the Company have been prepared by Management in accordance with Canadian generally accepted accounting principles (Canadian GAAP). These accounting principles are different in some respects from United States generally accepted accounting principles (U.S. GAAP) and the significant differences are described in Note 17... Items discussed in note 17: Net Income Reconciliation; Condensed Statement of Consolidated Income; Condensed Statement of Consolidated Financial Position; Income Taxes.

Several reporting entities have excellent disclosure on their derivatives such as the Royal Bank of Canada and Suncor Energy Inc, both of which are cross listed companies. The nature of its business may also have provided some impetuous in the case of the Royal Bank to provide this level of disclosure. Each reporting requirement is individually discussed below. Terms and conditions of derivative instruments were well-discussed as eleven (seventy three percent) of the annual reports provided adequate level of disclosure and all annual reports provided satisfactory disclosure.

The situation is different for the disclosure on interest rate risk. Six (forty percent) of the annual reports did not provide prominent disclosure on their interest rate risk. Credit risk disclosure is even less satisfactory. Only four (twenty seven percent) of the annual reports disclosed both their estimated maximum credit risk exposure and their position pertaining to credit risk concentrations. However, this is mainly caused by the fact that a number of entities have chosen not to report an estimated maximum credit risk exposure because it is deemed to be immaterial. Two examples follow:

> In management's opinion, none of the parties to the existing financial instruments is expected to default on their obligations given that they are Canadian chartered banks.
>
> [Alliance Forest Products Inc, 1996 note 16]

> The company ... mitigates this [credit] risk by dealing only with financially sound counterparties and, accordingly, does not anticipate loss for non-performance.
>
> [Inco Limited, 1996 note 18]

In our opinion, whether an entity is exposed to material credit risk should be left to financial statement readers to decide. It is more appropriate for reporting entities to estimate and report the amount of credit risk exposure even if their counterparties are deemed to be financially sound since large corporations have failed for reasons beyond expectations.

Fair value reporting is an item with strong disclosure amongst the Canadian reports. Thirteen (eighty seven percent) of the entities provided adequate disclosure on the fair value of their derivatives. Although fair value reporting has been challenged because of its complexity, most entities did not experience problems with providing such information. One reason could be that fair value estimation relies heavily on its underlying assumptions. Since reporting entities have significant control over these assumptions, therefore, alterations could be made so that fair value estimation could be performed without incurring significant cost. As a result, although fair value reporting is generally well complied with, it should be noted that fair value information is based on estimation and is subject to error or imprecision. Suncor Energy Inc. supplemented its fair value disclosure with the following comment:

> The estimated fair values of recognized financial instrument have been determined based on the company's assessment of available market information and appropriate valuation methodologies; however, these estimates may not necessarily be indicative of the amounts that could be realized or settled in a current market transaction.
>
> [Suncor energy Inc, 1996 note 18]

On the other hand, Alliance Forest Products Inc. provided the following disclosure to explain the its fair value reporting position, which is an indication that the cost-benefit argument was utilized by certain reporting entities to support the non-reporting of certain derivative-related information:

> The fair value of the investments accounted for at equity value has not been determined since the costs would have been excessively high.
>
> [Alliance Forest Products Inc, 1996 note 16]

The disclosure on hedges of anticipated future transactions is another item which reporting entities exhibited unsatisfactory reporting. Only four (twenty six percent) of the annual reports provided adequate disclosure on hedges. Most reporting entities merely stated the existence of their anticipated transactions without providing further descriptions of such transactions. Two examples follow:

> In order to reduce the potential negative effect of a rising Canadian dollar, the Corporation has entered into various arrangements to hedge anticipated future sales denominated in U.S. dollars.
>
> [Domtar Inc, 1996 note 14]

> Nortel enters into U.S. to Canadian dollar option contracts intended to hedge the U.S. to Canadian dollar exposure on future revenue and expenditure streams.
>
> [Northern Telecom Limited, 1996 note 23]

Most reporting entities briefly mentioned that derivatives were utilized to hedge anticipated sales or expenditures without further elaborating on the anticipated transactions. It would be difficult for financial statement readers to determine whether the hedging instrument and the anticipated transactions are highly correlated in nature.

Out of the fifteen reporting entities, only ten (sixty seven percent) explicitly stated the holding purpose of their derivative instruments. It is surprising that certain entities with no trading derivative positions did not positively state that they did not hold or issue derivatives for trading purposes.

☐ U.S. Financial Statement Survey

In general, most annual reports included in the survey complied well with FASB's derivative accounting standards. Chase Manhattan Corporation and Silicon Graphics Inc, in particular, provided excellent disclosure on their derivative positions.

Most U.S. entities did not have significant problems with reporting the nature and amount of their derivatives. Nine (sixty percent) of the annual reports provided adequate discussion on the nature and amount of their derivatives.

Similar to the situation in Canada, the disclosure on concentration was not satisfactory in the United States. Only five (thirty three percent) of the reporting entities have provided adequate disclosure pertaining to credit risk and concentrations. In many cases, it was only stated that credit risk is not considered material. Very few entities provided an estimated accounting loss related to credit risk. An example follows:

> PepsiCo's credit risk related to interest rate and currency swaps is considered low because they are only entered into with strong creditworthy counterparties, are generally settled on a net basis and are of relatively short duration.
>
> [PepsiCo Inc, 1996 note 11]

Fair value disclosure was quite satisfactory as eleven (seventy three percent) of the reporting entities provided adequate disclosure on the fair value of their derivatives. A number of reporting entities such as Chrysler Corporation and Seagram Company Ltd. also provided the underlying assumptions to their fair value estimation. However, the fact that fair value information is subject to imprecision due to management estimation must be considered as discussed previously in the section on the Canadian financial statement survey. Moreover, some entities merely stated that the fair value of their derivatives approximates carrying value without further elaboration.

The FASB outlined a number of reporting requirements for entities holding trading derivatives. In our survey, only three companies reported holding trading derivatives. Two of them provided adequate reporting on their trading derivatives. Since the number of annual reports with trading derivatives is insignificant, it would be difficult to comment on the level of compliance with the reporting requirements on trading derivatives.

As for derivatives held for purposes other than trading, ten (sixty seven percent) of the reporting entities provided adequate discussions on their holdings. None of the U.S. entities held derivatives primarily for trading purposes. Twelve (eighty percent) of them held derivatives only for hedging purposes. Similar to the situation in Canada, only ten (sixty seven percent) of the U.S. reporting entities explicitly stated the holding purpose of their derivatives.

Disclosure on hedges of anticipated transactions is not well complied with in the United States. Only six (forty percent) of the entities provided adequate disclosure on their hedges. This could mainly be attributed to the demanding reporting requirements on hedges. Not only does a company have to provide a description of the anticipated transaction, it also has to disclose the period of time until the anticipated transactions are expected to occur, the classes of derivatives used to hedge the anticipated transactions, the amount of hedging gains and losses explicitly deferred, and the transactions that result in the recognition in earnings of gains and losses deferred by hedge accounting. Since reporting entities were not particularly supportive of the disclosure requirements on hedges, the acceptance of the FASB's new hedging disclosure standards in SFAS No. 133 would be an interesting issue as they demand highly complicated and technical reporting.

■ INTERPRETATION OF THE FINDINGS

The survey reveals that all of the reporting entities indicated either explicitly or implicitly the holding purpose of their derivative instruments. This is important since investors could differentiate between entities with derivative trading activities from entities utilizing hedging strategies without the need for sophisticated knowledge on derivatives. However, professional investors who utilize highly sophisticated and technical derivative information to determine investment strategies would be affected by insufficient compliance with derivative standards in the preparation of annual reports. As a result, the lack of compliance could contribute to market inefficiencies.

According to the survey, a number of Canadian and U.S. reporting entities disregard disclosure requirements on credit risk and concentrations. These entities stated that credit risk is deemed to be immaterial since they only deal with creditworthy counterparties. However, we believe that the determination of the creditworthiness of an entity's counterparties should be left to financial statement readers. It would be more desirable if the major counterparties of an entity as well as its credit risk exposure be disclosed to financial statement users.

Hedges of anticipated transactions is another area where both Canadian and U.S. entities exhibited a lack of compliance in the survey. There are certain practical difficulties involved with this reporting requirement. For instance, it would be difficult for an entity to discuss all its hedges according to the respective reporting guidelines because of the substantial amount of information involved. In situations where hundreds of hedges were outstanding during the year, it would be impractical to provide detailed discussions on each of these transactions.

The FASB has released SFAS No. 133 in June 1998 which involves highly technical implementation issues concerning hedge disclosures. These standards had attracted much criticism because of their complexity during the period when they were released as exposure drafts. Despite the fact that these standards have the potential to enhance the reporting of derivatives and of hedges, their acceptance by reporting entities has yet to be determined as reporting standards on hedges have lacked adequate compliance.

Fair value disclosure was controversial when it was introduced. However, most reporting entities in the survey did not have significant problems with providing such information. Only three (ten percent) of the annual reports lack satisfactory disclosure on fair value. We believe that this could be attributed to the amount of flexibility that the reporting entities enjoy when preparing fair value information. Since stringent guidelines on fair value estimation do not exist, reporting entities could utilize their own assumptions and estimation in the preparation of fair value information. As a result, reliability has to be taken into consideration when interpreting fair value information on financial statements.

Other than introducing a new method of accounting for hedge transactions, SFAS No. 133 also requires entities to recognize all derivative instruments on their balance sheet as either assets or liabilities measured at fair value. This requirement should not induce as much difficulty as the one on hedge disclosure as fair value reporting did not encounter significant problem during its implementation.

In Canada, interest rate risk is a required disclosure that a number of reporting entities failed to comply with. The interest rate disclosure requirement outlined in paragraph 3860.57 of the *Handbook* requires discussions on contractual repricing or maturity dates and effective interest rates for each class of financial asset and financial liability. Practicality could be a potential problem for entities with numerous classes of financial instruments. However, we believe that compliance with interest risk disclosure requirement is realistic and reporting entities should strive to comply with this requirement.

In conclusion, the compliance with SFAS No. 133 in future reporting periods would be an interesting matter as it would determine the future direction of derivative reporting. As the CICA considers harmonizing Canadian derivative reporting standards with SFAS No. 133, the practicality of accounting standards and the reliability of the information reported under these standards must be taken into consideration. For instance, over-complicated standards that have practical difficulties would tend to be omitted by reporting entities such as the disclosure on hedges of anticipated future transactions. On the other hand, the reliability of information could be affected if the reporting guidelines are not sufficiently specific as in the case of fair value disclosure. Developing derivative reporting guidelines is an extremely challenging task and a balance between over-complication and the lack of specification must be obtained.

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