National Accounting

Alert

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FASB Issues Favorable Options Accounting Guidance

On August 10, 2001, the Financial Accounting Standards Board (FASB) issued final guidance on the accounting for options used as hedges under SFAS No. 133, *Accounting for Derivative Instruments and Hedging Activities*. Known as Derivatives Implementation Group (DIG) Issue G20, *Cash Flow Hedges: Assessing and Measuring the Effectiveness of a Purchase Option Used in a Cash Flow Hedge*, this favorable guidance dramatically changes the way in which real estate companies will account for options used as hedging instruments in financial statements.

Provided certain criteria are met, options can be considered fully effective hedging vehicles, with gains and losses due to changes in market value remaining on the balance sheet. Therefore, changes in market value will no longer cause volatility in earnings - both GAAP net income and Funds From Operations (FFO). The following is a snapshot of what option holders should know about G20:

◆ The improved accounting applies to purchased options such as interest rate caps, zero cost collars, and option combinations that are net purchased options;

◆ Only cash flow hedging transactions benefit - transactions whereby companies convert the interest rates on loans from a floating rate to a certain fixed rate. The inverse are fair value hedges, the accounting for which is not improved by the G20 modifications;

◆ The earnings impacts will be known in advance. At the time of inception,

> ***Editor's Note****: NAREIT was instrumental in the Financial Accounting Standard Board's (FASB) adoption of a more favorable way of accounting for the "time value" of options used as interest rate hedges. As a result of this FASB action, the earnings (net income and FFO) impacts of options will be more predictable. In a May 2001 letter to the FASB, NAREIT strongly urged the Board to adopt these changes recommended by the Board's Derivatives Implementation Group (DIG). We would like to thank representatives of the accounting firms and Chatham Financial Corporation (Chatham) who provided extensive advice and support in NAREIT's achieving this result. We especially want to thank Marti Tirinnanzi, Vice President, Chatham and chair of NAREIT's Derivatives and Hedging Task Force for her leadership and support in this effort.*

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option owners will obtain a schedule of fair 'caplet' values to the maturity of the hedge. This removes the uncertainty of option values that in the past have created unpredictable volatility in earnings. G20's modification to options accounting allows companies to easily project the extent to which an option's change in value would be reported in future earnings.

- For those options used in hedging risks associated with funding development projects, the premiums paid can be capitalized as a part of the project cost provided that the options are fully effective.

- Real estate companies that hold options can adopt this accounting immediately. G20 can be adopted as long as options are properly designated with updated documentation

Background and Discussion

Options and the Business of Real Estate

Since SFAS No. 133 was adopted, real estate companies holding options have been burdened by unpredictable earnings volatility caused by having to recognize the time-value component of an option's fair value. According to SFAS No. 133, time value was assumed an "ineffective" aspect of the hedge, and therefore reported in earnings every quarter.

Analysis of whether this volatility could materially influence reported FFO prompted savvy real estate financiers to switch their hedge approaches to non-option products such as interest rate swaps. Such modifications to hedging strategies were often accompanied by hedging counterparty credit concerns. Financial institutions tend to look at interest rate swaps just like loans, and will enter into swaps by applying standard loan underwriting criteria and/or relying on favorable credit ratings. Credit guarantors or rating agencies inevitably require options. Avoiding the problematic option accounting under SFAS No 133 by converting to other hedge products was not acceptable and ran counter to underwriting protocols established by the agencies. Although options kept the credit rating agencies or guarantors satisfied, they also introduced uncertainty in reported earnings.

NAREIT Instrumental in FASB's Favorable Change to Option Accounting Model

Recognizing the importance of options in real estate finance and the practical need to minimize volatile factors in forcasting earnings, in a May 2001 letter NAREIT urged the FASB to change the option accounting model under SFAS No. 133 by adopting the G20 proposal recommended by the DIG. In part, our letter stated:

> We [NAREIT] believe that [G20] represents a dramatic improvement to what has been understood of the current accounting model— which limited the measurement of effectiveness to the changes in an option's intrinsic value. The practical problem for anyone to predict the volatility of time value of options, and the required income recognition of the excluded time value component rendered these instruments practically useless as hedging instruments. On one hand, they were effective economic tools, but the recognition of time value in earnings made them appear as though they were speculative positions. For the past twelve months, many real estate companies have completely discontinued their use of option products to hedge interest rate risk, and have converted to swap positions based entirely on the avoidance of earnings volatility. We whole-heartedly welcome the change brought about by the Derivatives Implementation Group ("DIG"). We know that it will allow options to once again be a practical hedging vehicle and quell concerns of real estate finance executives related to recognizing the change in the time value component of option value in earnings each period.

Key to Options Accounting under G20: Perfect Effectiveness and Documentation

In order to achieve the desired accounting, and thereby eliminate the volatility that options might present, perfect effectiveness in an option's relationship with the hedged item is required. As long as an option is considered perfectly effective, G20 permits companies to include the change in the entire value of the option in other comprehensive income (a component of shareholders equity). The degree to which the other comprehensive income balance migrates into earnings is predetermined by the set of "caplet" values at the time of inception (explained in the example below).

To be perfectly effective, the critical terms of the hedging instrument must completely match the related terms of the hedged forecasted transaction: the strike price of the hedging option must match the specified level within which the entity's exposure is being hedged; the option's cash inflows at its 'maturity' must completely offset the change in the hedged transaction's cash flows; and the option can be recognized only for a single date - its contractual maturity date(s). If these conditions are not met, some degree of ineffectiveness is measured using a hypothetical derivative measurement compared to the subject option, and recognizing the "ineffective" portion in earnings and FFO.

Consistent with other hedging relationships, options also must be documented pursuant to SFAS No. 133. Real estate executives must be sure that options are sanctioned in the corporate policy governing interest rate risk management, and documented in the hedge designation memo. The designation must state that the option is hedging the exposure to variability in expected future cash flows attributable to a particular rate or price beyond a specified level. The assessment of effectiveness will be based on total changes in the option's cash flows.

When Changes are recognized in earnings - GAAP Net Income and FFO

The improved option accounting allows option holders to recognize gains and losses from other comprehensive income in the same period in which the hedged item affects earnings. G20 provides the following example:

The fair value of a cap at the inception of a hedge of interest rate risk on variable rate debt with quarterly interest payments over the next two years, for which the entity determines that the relationship will not result in any ineffectiveness, should be allocated to the respective caplets on a fair value basis at the inception of the hedging relationship. The change in each respective allocated fair value amount should be reclassified from accumulated other comprehensive income into earnings when each of the hedge forecasted transactions (the eight interest payments) impact earnings.

Effective Date

The effective date of this guidance is the first day of the first fiscal quarter after August 10, 2001. However, earlier application to the first day of an earlier fiscal quarter is permitted as long as an option is documented in such a way that is based only on changes in the intrinsic value, and the hedging relationship is designated as a new cash flow hedge in which the effectiveness is documented as being based on total changes in the option's cash flows.

Conclusion/Summary

NAREIT welcomes the FASB's new interpretation of option accounting under SFAS No. 133. The changes made to the accounting model restore options as a useful hedging instrument. The G20 decision removes the problematic mark-to-market impacts in earnings brought about by an unpredictable time-value component of fair value. Premium costs also may be capitalized in fully effective option positions pursuant to EITF 99-9, *Effect of Derivative Gains and Losses on the Capitalization of Interest*. Removing these issues will facilitate the use of options as an important component of interest rate risk hedging strategies for real estate companies.

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