

Loy, Carrie

11081

**NORTHERN ILLINOIS UNIVERSITY**

**"INTEREST RATE SWAPS: IS CURRENT DISCLOSURE SUFFICIENT?"**

**A THESIS SUBMITTED TO THE**

**UNIVERSITY HONORS PROGRAM**

**IN PARTIAL FULFILLMENT OF THE**

**REQUIREMENT OF THE BACCALAUREATE DEGREE**

**WITH UPPER DIVISION HONORS**

**DEPARTMENT OF ACCOUNTANCY**

**BY**

**CARRIE B. LOY**

**DEKALB, ILLINOIS**

**DECEMBER 13, 1997**

NORTHERN ILLINOIS UNIVERSITY

"INTEREST RATE SWAPS: IS CURRENT DISCLOSURE SUFFICIENT?"

A THESIS SUBMITTED TO THE

UNIVERSITY HONORS PROGRAM

IN PARTIAL FULFILLMENT OF THE

REQUIREMENT OF THE BACCALAUREATE DEGREE

WITH UPPER DIVISION HONORS

DEPARTMENT OF ACCOUNTANCY

BY

CARRIE B. LOY

DEKALB, ILLINOIS

DECEMBER 13, 1997

Student name: Carrie B. Roy

Approved by: Curt Norton

Department of: Accountancy

Date: Dec. 12, 1997

**Honors Thesis Abstract  
Thesis Submission Form**

**AUTHOR:** Carrie B. Loy

**THESIS TITLE:** Interest Rate Swaps: Is Current Disclosure Sufficient?

**ADVISOR:** Dr. Curtis L. Norton      **ADVISORS DEPT:** Accountancy

**DISCIPLINE:** Accountancy      **YEAR:** 1997

**PAGE LENGTH:** 37      **BIBLIOGRAPHY:** Yes      **ILLUSTRATED:** No

**PUBLISHED (YES OR NO):** No      **LIST PUBLICATION:** None

**COPIES AVAILABLE(HARD COPY, MICROFILM, DISKETTE):** Hard copy

**ABSTRACT:**

Interest rate swaps are becoming increasingly popular in financial markets today. Due to this increase in use, it was necessary for the Financial Accounting Standards Board and the Securities and Exchange Commission to regulate the disclosure of these financial derivatives. Although several pronouncements from both of the previously mentioned governing bodies have been released over the past few years, these minimum requirements do not fully present a company's financial position concerning their use of interest rate swaps. Since most publicly held companies are only meeting the minimum requirements, there are many third party users that are not given full disclosure. The purpose of this paper was to describe the current accounting standards set forth by the FASB and the SEC, to summarize the fundamental decisions of the FASB Exposure Draft, to provide some sample disclosures from companies annual reports, and finally to recommend improvements that will increase third party user's knowledge of a company's interest rate swap position.

## TABLE OF CONTENTS

### Interest Rate Swaps: Is Current Disclosure Sufficient?

Introduction.....	1
History of Interest Rate Swaps.....	1
Reasons to Swap.....	2
Types of Swaps.....	3
Risks Involved.....	3
Accounting and Disclosure Requirements.....	5
SFAS No. 105.....	5
SFAS No. 107.....	6
SFAS No. 119.....	8
SEC Disclosure Requirements.....	11
Quantitative Disclosures.....	12
Qualitative Disclosures.....	14
FASB Exposure Draft.....	14
Annual Report Summary.....	17
Company with Excellent Disclosure.....	17
Company with Minimum Disclosure.....	19
Company with Below Minimum Disclosure.....	21
Recommendations.....	22
Accounting Policy Footnote.....	23
Financial Instruments Footnote.....	23
Related Underlying Footnote.....	24
Conclusion.....	25
Appendix.....	26
Appendix A (Allstate Annual Report).....	27
Appendix B (Pzifer Annual Report).....	32
Appendix C (Aon Annual Report).....	36
Bibliography.....	37

## **INTRODUCTION**

In today's heightened struggle worldwide, many companies are trying to develop an organizational framework they believe is appropriate for their particular business. One of the methods companies are utilizing to accomplish this task is the use of interest rate swaps. In fact, the use of this particular type of derivative financial instrument has grown substantially over the last few years and mostly likely will be increasingly popular in the future.

Due to this rather new and quickly growing derivative financial instrument, the Financial Accounting Standards Board (FASB) has issued pronouncements that explain the appropriate accounting treatment and disclosure requirements for interest rate swaps. The Securities and Exchange Commission (SEC) has also tried to regulate the disclosure for publicly held companies. There are many companies now who are merely obeying the current regulations even though there is a great amount of money that is at risk through these interest rate swaps. The disclosure of these types of transactions is especially valuable information for any interested third party users of company financial statements. Obviously, these disclosures should meet the FASB and SEC requirements but more importantly, the disclosures should alleviate the financial statement readers' fears and assure them that these interest rate swaps are used wisely. The following discussion will focus on the deficiencies in the current regulations and will explain how and exactly where companies should be reporting the use of interest rate swaps.

## **HISTORY OF INTEREST RATE SWAPS**

An interest rate swap occurs when two parties agree to exchange interest obligations for a specified period of time or when the sale of a security is coupled with

a contemporaneous purchase of a similar security with a different coupon rate. The purpose of an interest rate swap between two parties is usually for one party to convert a fixed-interest rate payment into a variable-interest rate payment, while the other party takes the opposite position. An example would be where one company is holding debt that was issued at a fixed rate and another company has debt that was issued at a variable rate. If both companies are dissatisfied with the current interest rates on their debt, they could contact a commercial bank or an investment bank to find a compatible swap partner and make the swap.

Financial institutions have used interest rate swaps for many years, but there has also been an increasing degree of use in the non-financial area over the past decade. Many large corporations today are involved in some type of interest rate swap transaction. Due to such an extensive use of these swaps, the accounting treatment and the reporting standards are of the utmost significance.

### **Reasons to Swap**

There are many reasons why companies would find it beneficial to engage in an interest rate swap agreement. One of the primary reasons would be to minimize the company's interest rate risk. For example, if a company has some debt that is being charged a variable rate and they believe that interest rates will be increasing, they would want to trade their rate with a company that has a fixed rate on their debt. In order for the company to get rid of the variable rate and not to experience a loss, they would have to have the fixed rate that was swapped lower than what was expected of the variable rate.

Another important reason to engage in interest rate swaps is so management can gain improved regulation over their circulation of cash. In other words, when a company's infusion of cash depends heavily on the level of interest rates, it would definitely be to their advantage to have the companies outflows also dependent on these same interest rates. The companies management could then have a greater extent of command over the financial situation of the company.

### **Types of Swaps**

There are four basic types of interest rate swaps as follows: matched, hedged, unmatched and offsetting. A matched swap is one in which a swap transaction's payments are like those of an interest bearing asset or liability. If a company intended to enter into the swap to reduce their risk that was related with a specific transaction(s), then it is a hedged swap.

An unmatched swap is one that is not associated to any asset, liability, or transaction. These swaps can be used to reduce the companies overall exposure to interest rate risk. The last type of interest rate swap is the offsetting swap, which is concerned with the third parties involved in the swap transaction. When there are two companies that contact a middleman, like a commercial bank, instead of just directly agreeing to swap with each other and the swap is formed, the commercial bank would hold the other swap.

### **Risks Involved**

When a company uses interest rate swaps for any reason they will take on some risk. The two principal components of risk that are included with swaps are credit risk and market risk. Many companies establish certain standards concerning the



tolerable level of risk that is allowed to be taken on for any swap transaction. When a swap is determined to be too risky then it is abandoned. This forces the company then to find another partner to swap with or they will have to keep their present interest payments.

Credit risk is the possibility that the other party in a swap transaction will default on their interest payments. Due to this risk, companies have to investigate their prospective partners by looking scrupulously for any signs that the company might be financially unsteady. After it is determined that the company is capable to execute the agreement, then a swap could then be entered into.

The most notable risk that is involved with interest rate swap transactions is market risk, which is the likelihood of shifts in interest rates over the time of a swap. Monitoring and managing this risk is a continual process that is carried out by the Board of Directors and senior management, who review and approve the company's risk management policies that are developed by the risk management policy committee. Market risk is managed based on an ongoing assessment of trends in interest rates, while giving consideration to the possible effects on both total return and reported earnings. The companies exposure to market risk is related to the size and complexity of positions taken, and the volatility of shifts in interest rates.

The degree of market risk is dependent on the size of the swap agreement and also on the instability of interest rates. In order to decrease the danger of market risk, many companies will go with a "plain vanilla" swap because they have the easiest arrangement of interest rate transfers and they do not involve any damages due to

the unsteadiness of interest rates. Even though many companies may be able to reduce their exposure of credit risk to zero, there will still be a small degree of market risk when they enter into a swap transaction.

### **Accounting and Disclosure Requirements**

The first accounting and disclosure of interest rate swaps was not made until about 1990 when the FASB implemented SFAS No. 105. There have also been several pronouncements since that time that have been released by the FASB on these same questions. The SEC has also voiced their opinion with some of their own individual disclosure requirements.

#### **FASB STATEMENTS OF FINANCIAL ACCOUNTING STANDARDS**

**SFAS No. 105** *"Disclosure of Information about Financial Instruments with Off-Balance Sheet Risk and Financial Instruments with Concentrations of Credit Risk."*

This particular statement encompasses all of the financial instruments that possess credit and market risk that are not disclosed on the balance sheet and it was effective for financial statements that were issued for fiscal years ending after June 15, 1990.

Financial instruments, including an interest rate swap, requires an exchange between parties of cash or perhaps another financial instrument that might possibly be disadvantageous for one of the parties that is involved in the transaction. According to the FASB, they felt there were some financial instruments that were not being reported on the balance sheet and this was not being made known to any third party users of the financial statements.

Statement 105 requires that companies with these financial instruments disclose either in the body of their financial statements or in the footnotes specified features of the

instruments that are separated by class. The "face or the contract amount" of the contract is the first characteristic that must be disclosed and would include disclosing the notional source of the swap. We must also look at the type and the terms of the contract. When looking at this last disclosure it requires the following: the credit and market risk of the instruments, the cash requirements of the instruments and the related accounting policy in compliance with APB Opinion No. 23.

If it appears that the instrument being disclosed contains any credit risk, then the company has to state their knowledge concerning the possibility of losses if the other party to the agreement would totally default, or if the collateral that was given in exchange for the agreement would become useless. There must also be an itemized account of the provisions of the collateral, which incorporates information concerning the companies collateral requirements, their ability to obtain the collateral and a listing of the items that they presently hold.

Although this was a great start for the FASB in requiring companies to disclose to third party users of the financial statements the likelihood of losses from any off-balance sheet transactions, the FASB needed to exert more to attain some type of conventional reporting for all companies.

**SFAS No. 107 *"Disclosures about Fair Value of Financial Instruments."***

The FASB soon realized that there was a need to value financial instruments, both on and off the balance sheet, and in accordance it released this statement. It became effective for financial statements that were issued for fiscal years ending after December 15, 1992 for companies with less than \$150 million in total assets, and for companies that had

\$150 million or less in total assets it would start with fiscal years ending after December 15, 1995.

According to this new statement, all financial instruments had to be reported at their fair market value. This may appear to be pretty simple to apply, but in actual practice it is quite tough to ascertain what the instrument's fair market value really is. Fair market value is to be determined and supported by one of the methods as follows: financial instruments that do not have a market value and are close in type; the amount for which the instrument could be exchanged between an interested party in a present transaction; the product of the quoted market price per instrument times the number of instruments that are held by the company; and finally using valuation techniques like discounting future cash flows by a suitable interest rate, matrix pricing models or option pricing models.

There is really no market for the trading of interest rate swaps or for determining the applicable market price, due to the fact that these are contracts that have been formed in conformance with the parties specifications. Determining fair market value by discounting of future cash flows or by using the present market rate as the suitable interest rate, arrives at a number that is fair, but in essence if the market rate changes then the value of the financial instrument could be substantially different than what was previously figured.

Obviously, these interest rate swaps are very hard to value precisely. This statement also suggests that companies must disclose other information if they cannot reasonably estimate the fair value of their financial instrument(s), and they should supply as much information as they reasonably can regarding the fair value. Also, they need

to mention in their disclosure why exactly they could not determine the instruments fair market value.

**SFAS No. 119** "*Disclosure about Derivative Financial Instruments and Fair Value of Financial Instruments.*" What comes next in the expansion of the financial reporting on derivatives is this statement that was effective December 15, 1994 for companies with total assets of more than \$150 million, and effective December 15, 1995 for companies with less than \$150 million in total assets.

The FASB had received numerous grievances and recommendations concerning the present disclosure standards for derivatives. These recommendations regarded such issues as enhancing present disclosure requirements, willing disclosure by companies and they also requested that the FASB further explain how to value fair market value.

SFAS 119 requires basic information to be disclosed concerning the terms and conditions of the derivative instruments. These basic disclosures include face/contract amount, fair value, cash requirements, market risk, credit risk, leverage features and a discussion of the accounting policy. The basic terms are informative to the reader of the financial statements, but the conditions add insight beyond the basic terms. The conditions of the derivative financial instruments are as follows: credit risk, market risk, leverage features and cash requirements.

Leverage features exist with derivatives because there is a small amount of cash outlay relative to the notional values. The main concern with this leverage feature is that the aggregate notional value could somehow exceed the underlying hedged amount. By understanding the leverage features of the firm's derivatives it can help understand the

firm's potential exposure.

The objective of SFAS 119 is to enlighten the financial statement reader as to why the firm holds derivative instruments. It requires classification of all derivatives into one of two categories: trading and other than trading. A firm that buys derivatives on a regular basis for the purpose of selling them in the near future must classify their derivatives as trading. All other derivatives are classified as other than trading. This in turn helps users to understand why the company is using derivatives.

If derivatives are held for trading purposes then companies must disclose the following two items: the net gains or losses from trading activities during the reporting period that are broken down by "class, activity, risk or any other suitable class that is in line with the management of those activities," and the average fair value of the financial instruments for the period, showing the associated end-of-period fair value, with a separation of assets and liabilities.

For financial instruments that are used for purposes other than trading, these require more itemized disclosure such as the following: the reason that the company is holding the instruments, any necessary information required to comprehend these reasons, and the companies plan in reaching these goals; a description of how each class of derivative is actually reported in the financial statements, which includes their policy for recognizing and measuring the instruments currently held and a description of how gains and losses are reported in the balance sheet and income statement; and the financial instruments that are used as hedges for anticipated transactions have to give a description of the transaction including the time period that it is to happen, a description of the classes of derivatives used, the amounts of hedging gains and losses deferred and finally a

description of other events that effect the recognition of gains and losses in earnings that are deferred by hedge accounting.

While these required disclosures help to increase the amount of information that companies supply concerning derivatives in their financial statements, they are only considered adequate and companies were encouraged by the FASB to add additional disclosures for the users. Therefore, the FASB expanded their statement with "Encouraged Disclosure about All Derivative Financial Instruments Held or Issued."

The encouraged disclosures central purpose is to provide a quantitative description concerning the interest rate risk, market risk, current position and activity during the period, gap analysis of interest rate repricing or maturity dates, hypothetical effects of market changes on equity or income, duration of financial instruments or the companies value at risk that might attribute to the manner in which the instruments are controlled. These quantitative descriptions would be more applicable and not as easily misinterpreted. According to the statement, there are many ways that companies could show this quantitative information either in their financial statements or in the notes.

Even though the FASB has come a long way since 1990 regarding the disclosure of derivative financial instruments, most statement users would agree that they are still very unsatisfied with the existing derivative disclosures. They were really intended as a first step towards a more complete and adequate disclosure of derivative information. They are by no means intended to answer properly all of the concerns that investors and creditors have at this time. Companies should be encouraged to develop derivative disclosure that explain more fully the nature and the purpose of their derivative activity.

Investors should also be warned to analyze the disclosures carefully and to question company management if there are areas of concern that remain.

### **SECURITIES AND EXCHANGE COMMISSION DISCLOSURE REQUIREMENTS**

The SEC rules that are added to Regulation S-K as Item 305 require that you make both quantitative and qualitative disclosures for each risk exposure category. The disclosures are not part of the formal financial statements or footnotes. Instead, they appear in the front of an SEC filing. When derivatives are linked to financial instruments, the SEC's position is that disclosures of derivatives go hand-in-hand with disclosures about the reported items. This is nothing new; in fact it expresses the current stance of the Commission. When registrants provide disclosures about reported items, disclosures about derivatives that directly or indirectly affect such reported items are also required, to the extent that effects of such information are material and necessary to prevent the disclosures from being misleading.

Small business issuers and registered investment companies are exempt from the quantitative and qualitative disclosure requirements, but accounting policy requirements still apply. For fiscal years ending after June 15, 1997, quantitative and qualitative risk disclosures are required for all banks, thrifts and other affected registrants with a market capitalization greater than \$2.5 billion at January 28, 1997. For fiscal years ending after June 15, 1998, quantitative and qualitative risk disclosures are required for non-bank, and non-thrift registrants with a market capitalization less than \$2.5 billion at January 28, 1997.

Market risk exposure categories are at the heart of the rules. At the balance sheet date, a registrant evaluates its market risk sensitive instruments and contract



terms to determine whether it has material market risk exposure in one or more categories. When the answer is yes, quantitative and qualitative disclosures related to that market risk exposure category are triggered. The categories are as follows: interest rate risk, foreign currency exchange rate risk, commodity price risk, and other relevant market risks. A registrant decides whether a market risk exposure category is material by considering both (1) the year-end fair value of market risk sensitive instruments and (2) potential near-term losses in earnings, fair values, and cash flows due to reasonably possible near-term changes in market rates or prices. Registrants should also separately evaluate market risk exposures arising from trading and other than trading portfolios of market risk sensitive instruments.

### **Quantitative Disclosures**

The quantitative disclosures are not part of, nor are they to be incorporated in the formal financial statements or footnotes. Instead, they appear in the front of SEC filings and should also include this information in the annual reports that are delivered to the shareholders. There are three alternative methods for disclosing quantitative market risk as follows: the tabular presentation of contractual cash flows, sensitivity analysis and value at risk.

The tabular presentation of contractual cash flows, deals with disclosing the fair values of market risk sensitive instruments and information about contract terms that is sufficient to determine future cash flows, which is categorized by expected maturity dates. Within each risk exposure category, the group market risk sensitive instruments are based on common characteristics. Some examples of this are fixed vs.

variable debt, long vs. short forwards, currencies in which the cash flows are denominated and fixed and variable interest rate swaps. For many companies, these tabular disclosures promise to be detailed and abundant.

The second alternative that companies may use is sensitivity analysis. It discloses the potential loss in future earnings, fair values or cash flows of market risk sensitive instruments resulting from one or more selected hypothetical changes in interest rates, foreign currency exchange rates, and commodity prices or other relevant market rates or prices over a selected period of time. Also, market risk sensitive instruments that are exposed to more than one market risk should be included in the sensitivity analysis for each market risk category that applies.

The last alternative available to companies is the value at risk method, which discloses the potential loss in future earnings, fair values or cash flows of market risk sensitive instruments over a selected period of time, with a selected likelihood of occurrence, from changes in interest rates, foreign currency exchange rates, commodity prices, and other relevant market rates or prices.

Though normally required, summary prior year information does not have to be presented in the year the current data is first presented. The quantitative disclosures are based on year-end information. However, the rules do permit registrants using sensitivity analysis or the value at risk method to disclose intra-period information in lieu of year-end information. An encouraged, but not required disclosure in quantitative amounts that reflect the aggregate market risk inherent in the trading and other than trading portfolios, for both sensitivity analysis and the value at risk method. A description of the model should also be given, for sensitivity analysis and the value at risk method, and assumptions

and parameters which are necessary to understand the disclosures. As with the proposed rules, registrants have latitude in making assumptions underlying their sensitivity and value at risk model. The final rules do require economic justification if the registrant uses a hypothetical adverse change in rates/prices that is less than 10% of end of year rates/prices for sensitivity analysis or confidence intervals less than 95% for the value at risk method. If a registrant uses sensitivity analysis or the value at risk method, it is permitted to present comprehensive market risk disclosures. These reflect the market exposures of market risk sensitive instruments combined with voluntarily selected "instruments, positions, and transactions."

### **Qualitative Disclosures**

The same rules governing the location of quantitative disclosure govern the location of qualitative disclosures. The SEC expects to see qualitative disclosures go hand-in-hand with quantitative disclosures. Both are centered around the same market risk exposure categories, separate disclosures are required for trading and other than trading portfolios and both are triggered by the same materiality tests.

Within each market risk exposure category, a registrant must disclose the particular markets that present the primary risk of loss as of the end of the latest fiscal year and how it manages those exposures.

### **FASB EXPOSURE DRAFT**

The FASB has been redeliberating all of the provisions of its June 20, 1996 exposure draft, *Accounting for Derivatives and Similar Financial Instruments and for Hedging Activities*. The proposed standard goes beyond recently issued standards and

addresses the accounting and disclosure of derivative transactions, rather than just the disclosure of such transactions. The proposed standard is also broader in scope in that it addresses the accounting and disclosure of all derivative financial instruments and hedging transactions rather than just select instruments and transactions. Additionally, the definition of a derivative is broader and now encompasses financial instruments that previously were not included in the definition.

In deciding on the accounting for derivatives and hedging activities proposed in the Exposure Draft, there are four fundamental decisions that are the cornerstone of the Exposure Draft. Those fundamental decisions are listed below:

- Derivatives are assets or liabilities and should be reported in the financial statements
- Fair value is the most relevant measure for financial instruments and the only relevant measure for derivatives. Derivatives should be measured at fair value, and adjustments to the carrying amounts of hedged items should reflect offsetting changes in their fair value (such as, gains/losses) arising while the hedge is in effect. This is intended to focus on the entire change in each hedged item's fair value.
- Only items that are assets or liabilities should be reported as such in the financial statements.
- Special accounting for items designated as being hedged should be provided only for qualifying transactions, and one aspect of qualification should be an assessment of offsetting changes in fair values or cash flows.

I feel that there should be appropriate financial statement disclosures and that these disclosures should reflect economic events in their entirety. Therefore, they should report overall levels of hedged activities on a macro level rather than the results of each component of each hedged activity. Under the SEC's rules they require qualitative and quantitative disclosures on the different risk hedged or incurred by companies.

Additionally, companies must also provide information on how the risks are managed and

the amount of potential loss to which the firm is exposed as a result of the risk. The SEC's disclosure requirements are focused on a macro approach to explaining hedging strategies and balance sheet risk, where FASB's disclosure requirements focus on the gains and losses of the derivatives instruments.

For fair value hedges, FASB's Exposure Draft requires companies to identify the gains and losses of the derivatives separately from the gains and losses of the hedged instrument. For cash flow hedges, companies must disclose the events that will result in recognition of the deferred gains and losses. Also, the company must disclose the amount of deferred gains and losses that will be recognized with the next 12 months. Disclosing this information then would provide competitors with extremely confidential information.

Deferred gains and losses from derivatives hedging cash flows have to be divided between hedges that have ended and those that are still in existence. FASB will require the results of both elements to be reported in financial statements. However, I do not understand how separate disclosures of the two elements are going to be useful to investors. Again, detailing this information is going to provide sensitive strategy information to competitors.

Furthermore, FASB's proposed disclosure requirements will be time consuming to accumulate. Companies are going to have to commit valuable resources to monitor and present the information which will have limited benefits to financial statement users, but disclose confidential information to competitors.

In fact, the SEC's disclosure rules more effectively present the impact a risk may have on a company. Their rules do not require companies to present how much of the risk, if any, was lessened by derivatives. Furthermore, they do not require companies to

disclose when gains and losses are expected to be reclassified from other comprehensive income into earnings. In order to simplify the disclosure requirements and reduce the associated burdens on firms, FASB should consider adopting the SEC's disclosure requirements within its proposals.

Due to sharp criticism by some respondents to the Exposure Draft, the Board has now decided that a final statement will be effective for fiscal years beginning after December 15, 1998. It has required years of efforts on the FASB's part to finalize the standards. As currently proposed, the FASB would require all derivatives to be reported at their fair values in the financial statements. Unrealized changes in the fair value of traded derivative instruments would be recognized in earnings. Gains or losses on derivative instruments meeting hedge criteria specified in the proposal would be either recognized in earnings or in comprehensive income.

### **ANNUAL REPORT SUMMARY**

I will be looking at three companies annual reports and using the guidelines as follows to rate their disclosures: (1) the sufficiency of their reporting concerning current requirements, and (2) providing additional information to increase user comprehension.

#### **Company with Excellent Disclosure**

The first annual report that I will be referring to is that of a company that provides information above and beyond what is required by the FASB and the SEC. This company is on the leading edge of derivative disclosure and is setting the pace for other companies to follow.

*The Allstate Corporation*

One of the best derivative disclosures can be found in the notes to the financial statements for The Allstate Corporation for the fiscal year 1996. Under the heading of Derivative Financial Instruments, all aspects of the FASB regulations have been clearly met in an easily comprehensible manner.

The first paragraph states that Allstate strictly prohibits the use of derivatives for trading purposes, and also informs users that controls have been implemented to monitor and control their use. According to Allstate, the following represents their objectives for holding interest rate swaps:

Allstate generally enters into swap agreements to change the interest rate characteristics of existing assets to more closely match the interest rate characteristics of the corresponding liabilities. The notional amount, interest payment dates and the maturity dates of the swaps match the principal, interest payment dates and maturity dates of the related debt. Also, any market risk that is associated with these swaps is fully offset by the opposite market impact on the related debt.

This paragraph clearly states the objectives that Allstate has set for their interest rate swap activities. They have also addressed their method for accomplishing these objectives in the form of matching all the relevant dates and notional amounts at the time of issuance. The final statement regarding market risk may even be considered to be overly optimistic in that swaps rarely can perform as a complete and total hedge of a transaction. There will more than likely be some gain or loss recognized as interest rates change.

The issue of credit risk is also in the footnotes, but is very brief. Allstate has assessed their credit risk at a minimum because they prefer to deal with only "highly rated counterparties," have established risk control limits, execute legally enforceable

master netting agreements, and obtain collateral where appropriate. To date, they have not incurred any losses on derivative financial instruments due to counterparty nonperformance. This explanation, though succinct, is effective in representing Allstate's requirements for interest rate swap partners and in assisting third party users to measure the credit risk of these swap transactions.

What distinguishes Allstate from other corporations in terms of their interest rate swap disclosures is their effective use of tables (see Appendix) to communicate the current status of their outstanding swap agreements. Their format presents an easily understandable representation of different views of their swaps. The table that is included in their 1996 annual report classifies swaps into three categories: pay floating rate, receive fixed rate; pay fixed rate, receive floating rate; and pay floating rate, receive floating rate. Beneath each category is the notional amount of the applicable swaps, the weighted average pay rate, and the weighted average receive rate. This disclosure is especially advantageous to users to help them to determine the current gains or losses concerning the swap transactions.

Another table that is used in Allstate's annual report represents a breakdown of their interest rate swap agreements by the three categories that were listed above according to their notional amount, credit exposure and it also discloses the fair value of their financial instruments.

#### **Company with Minimum Disclosure**

The next company that I am presenting reported the minimum amount of information that is required by the FASB and the SEC regarding their interest rate



contracts. This is the category that most companies have a tendency to be in.

By disclosing only the minimum amount of information they are not violating any requirements or standards, but they are not being overly enlightening to third party users.

*Pzifer*

According to Pzifer's annual report, they had swapped notional amounts of approximately \$1,360 million at the end of their 1996 fiscal year. With such an extensive amount of interest payments that are being exchanged they should have itemized disclosure of the type of contracts found in the financial statements. Even though the information that they furnish to us does not drop below any required guidelines, it does allow a sufficient comprehension of their financial position concerning these transactions.

They provide such information as their intentions for holding these swaps and the manners in which they are employing them to reach these goals. Also, they could supply us with information regarding the accounting treatment for unrealized gains and losses that have happened. This is one way that the current requirements fall short of giving an accurate portrayal of the current financial position of these contracts.

The key question in their annual report is that they did not reveal anything about the market risk of the interest rate contracts they entered into. When swapping such a large amount of interest rate payments, a radical turn of interest rates in the opposite direction can really create problems for the company. Depending on the type of swap contract that the company employs, even a small movement can become magnified. There is no mention of market risks pertaining to interest rate contracts that third party users

need to be informed of so they can properly assess the risks that are involved with these derivative financial instruments. This a major deficiency in the reporting requirements set by the FASB, and one that is addressed in the SEC regulations.

### **Company with Below Minimum Disclosure**

Although most companies fall into one of the first two categories, there are some that do not even report the minimum required information. There are several important issues that have been left out by many companies concerning their disclosures of interest rate contracts.

#### *Aon Corporation*

Aon Corporation is a family of insurance brokerage, consulting and insurance underwriting companies that serve clients and policyholders through directly owned global distribution networks. Aon provides insurance brokerage; reinsurance and wholesale/specialty brokerage; insurance management services; consulting solutions for commercial and industrial businesses and insurance organizations; and consumer insurance products for individual policy holders. In 1996, they reported \$3.9 billion in total revenues. With such a large company there is a huge exposure to interest rate changes. Aon states that interest rate swaps are used to minimize this exposure, but the information that is given concerning these swap transactions falls short of what is required by both the FASB and the SEC.

In the first paragraph of their footnote the reasons for holding the interest rate contracts are given as follows:

The interest rate contracts are used to manage the interest rate risk that is associated with assets and liabilities underlying its underwriting business. Interest rate derivatives are also utilized to manage the company's funding and other corporate risks. Interest rate swap agreements have been used primarily to manage asset and liability durations.

This statement is in accordance with FASB SFAS 119 because these interest rate swaps are being used primarily as hedges. Aon also feels that it is not necessary to report any additional information regarding these swaps. At no point in the footnotes do they ever mention the notional amounts, fair values or maturity dates of these contracts either in the discussion or in a table. This is definitely a shortcoming of the previously stated requirements of the FASB.

Aon also fails to talk about the fair value of their future investment commitments. They have stated in their annual report that the estimation of the fair market value of these particular instruments is not possible. According to SFAS 119, if the fair value of any instrument is not determinable, then more information concerning the instrument must be given such as: the maturity dates, carrying amounts, and effective interest rates. They must also discuss why exactly these fair values were not possible to determine. This is another example of Aon's failure to meet the established disclosure requirements.

### **RECOMMENDATIONS**

It is definitely evident that there are several additional disclosures that need to be made. Most of these added disclosures could be made by firms without additional preparation costs. The disclosures should focus on clarifying the how, when, what and why of derivative trading. Disclosure and discussion of the firms' derivative trading should be in at least three footnotes: (1) the accounting policy footnote, (2) the financial statement footnote and (3) the related underlying footnote.

### **Accounting Policy Footnote**

The accounting policy footnote should clearly state all of the following: whether all the derivatives are intended for trading or non-trading purposes; which derivatives are on the balance sheet versus off balance sheet items; what valuation method is used; and how they are treating gains and losses on derivatives. This footnote should refer the reader to the other footnotes that contain derivative information. It should be there to provide help so that the users can find their way through the mass of details that are available.

### **Financial Instruments Footnote**

The financial instrument footnote should clearly indicate which instruments are derivatives. For the ones that are derivatives it is essential to provide some background about the terms and nature of the instrument, and the market and credit risk that is involved. When presenting the risk factors, any related collateral and cash requirements should be discussed. The footnote should indicate, preferably in table form, the cost, carrying amount, notional value and market value of every derivative. The reader should be given some understanding about how fair market values were determined, by reference to similar instruments, by market prices that are published or perhaps by some other means. If there are changes in fair value or gains/losses that occur, they should present them separately. Consequently, readers should be able to determine how the gains and losses relate to overall investment risk and performance.

Readers should be warned about the proper use of derivative information, especially regarding fair value measurements. The fair value measurement simply measures the market price of the derivative at one point in time, the balance sheet date.

The market prices of many derivatives are subject to violent shifts as market conditions change. Also, the relationship between the carrying amount and fair value, without considering other factors, is not a good indicator of whether a derivative position has been effective.

Finally, the company should communicate the sufficiency of the controls, policies, and procedures that have been established for derivatives. Additional accounting and disclosure requirements will not assist investors, creditors or analysts if the company's internal controls are deficient. However, it is very unlikely that we will ever be able to provide enough information to allow statement users to determine the adequacy of the control and reporting vehicle. Third party users will be forced to rely on the reputation and history of the company, the company management and the external auditor to have complete confidence that a major derivative disaster will not occur.

#### **Related Underlying Footnote**

Most companies use derivatives for either hedging or to reduce risk. In those situations, the investors will only be able to measure investment performance if they can look at both sides of the investment, the underlying instrument or transaction and the derivative that is being used to hedge it. Therefore, the derivative should be cross-referenced to the footnote that presents the underlying related item. The underlying items could be interest rate risk on debt, foreign currency transactions or inventory. For example, if a company purchased an option to sell inventory at a specified future date for a specified future price and if the selling price of the inventory decreases then the value of the option will decline. If investors were to look at the derivatives disclosure by itself

they will see an unrealized loss and may infer, mistakenly, that this derivative situation was foolish. However, when looked at with the related underlying inventory footnote, the option has lowered the company's risk and may have been a smart move by the company's management after all.

## **CONCLUSION**

The derivatives disclosures available to investors represent an attempt to address a very difficult and complicated issue. The statement users may be very unsatisfied with the existing derivative disclosures because the existing disclosure rules were designed as a first step towards a more complete and adequate disclosure of derivative information. They were never intended to answer sufficiently all of the concerns of investors and creditors. Companies should be encouraged to develop derivative disclosures that explain more fully the nature and purpose of their derivative activity. Investors should be warned to analyze these disclosure carefully and to question the company's management if there are any areas of concern that remain. Finally, with the Exposure Draft it may drastically change the information available about derivatives and also provide more information about derivative activity.

## **APPENDIX**

**Appendix A: Notes to Consolidated Financial Statement of Allstate's 1996 Annual Report**

**Appendix B: Notes to Consolidated Financial Statement of Pzifer's 1996 Annual Report**

**Appendix C: Notes to Consolidated Financial Statement of Aon's 1996 Annual Report**

# Appendix A

## notes to consolidated financial statements (continued)

62 . ALLSTATE

Allstate distributes the majority of its property-liability products through approximately 14,100 Allstate agents, primarily employee and non-employee exclusive agents, but also utilizes independent agents and specialized brokers to expand market reach including over 5,500 independent agents appointed to market non-standard auto business. ALIC distributes its products using a combination of Allstate agents including life specialists, banks, independent agents, brokers and direct response marketing.

### 2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

**INVESTMENTS** Fixed income securities include bonds, redeemable preferred stocks, and mortgage-backed and asset-backed securities. All fixed income securities are carried at fair value and may be sold prior to their contractual maturity ("available for sale"). The difference between amortized cost and fair value, net of deferred income taxes, certain life deferred policy acquisition costs and reserves for life and annuity policy benefits, is reflected as a component of shareholders' equity. Provisions are recognized for declines in the value of fixed income securities that are other than temporary. Such writedowns are included in realized capital gains and losses.

Equity securities include common and non-redeemable preferred stocks, and real estate investment trusts which are carried at fair value. The difference between cost and fair value of equity securities, less deferred income taxes, is reflected as a component of shareholders' equity.

Mortgage loans are carried at outstanding principal balance, net of unamortized premium or discount and valuation allowances. Valuation allowances are established for impaired loans when it is probable that contractual principal and interest will not be collected. Valuation allowances for impaired loans reduce the carrying value to the fair value of the collateral or the present value of the loan's expected future repayment cash flows discounted at the loan's original effective interest rate. Valuation allowances on loans not considered to be impaired are established based on consideration of the underlying collateral, borrower financial strength, current and expected market conditions, and other factors.

Real estate investments, including real estate acquired through foreclosure and held for investment, are accounted for by the equity method. Real estate for which the Company has an active plan to sell is carried at depreciated cost, net of valuation allowances. These allowances reduce the carrying value of properties to be sold to their estimated fair value less selling costs.

Short-term investments are carried at cost which approximates fair value. Other investments, which consist primarily of policy loans, are carried at the unpaid principal balances.

Investment income consists primarily of interest and dividends. Interest is recognized on an accrual basis and dividends are recorded on the date of declaration. Interest income on mortgage-backed and asset-backed securities is determined on the effective yield method, based on estimated principal repayments. Accrual of income is suspended for fixed income securities and mortgage loans that are in default or when the receipt of interest payments is in doubt. Realized capital gains and losses are determined on a specific identification basis.

**DERIVATIVE FINANCIAL INSTRUMENTS** Derivative financial instruments include swaps, futures, forwards, and options, including caps and floors. When derivatives meet specific criteria they may be designated as accounting hedges and accounted for on either a fair value, deferral or accrual basis, depending upon the nature of the hedge strategy, the method used to account for the hedged item and the derivative used. Derivatives that are not designated as accounting hedges are accounted for on a fair value basis.

If, subsequent to entering into a hedge transaction, the derivative becomes ineffective (including if the hedged item is sold or otherwise extinguished or the occurrence of a hedged anticipatory transaction is no longer probable), the Company terminates the derivative position. Gains and losses on these terminations are reported in realized capital gains and losses in the period they occur. The Company may also terminate derivatives as a result of other events or circumstances. Gains and losses on these terminations are either deferred and amortized over the remaining life of the hedged item or are reported in shareholders' equity, consistent



*Fair Value Accounting* Under fair value accounting, realized and unrealized gains and losses on derivatives are recognized in either earnings or shareholders' equity when they occur.

The Company accounts for interest rate swaps, certain equity-indexed options, equity futures and foreign currency swaps and forwards as hedges on a fair value basis when criteria are met. When the Company uses swaps or options as hedging instruments, the derivative must reduce the primary market risk exposure (e.g., interest rate risk or equity price risk) of the hedged item in conjunction with the specific hedge strategy; be designated as a hedge at the inception of the transaction; and have a notional amount and term that does not exceed the carrying value and expected maturity, respectively, of the hedged item. In addition, options must have a reference index (e.g., three-month LIBOR) that is the same as, or highly correlated with, the reference index of the hedged item.

When the Company uses futures or forward contracts as hedging instruments, the derivative must reduce the primary market risk exposure on an enterprise basis in conjunction with the hedge strategy; be designated as a hedge at the inception of the transaction; and be highly correlated with the fair value of, or interest income or expense associated with, the hedged item at inception and throughout the hedge period.

Changes in fair values of these derivatives are reported net of tax in shareholders' equity, exclusive of interest accruals. Accrued interest receivable and payable on swaps are reported in net investment income. Premiums paid for equity-indexed options are reported as equity securities and amortized to net investment income over the lives of the agreements.

The Company also has the following derivatives that are accounted for on a fair value basis but which are not designated as accounting hedges: 1) Certain interest rate futures contracts reported as other assets, where changes in fair value are reported in realized capital gains and losses; 2) Certain equity-indexed options, where changes in fair value are reported in shareholders' equity and premiums paid are reported as equity securities and amortized to realized capital gains and losses over the lives of the agreements; and 3) Commodity swaps reported as accrued investment income, where changes in fair value are reported in net investment income.

*Deferral Accounting* Under deferral accounting, gains and losses on derivatives are deferred on the statement of financial position and recognized in earnings in conjunction with earnings on the hedged item. The Company accounts for interest rate futures as hedges using deferral accounting for anticipatory investment purchases and sales when the criteria for futures (discussed above) are met. In addition, anticipated transactions must be probable of occurrence and their significant terms and characteristics identified.

Changes in fair values of these derivatives are initially deferred as other liabilities and accrued expenses. Once the anticipated transaction occurs, the deferred gains or losses are considered part of the cost basis of the asset and reported net of tax in shareholders' equity or recognized as a gain or loss from disposition of the asset, as appropriate. The Company reports initial margin deposits on futures in short-term investments. Fees and commissions paid on these derivatives are also deferred as an adjustment to the carrying value of the hedged item.

*Accrual Accounting* Under accrual accounting, interest income or expense related to the derivative is accrued and recorded as an adjustment to the interest income or expense on the hedged item. The Company accounts for interest rate caps and floors as hedges on an accrual basis when the criteria for options (discussed above) are met.

Premiums paid for these derivatives are reported as investments and amortized to net investment income over the lives of the agreements.

**RECOGNITION OF PREMIUM REVENUES AND CONTRACT CHARGES** Property-liability premiums are deferred and earned on a pro rata basis over the terms of the policies. The portion of premiums written applicable to the unexpired terms of the policies is recorded as unearned premiums. Premiums for traditional life insurance are recognized as revenue when due. Accident and disability premiums are earned on a pro rata basis over the policy period. Revenues on universal life-type contracts are comprised of contract charges and fees, and are recognized when assessed against the policyholder account balance. Revenues on investment contracts include contract charges and fees for contract administration and surrenders. These revenues are recognized when levied against the contract balances. Gross premium in excess of the premium on limited payment contracts are deferred and recognized over the contract period.

notes to consolidated financial statements (continued)

72 . ALLSTATE

**DERIVATIVE FINANCIAL INSTRUMENTS** Derivative financial instruments include swaps, futures, forwards and options, including caps and floors. The Company primarily uses derivative financial instruments to reduce its exposure to market risk (principally interest rate and equity price risk), in conjunction with asset/liability management, in its life and annuity operations. The Company does not hold or issue these instruments for trading purposes. The following table summarizes the contract or notional amount, credit exposure, fair value and carrying value of the Company's derivative financial instruments:

(\$ in millions)	At December 31,							
	1996				1995			
	Contract/ notional amount	Credit exposure	Fair value	Carrying value assets/ (liabilities)	Contract/ notional amount	Credit exposure	Fair value	Carrying value assets/ (liabilities)
<b>INTEREST RATE CONTRACTS</b>								
Interest rate								
swap agreements								
Pay floating rate, receive fixed rate	\$ 498	\$ 19	\$ 18	\$ 18	\$ 545	\$ 35	\$ 35	\$ 34
Pay fixed rate, receive floating rate	357	-	(2)	(2)	172	-	(4)	(1)
Pay floating rate, receive floating rate	67	-	(1)	(1)	84	-	(1)	(1)
Financial futures and forward contracts	655	7	7	6	374	4	4	(8)
Interest rate cap and floor agreements	2,389	6	6	7	371	4	4	4
Total interest rate contracts	3,966	32	28	28	1,546	43	38	28
<b>EQUITY AND COMMODITY CONTRACTS</b>								
Commodity swap agreements								
Financial futures	122	4	4	4	122	12	12	12
Options and warrants	122	2	2	2	203	-	-	5
Total equity and commodity contracts	691	149	149	149	402	88	88	75
Total equity and commodity contracts	965	155	155	155	727	100	100	92
<b>FOREIGN CURRENCY CONTRACTS</b>								
Foreign currency swap agreements								
Foreign currency forward contracts	20	-	(3)	(3)	27	1	(3)	-
Total foreign currency contracts	34	-	-	-	-	-	-	-
Total derivative financial instruments	54	-	(3)	(3)	27	1	(3)	-
	\$4,985	\$187	\$180	\$180	\$2,300	\$144	\$135	\$120

Credit exposure includes the effects of legally enforceable master netting agreements.  
Credit exposure and fair value include accrued interest where applicable.  
Carrying value is representative of deferred gains and losses, unamortized premium, or accrued interest,  
depending on the accounting for the derivative financial instrument.

The contract or notional amounts are used to calculate the exchange of contractual payments under the agreements and are not representative of the potential for gain or loss on these agreements.

Credit exposure represents the Company's potential loss if all of the counterparties failed to perform under the contractual terms of the contracts and all collateral, if any, became worthless. This exposure is represented by the fair value of contracts with a positive fair value at the reporting date reduced by the effect, if any, of master netting agreements.

The Company manages its exposure to credit risk by utilizing highly rated counterparties, establishing risk control limits, executing legally enforceable master netting agreements and obtaining collateral where appropriate. To date, the Company has not incurred any losses on derivative financial instruments due to counterparty nonperformance.

Fair value is the estimated amount that the Company would receive (pay) to terminate or assign the contracts at the reporting date, thereby taking into account the current unrealized gains or losses of open contracts. Dealer and exchange quotes are available for the Company's derivatives.

*Interest rate swap agreements* involve the exchange, at specified intervals, of interest payments calculated by reference to an underlying notional amount. The Company generally enters into swap agreements to change the interest rate characteristics of existing assets to more closely match the interest rate characteristics of the corresponding liabilities. The Company did not record any material deferred gains or losses on swaps in 1996, 1995 or 1994.

The Company did not realize any material gains or losses on swap terminations in 1996, 1995 or 1994. The Company paid a weighted average floating interest rate of 6.3% and received a weighted average fixed interest rate of 7.1% in 1996. The Company paid a weighted average fixed interest rate of 6.4% and received a weighted average floating interest rate of 6.5% in 1996.

*Financial futures and forward contracts* are commitments to either purchase or sell designated financial instruments at a future date for a specified price or yield. They may be settled in cash or through delivery. As part of its asset/liability management, the Company generally utilizes futures and forward contracts to manage its market risk related to fixed income securities, equity securities and anticipatory investment purchases and sales. Futures and forwards used as hedges of anticipatory transactions pertain to identified transactions which are probable to occur and are generally completed within 90 days. Futures contracts have limited off-balance-sheet credit risk as they are executed on organized exchanges and require security deposits, as well as the daily cash settlement of margins.

*Interest rate cap and floor agreements* give the holder the right to receive at a future date, the amount, if any, by which a specified market interest rate exceeds the fixed cap rate or falls below the fixed floor rate, applied to a notional amount. The Company purchases interest rate cap and floor agreements to reduce its exposure to rising or falling interest rates relative to certain existing assets and liabilities in conjunction with asset/liability management.

*Commodity swap agreements* involve the exchange of floating-rate interest payments for the total return on a commodity index. The Company enters into commodity swap transactions to mitigate market risk on the fixed income and equity securities owned.

*Equity linked option contracts* provide returns based on a specified equity index applied to the option's notional amount. The Company purchases equity linked options to achieve equity appreciation or to reduce the market risk associated with certain annuity contracts. Where required, counterparties post collateral to minimize credit risk. Debt warrants provide the right to purchase a specified new issue of debt at a predetermined price. The Company purchases debt warrants to protect against long-term call risk.

*Foreign currency contracts* involve the exchange or delivery of currencies. The Company enters into these agreements to manage the currency risk associated with foreign securities owned.

Market risk is the risk that the Company will incur losses due to adverse changes in market rates and prices. Market risk exists for all of the derivative financial instruments that the Company currently holds, as these instruments may become less valuable due to adverse changes in market conditions. The Company mitigates this risk through established risk limits set by senior management. In addition, the change in the value of the Company's derivative financial instruments designated as hedges are generally offset by the change in the value of the related assets and liabilities.

notes to consolidated financial statements (continued)

74 . ALLSTATE

**OFF-BALANCE-SHEET FINANCIAL INSTRUMENTS** A summary of the contractual amounts and fair values of off-balance-sheet financial instruments follows:

(\$ in millions)	At December 31,			
	1996	1995		
	Contractual amount	Fair value	Contractual amount	Fair value
Commitments to invest	\$294	\$ -	\$223	\$ -
Commitments to extend mortgage loans	72	1	88	1
Financial guarantees	25	(4)	28	(7)
Credit guarantees	100	-	50	-

Except for credit guarantees, the contractual amounts represent the amount at risk if the contract is fully drawn upon, the counterparty defaults and the value of any underlying security becomes worthless. Unless noted otherwise, the Company does not require collateral or other security to support off-balance-sheet financial instruments with credit risk.

Commitments to invest generally represent commitments to make equity investments in various limited partnerships. The Company enters these agreements to allow for additional participation in certain investments. Because the equity investments in limited partnerships are not actively traded, it is not practicable to estimate the fair value of these commitments.

Commitments to extend mortgage loans are agreements to lend to a customer provided there is no violation of any condition established in the contract. The Company enters these agreements to commit to future loan fundings at a predetermined interest rate. Commitments generally have fixed expiration dates or other termination clauses. Commitments to extend mortgage loans, which are secured by the underlying properties, are valued based on estimates of fees charged by other institutions to make similar commitments to similar borrowers.

Financial guarantees represent conditional commitments to repurchase notes from a creditor upon default of the debtor. The Company enters into these agreements primarily to provide financial support for certain equity investees. Financial guarantees are valued based on estimates of payments that may occur over the life of the guarantees.

Credit guarantees represent conditional commitments to exchange identified AAA or AA rated credit risk for identified A rated credit risk upon bankruptcy or other event of default of the referenced credits. The Company receives fees for assuming the referenced credit risks, which are reported in net investment income when earned over the lives of the commitments. The Company enters into these transactions in order to achieve higher yields than if the referenced credits were directly owned.

The Company's maximum amount at risk, assuming bankruptcy or other default of the referenced credits and the value of the referenced credits become worthless, is the fair value of the identified AAA or AA rated securities. The identified AAA or AA rated securities had a fair value of \$102 million at December 31, 1996. The Company includes the impact of credit guarantees in its analysis of credit risk, and the referenced credits were current with respect to their contractual terms at December 31, 1996.

**6. RESERVE FOR PROPERTY-LIABILITY INSURANCE CLAIMS AND CLAIMS EXPENSE**

As described in Note 2, the Company establishes reserves for claims and claims expense on reported and unreported claims of insured losses. These reserve estimates are based on known facts and interpretation of circumstances, including the Company's experience with similar cases and historical trends involving claim payment patterns, loss payments, pending levels of unpaid claims and product mix, as well as other factors including court decisions, economic conditions and public attitudes.

# Appendix B

## Notes to Consolidated Financial Statements continued

### Financial Subsidiaries

Combined financial data/segment information as of November 30, 1996, 1995 and 1994 applicable to the Company's financial subsidiaries, consisting of Pfizer International Bank Europe (PIBE) and a small captive insurance company, were as follows:

#### Condensed Balance Sheet

(millions of dollars)	1996	1995	1994
Cash and interest-bearing deposits	\$ 78	\$ 13	\$ 285
Eurosecurities and securities purchased under resale agreements	45	34	4
Loans, net	381	433	767
Other assets	8	8	13
<b>Total assets</b>	<b>\$512</b>	<b>\$488</b>	<b>\$1,069</b>
Certificates of deposit and other liabilities	\$ 87	\$ 85	\$ 198
Shareholders' equity	425	403	871
<b>Total liabilities and shareholders' equity</b>	<b>\$512</b>	<b>\$488</b>	<b>\$1,069</b>

#### Condensed Statement of Income

(millions of dollars)	1996	1995	1994
Interest income	\$ 28	\$44	\$ 49
Interest expense	(3)	(3)	(4)
Other income/(expense)—net	2	(6)	(12)
<b>Net income</b>	<b>\$ 27</b>	<b>\$35</b>	<b>\$ 33</b>

The 1995 data reflect a reduction in PIBE's loan portfolio to bring PIBE's balance sheet into line with its business needs. PIBE continues to have S&P's highest short-term rating of A1+.

#### Investments in Debt and Equity Securities

Investments in debt and equity securities are summarized in the following tables:

(millions of dollars)	Amortized Cost		
	1996	1995	1994
<b>Held-to-maturity:</b>			
Certificates of deposit	\$ 657	\$ 350	\$235
Corporate debt	602	682	381
Municipals	29	222	89
Other	81	186	204
<b>Total</b>	<b>\$1,369</b>	<b>\$1,440</b>	<b>\$909</b>

As of December 31, 1996, 1995 and 1994, the aggregate fair value of held-to-maturity securities was substantially the same as the amortized cost and gross unrealized gains and losses by type of security were not material.

(millions of dollars)	Amortized Cost	Gross Unrealized	
		Gains	Losses
<b>Available-for-sale:</b>			
<b>Debt and equity securities</b>			
1996	\$717	\$73	\$ (8)
1995	68	50	(8)
1994	57	18	(15)

In 1996, the available-for-sale securities included certificates of deposit and corporate debt with a cost of \$636 million, which approximates fair value.

These securities are reflected in the Consolidated Balance Sheet as follows:

(millions of dollars)	1996	1995
Cash and cash equivalents	\$ 640	\$ 153
Short-term investments	487	1,109
Long-term loans and investments	1,024	288

The contractual maturities of the held-to-maturity and available-for-sale securities as of December 31, 1996 were as follows:

(millions of dollars)	Years			
	Within 1	Over 1 to 5	Over 5 to 10	Over 10
<b>Held-to-maturity:</b>				
Certificates of deposit	\$ 640	\$ 17	\$ 0	\$ 0
Corporate debt	425	157	15	5
Municipals	9	20	0	0
Other	53	0	13	15
<b>Available-for-sale:</b>				
Certificates of deposit	0	95	350	0
Corporate debt	0	41	150	0
<b>Total</b>	<b>\$1,127</b>	<b>\$330</b>	<b>\$528</b>	<b>\$20</b>

#### Financial Instruments and Risk Management

Changes in the value of the U.S. dollar and other currencies affect the Company's financial position and results of operations since the Company has manufacturing operations in many countries and sells its products on a worldwide basis. Changes in interest rates affect the Company's financial position and results of operations because of its investments and borrowings. The Company manages its foreign exchange and interest-rate risks through a variety of techniques, including the use of foreign-currency and interest-rate contracts.

Generally, gains and losses arising from contracts used for foreign-exchange and interest-rate risk management are recognized in income simultaneously with the net income effect of the related transactions generating such risks.

The aggregate notional amounts of the Company's foreign-currency and interest-rate contracts were as follows:

(millions of dollars)	1996	1995	1994
Foreign-currency contracts:			
Forward-exchange	\$2,844	\$1,888	\$750
Purchased options	367	497	150
Written options	—	74	—
Swaps	45	559	90
Interest-rate contracts:			
Swaps	1,360	874	275

The Company enters into certain forward-exchange contracts to match local market short-term assets and liabilities denominated in currencies other than the functional currency. The Company's contracts generally have maturities of six months or less. Changes in the fair value of forward-exchange contracts are included in Other deductions—net, together with foreign exchange gains and losses.

The Company also enters into other forward-exchange sale contracts to hedge its foreign currency-denominated net investments in Japan and Switzerland. These contracts have maturities of three months. Changes in the fair value of these forward-exchange contracts are included in the Currency translation adjustment and other account in Shareholders' equity. Discounts on currencies sold are amortized on a straight-line basis and are included in Other deductions—net.

The Company purchases currency options to hedge anticipated inventory purchases and sales. The currency options are reported at cost, which is amortized to operations on a straight-line basis through the expected inventory delivery date. Unrealized gains at that date are deferred as a reduction of inventory cost and recognized in net income as the inventory is sold. These options have maturities of up to one year in 1996 and up to two years in 1995 and 1994.

The U.S. dollar equivalent notional amounts of the significant foreign currency forward contracts and purchased options were as follows:

(millions of dollars)	1996	1995	1994
Commitments to sell foreign currencies:			
U.K. pounds	\$564	\$645	\$ 61
French francs	193	238	34
German marks	131	67	29
Irish punt	112	104	49
Japanese yen	94	40	107
Belgian francs	67	114	8
Net investment hedges:			
Japanese yen	615	—	—
Swiss francs	342	—	—
Commitments to purchase foreign currencies:			
Swiss francs	154	1	4
U.K. pounds	128	283	132
German marks	54	79	55
Irish punt	21	35	92
Japanese yen	7	39	—
Purchased options:			
Japanese yen	221	231	150
French francs	35	87	—
German marks	28	104	—
Belgian francs	25	56	—

The commitments to sell and purchase foreign currencies and purchased options are primarily in exchange for U.S. dollars.

During 1995, the Company wrote Japanese yen put options with terms identical to previously purchased put options. Both options are reported at market value and any market value changes are reported in Other deductions—net. Due to the fact that these positions effectively offset, there was no net impact on earnings.

Interest-rate swap contracts are used to manage interest-rate risk on assets and liabilities and to lower the Company's borrowing cost. The differential to be paid or received under the contracts is accrued over the lives of the contracts as interest rates change. Such amounts are included in Other deductions—net.

At December 31, 1996 and 1995, the interest-rate swap contracts included Japanese yen-denominated contracts with aggregate notional principal amounts of \$932 and \$350 million, respectively. These contracts are in place to effectively convert short-term floating-rate debt (based on the yen London Interbank Offered Rate [LIBOR]—0.5% in 1996 and 1995) into fixed-rate debt (0.7% in 1996 and 1.3% in 1995). The contracts outstanding at December 31, 1996 mature in December 1997.

# Notes to Consolidated Financial Statements continued

At December 31, 1996, the Company had other interest-rate swap contracts with a notional amount of \$428 million that mature in December 1997. These contracts are in place to effectively convert short-term floating rate debt (based on Swiss franc LIBOR—2.1% in 1996) into 2.1% fixed-rate debt.

At December 31, 1994, PIBE had contracts of \$200 million to effectively convert certain floating-rate assets to fixed-rate assets. The Company sold the right to receive the fixed-rate payments under the contracts totaling \$200 million in order to reduce counterparty credit risk. Income on this transaction was deferred and amortized over the life of the swap contracts, all of which expired in 1995. Additionally, a contract of \$50 million that matured early in 1995 effectively converted certain fixed-rate assets of PIBE into floating-rate assets based on U.S. dollar LIBOR.

Currency-swap contracts are used to manage foreign-exchange risk on foreign currency denominated assets and liabilities with the differential to be paid or received under the agreements accrued over the lives of the contracts as foreign exchange gains and losses. Such amounts are included in Other deductions—net. Currency-swap contracts are reported net in the Consolidated Balance Sheet.

In 1995, in connection with a sale-and-repurchase financing, the Company entered into an interest-rate swap and a currency swap to effectively convert a U.K. pound liability from fixed rate to U.S. dollar variable rate for a period of five years. The notional amount of the U.K. pound denominated interest-rate swap was \$499 million. In

**48** December 1996, the financing was repaid and the swaps were terminated.

At December 31, 1996, 1995 and 1994, the Company had other currency-swap contracts with notional amounts of approximately \$45, \$60 and \$90 million outstanding, respectively, maturing through 1997. Such contracts effectively convert certain PIBE fixed-rate (6.2% in 1996, 6.8% in 1995 and 6.4% in 1994) foreign currency assets into floating-rate (based on U.S. dollar LIBOR—6.0% in 1996, 6.0% in 1995 and 5.8% in 1994) U.S. dollar-denominated assets.

The Company periodically reviews the credit quality of financial institutions which are counterparties to its foreign-currency and interest-rate contracts and does not expect any loss from the failure of such institutions to perform under the contracts. The Company generally requires no collateral from its customers and performs ongoing credit evaluations of its customers' financial condition.

At December 31, 1996, the Company had no significant concentrations of credit risk related to financial instruments.

## Fair Value of Financial Instruments

The following methods and assumptions were used to estimate the fair value of financial instruments:

For short-term financial instruments, the carrying amount approximates fair value because of the short maturities of those instruments. For loans, the carrying amount approximates fair value because of the short reset period.

Quoted market prices or dealer quotes for the same or similar instruments were used for certain long-term interest-bearing debt and investments, long-term debt, forward-exchange contracts and currency options.

Interest-rate and currency-swap agreements have been valued using an estimated amount that the Company would receive or terminate the swap agreements at the reporting date based on dealer quotes, taking into account current interest rates and the current creditworthiness of the swap counterparties.

The difference between fair and carrying values of the Company's financial instruments was not material.

## Property, Plant and Equipment

The major categories of property, plant and equipment follow:

(millions of dollars)	1996	1995
Land	\$ 119	\$ 95
Buildings	1,597	1,406
Machinery and equipment	2,511	2,345
Furniture, fixtures and other	1,291	1,100
Construction in progress	487	517
	6,005	5,463
Less: accumulated depreciation	2,155	1,990
	<b>\$3,850</b>	<b>\$3,473</b>

## Long-Term Debt

Long-term debt, exclusive of current maturities of \$261, \$277 and \$7 million in 1996, 1995 and 1994, respectively, is summarized below:

(millions of dollars)	1996	1995
Floating-rate unsecured notes	\$636	\$ —
Repurchase agreement obligation	—	499
7½% Notes due 1996	—	—
6½% Notes due 1997	—	250
Other borrowings and mortgages	51	84
	<b>\$687</b>	<b>\$833</b>

In 1996, the Company issued a series of unsecured notes with an aggregate principal amount of \$636 million maturing on various dates from the year 2001 through 2005. The notes bear interest at a variable rate (weighted-average rate of 5.7% at December 31, 1996) based on the commercial paper rate. The notes enable the Company to minimize credit risk exposures of certain of its long-term investments by providing, in part, that the Company may satisfy the notes at the time of delivery of the specified long-term investments, which have a value of \$636 million at December 31, 1996.

In 1995, the Company sold securities for \$499 million with an obligation to repay the same principal amount pursuant to a repurchase agreement maturing in December 2000. In 1996, this obligation was terminated in accordance with the agreement, the principal repaid and the related swaps terminated.

Long-term debt maturities for the years 1998 through 2001 are \$4, \$3, \$1 and \$136 million, respectively. At December 31, 1996, the Company had approximately \$1.2 billion in major unused lines of credit.

The effective weighted average interest rate on short-term borrowings outstanding as of December 31, 1996, 1995 and 1994 was 5.0%, 5.2% and 5.8%, respectively.

During 1996, 1995 and 1994, respectively, the Company incurred interest costs of \$170, \$205 and \$142 million, including \$5, \$13 and \$15 million that were capitalized.

#### Other Deductions—Net

Other deductions—net are summarized below:

(millions of dollars)	1996	1995	1994
Interest income	\$(135)	\$(158)	\$(123)
Interest expense	165	192	127
Amortization of goodwill and other intangibles	66	46	14
Other, net	180	181	97
Other deductions—net	\$ 276	\$ 261	\$ 115

Other, net for 1996 included income of \$48 million related to revised royalty arrangements covering sales of Procardia XL, an \$18 million write-off of in-process R&D in connection with the Corvita acquisition and payments totaling \$45 million related to the purchase of certain product licensing rights.

In 1995, Other, net included approximately \$57 million of net pre-tax income related to the completion of all appeals in a patent infringement case with SciMed Life Systems, Inc., a provision for various litigation issues and pre-tax charges of approximately \$53 million that resulted from decisions to withdraw from a product line and to modify certain distribution relationships.

#### Restructuring Program

In 1993, the Company initiated a worldwide restructuring program which included the consolidation of manufacturing facilities, the demolition of buildings resulting from the consolidation, reconfiguration and rehabilitation of remaining facilities and the consolidation of distribution and administrative organizations and infrastructures. As a result, the Company recorded restructuring charges of \$679 million. The restructuring reserve was utilized in the amounts of \$217, \$157, \$9 and \$146 million in 1996, 1995, 1994 and 1993, respectively. As of December 31, 1996, this program was completed.

#### Taxes on Income

Income from continuing operations before taxes consisted of the following:

(millions of dollars)	1996	1995	1994
United States	\$1,065	\$1,041	\$1,057
International	1,739	1,258	773
Total income from continuing operations before taxes	\$2,804	\$2,299	\$1,830

The classification of items presented in the table above differs from that in the geographic data table on page 40. The geographic data table displays information by management organization, exclusive of financial subsidiaries, net interest and corporate expenses. Income from continuing operations before taxes in the above table is classified based on the location of the operations of the Company.

The provision for taxes on income consisted of the following:

(millions of dollars)	1996	1995	1994
United States			
Taxes currently payable			
Federal	\$332	\$341	\$238
State and local	54	41	15
Deferred income taxes	10	(22)	35
Tax provision	396	360	288
International			
Taxes currently payable	408	368	264
Deferred income taxes	65	10	(3)
Tax provision	473	378	261
Total provision for taxes on income	\$869	\$738	\$549

The provision for taxes on income in the above table is classified based on the location of the taxing authority. A provision for U.S. income taxes which would approximate \$880 million has not been made on approximately \$3.9 billion of international subsidiaries' unremitted earnings as of December 31, 1996, which, for the most part, are expected to be reinvested overseas.

The earnings of the Company's pharmaceutical subsidiary operating in Puerto Rico are subject to taxes pursuant to an incentive grant effective through December 31, 2002. Under this grant, the Company is partially exempt from income, property and municipal taxes. Tax legislation in 1993 and 1996 has limited the tax incentives available to the Company from its operations in Puerto Rico. For further information, see "Tax Legislation" on page 37. In addition, the 1996 Act extended the R&D tax credit for 11 months effective July 1, 1996. As a result, taxes have been provided to the extent required by these changes in law.



# Appendix C

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

A summary of Aon's stock option activity and related information consists of the following:

Years ended December 31	1996		1995		1994	
(shares in thousands)	Shares	Weighted Average Exercise Price	Shares	Price Range	Shares	Price Range
Beginning outstanding	3,475	\$32	3,346	\$14-36	2,699	\$14-36
Granted (at fair value)	1,023	52	1,086	32-38	1,134	31-36
Exercised	(488)	26	(747)	14-29	(353)	14-26
Canceled	(493)	35	(210)	17-36	(134)	14-36
Ending outstanding	3,517	39	3,475	20-38	3,346	14-36
Exercisable at end of year	310	29	425	20-35	648	14-32
Options available for grant	863		1,450		2,326	

A summary of options outstanding and options exercisable at December 31, 1996 is as follows:

Range of Exercise Prices	Options Outstanding			Options Exercisable	
	Number Outstanding As of 12/31/96	Weighted Average Contractual Life (Years)	Weighted Average Exercise Price	Number Exercisable As of 12/31/96	Weighted Average Exercise Price
\$24.50-\$33.44	692	2.7	\$28.94	235	\$26.44
33.96- 33.96	802	4.2	33.96	—	—
34.25- 35.75	746	5.1	35.65	14	34.46
35.83- 48.88	310	3.7	36.77	61	36.00
51.50- 60.25	967	6.3	52.13	—	—
\$24.50-\$60.25	3,517	4.6	\$38.56	310	\$28.68

### 11. FINANCIAL INSTRUMENTS

#### *Financial Risk Management*

Aon is exposed to market risk from changes in interest rates and foreign currency exchange rates. To manage the volatility related to these exposures, Aon enters into various derivative transactions that have the effect of reducing these risks by creating offsetting market exposures. If Aon did not use derivative contracts, its exposure and market risk would be higher.

Derivative transactions are governed by a uniform set of policies and procedures covering areas such as authorization, counterparty exposure and hedging practices. Positions are monitored using techniques such as market value and sensitivity analyses.

In addition to creating market risks that offset the underlying business exposures, certain derivatives also give rise to credit risks due to possible non-performance by counterparties. The credit risk is generally limited to the fair value of those contracts that are favorable to Aon. Aon has limited its credit risk by restricting investments in derivative contracts to a diverse group of highly rated major financial institutions and by using exchange-traded instruments. Aon closely monitors the creditworthiness of and exposure to its counterparties and considers its credit risk to be minimal. At December 31, 1996 and 1995, Aon placed securities in escrow amounting to \$13 million and \$1 million, respectively, relating to these derivative contracts.

#### *Interest Rate Risk Management*

Aon uses interest rate derivative contracts to manage the interest rate risk associated with assets and liabilities underlying its underwriting businesses. Interest rate derivatives are also utilized to manage the company's funding and other corporate risks.

Interest rate swap agreements have been used primarily to manage asset and liability durations. Exchange-traded Eurodollar futures, used in conjunction with basis rate swaps, are used to manage asset liability durations related to various other crediting arrangements emanating from other insurance businesses. As of December 31, 1996 and 1995, these swap agreements had the net effect of shortening asset durations. Variable rates received on interest rate and basis rate swap agreements correlate with crediting rates paid on outstanding liabilities. The net effect of swap payments is settled periodically and reported in income. There is no settlement of underlying notional amounts.

Exchange-traded treasury futures and options are used primarily as a hedge against the value of Aon's available for sale fixed maturity and equity investments. Aon sells futures as well as writes call options and limits its risk on these written options to a spread by purchasing call options. Exchange-traded futures and options are valued and settled daily. The premium that Aon pays for purchased options and receives for written options represents the cost basis of the option until it expires or is closed.

Aon also enters into interest rate swap agreements, sells exchange-traded interest rate futures and purchases interest rate caps to limit its interest expense on short-term borrowings. The premium that Aon pays for interest rate caps represents the cost basis of the position until it expires or is closed.

Aon performs frequent analyses to measure the degree of correlation associated with its derivative programs. Aon assesses the adequacy of the correlation analyses results in determining whether the derivatives qualify for hedge accounting. The premium that Aon pays or receives for options (including interest rate caps and floors) represents the cost basis of the option until it expires or is closed. Realized gains and losses on derivatives that qualify as hedges are deferred and reported as an adjustment of the cost basis of the hedged item. Deferred gains and losses are amortized into income over the remaining life of the hedged item. Outstanding derivatives that are hedges of items carried at fair value are reflected in the financial statements at fair value with changes in the derivative fair value reported as unrealized gains and losses directly in stockholders' equity.

In January 1997, Aon issued \$800 million of 8.205% capital securities (see note 8). To hedge its exposure to rising long-term interest rates associated with the anticipated debt issue, Aon entered into various exchange-traded derivative contracts including treasury futures and options. The hedge was in place from December 1996 until January 1997.

#### *Foreign Exchange Risk Management*

Aon uses foreign currency futures, options and forward contracts to hedge against the effects of foreign currency fluctuations on the translation of the financial statements of Aon's

## **BIBLIOGRAPHY**

Annual Report - The Allstate Corporation. December 31, 1996.

Annual Report - Pfizer. December 31, 1996.

Annual Report - Aon Corporation. December 31, 1996.

FASB Exposure Draft. "Accounting for Derivative and Similar Financial Instruments and for Hedging Activities." June 1996

FASB- Original Pronouncements 1995/96 Edition. John Wiley & Sons, Inc., New York, 1995.