MINUTES

Financial Accounting Standards Board

To: Board Members

From: Bennett, Ext. 229

Subject: Minutes of the August 16, 2006 Board Meeting—Statement 133 Implementation Issue—Hedging Proceeds to Be Received from a Forecasted Foreign Currency Denominated Debt Issuance

Date: August 24, 2006

cc: FASB: Smith, Bielstein, MacDonald, Leisenring, Golden, Fanzini, Wilkins, Stoklosa, Jacobs, Mayrhofer, Glotzer, Swift, Polley, Gabriele, Carney, Allen, FASB Intranet

The Board meeting minutes are provided for the information and convenience of constituents who want to follow the Board's deliberations. All of the conclusions reported are tentative and may be changed at future Board meetings. Decisions become final only after a formal written ballot to issue a final Statement or Interpretation.

Topic: Issuance of Proposed Statement 133 Implementation Issue No. H17: "Hedging Functional Currency Equivalent Proceeds to Be Received from a Forecasted Foreign Currency Denominated Debt Issuance."

Basis for Discussion: Board Memorandum No. 1

Length of Discussion: 10:30 to 11:00 a.m.

Attendance:

Board members present: FASB: Batavick, Crooch, Herz, Linsmeier, Seidman, and Trott
IASB: Leisenring

Board members absent: Young

Staff in charge of topic: Fanzini

Other staff at Board table: Smith, Stoklosa, Jacobs, and Bennett

Summary of Decisions Reached:

The Board discussed the issuance of proposed Statement 133 Implementation Issue "Hedging Functional-Currency-Equivalent Proceeds to Be Received from a Forecasted Foreign-Currency-Denominated Debt Issuance." The Board deferred a decision on the issuance of that proposed Implementation Issue and requested that the staff perform further analysis including additional examples. That analysis will be presented to the Board at a future meeting.

Objectives of Meeting:

The objective of the meeting was for the Board to approve the issuance of proposed Statement 133 Implementation Issue "Hedging Functional-Currency-Equivalent Proceeds to Be Received from a Forecasted Foreign-Currency-Denominated Debt Issuance." That objective was not met.

Matters Discussed and Decisions Reached:

1. Mr. Fanzini opened the discussion by stating that the Board will consider the following two issues:

a. Whether the Board agrees with the Technical Application and Implementation (TA&I) Committee's conclusions in the response section of the proposed Implementation Issue.

b. If the Board agrees with the TA&I Committee's (the Committee's) conclusions, whether the Board agrees with the Committee's recommendation to issue the proposed Implementation Issue.

Background

2. Mr. Fanzini provided the Board with a brief background of the issue. He stated that the proposed Implementation Issue was added to the Board's agenda in February 2006 due to the apparent diversity in practice. The proposed Implementation Issue provides guidance on whether the functional currency variability in proceeds to be received from the forecasted issuance of debt

denominated in a currency other than the reporting entity's functional currency is eligible for designation as the hedged transaction in a cash flow hedge. The issue in question centers on whether a forecasted issuance of a fixed amount of foreign-currency-denominated debt is eligible for designation as a hedged transaction in a cash flow hedge of the functional-currency-equivalent variability of the proceeds received. The specific concern is with paragraph 29(c) of FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities,* which requires that "the forecasted transaction…presents an exposure to variations in cash flows for the hedged risk that could affect reported earnings."

3. The Committee concluded that the forecasted issuance of debt denominated in a currency other than the reporting entity's functional currency is not eligible for designation as the hedged transaction in a cash flow hedge. The Committee and staff concluded that for example, the variation in U.S. dollar equivalent that a U.S. company will receive upon borrowing 100 Euros at some specified date in the future exposes the company to a risk that does not affect reported earnings. The staff believes that whether the 100 Euros equates to 110 U.S. dollars or 115 U.S. dollars (or any other amount) at the date of issuance does not affect reporting earnings. In contrast, the forecasted acquisition of a fixed asset denominated in a foreign currency will affect earnings through higher or lower depreciation expense. Likewise, the forecasted purchase of inventory denominated in a foreign currency will affect earnings through U.S. dollar equivalent cost of goods sold.

4. The Committee noted that the gain or loss on the derivative that occurs during the period between the forecasted date and the issue date bears no relationship to the transaction gains or losses that occur subsequent to the date of issuance on the recorded debt. The currency risk does not impact the entity's reported earnings because future transaction gains or losses bear no relationship to the difference in U.S. dollar equivalent proceeds received due to changes in exchange rates between the forecasted date and the issue date. The functional-currency-equivalent difference in proceeds received does not impact earnings by

the amount of the gain or loss of the derivative either through future foreign currency transaction gains or losses attributable to future exchange rate changes or interest expenses.

5. This view is further supported by the inability to apply the provisions of paragraph 31 of Statement 133, which requires that the amounts in accumulated other comprehensive income (that is, the effective portion of the gain or loss on the derivative) be reclassified into earnings in the period in which the hedged forecasted transaction affects earnings. The staff believes that a linkage exists between paragraph 31 and 29(c). Paragraph 29(c) requires that the transaction presents an impact that could affect reported earnings, while paragraph 31 requires that the amounts in other comprehensive income be reclassified into earnings in the same period or periods during which the hedged forecasted transaction affects earnings. Additionally, the staff is concerned that the gain or loss on the derivative would be the same for an anticipated issuance of a one-year, five-year, or thirty-year debt, for which an adjustment to interest expense would have notably different effects.

6. One Board member on the Committee expressed an alternative view that the variation in functional-currency-equivalent cash flow relates to the possibility that if exchange rates change, the amount of functional-currency-equivalent cash proceeds received upon issuance also would fluctuate. The effect on reported earnings relates to the requirement under FASB Statement No. 52, *Foreign Currency Translation,* to recognize foreign currency transaction gains and losses (through earnings) once the debt is issued and outstanding, as well as the amount of interest expense, which is calculated based on a higher or lower amount of proceeds. Statement 133 does not include a requirement that the earnings effect be immediate upon the occurrence of the forecasted transaction, simply that the hedged item has the **potential** to give rise to an earnings effect at some point in time. That Board member believes that the forecasted issuance of debt is analogous to the forecasted purchase of a machine in a foreign currency, which clearly qualifies as a potential hedged item in a cash flow hedge.

7. However, a majority of the Committee concluded that hedges of anticipated purchases of an asset and inventory differed from a hedge of the functional-currency-equivalent proceeds to be received on a forecasted issuance of foreign-currency-denominated debt since the impact on earnings on the anticipated asset purchase will be realized through sale or depreciation and in the case of inventory, the impact on earnings would occur through cost of goods sold.

8. The Committee and the staff agreed that the foreign exchange variability in **future interest payments** of forecasted foreign-currency-denominated debt is eligible for cash flow hedge accounting. The staff acknowledged that a company could enter into a forward starting cross-currency swap (or a series of forwards for each individual forecasted interest payment) and designate as the hedged risk the risk of changes in functional-currency-equivalent cash flows associated with forecasted interest payments with respect to the forecasted debt issuance. Additionally, with regard to convergence, the staff believes that the Committee's conclusion is consistent with IAS 39, *Financial Instruments: Recognition and Measurement.* Therefore, the Committee concluded that additional guidance is warranted and recommends that the Board issue a Statement 133 Implementation Issue in order to promote consistency in the application of cash flow hedge accounting.

9. The Committee believes that this proposed Implementation Issue warrants special transition guidance given the diversity in practice and recommends a one-time adjustment to beginning retained earnings in the current period to adjust amounts in other comprehensive income for the changes in the derivative that would have been reported in earnings as those changes occurred. The Committee concluded that the effective date for this proposed Implementation Issue should be the first day of the reporting entity's first fiscal quarter beginning after the date that the Board-cleared guidance is posted on the FASB website.

10. Mr. Fanzini noted that if the Board agrees to issue the proposed Implementation Issue, the Committee would recommend a 35-day comment period. He asked if the Board agrees with the Committee's conclusions.

Discussion of Implementation Issue

11. Mr. Trott stated that the issue in question may be subject to misinterpretation by some constituents. He reiterated that the proposed Implementation Issue is attempting to address whether an entity is allowed to use a cash flow hedge in the forecasted issuance of foreign-currency-denominated debt from the point in time when the entity decides to issue the debt (forecast date) to the point in time when the debt is issued (issuance date). He noted that the proposed Implementation Issue is not proscribing the hedge of foreign currency debt once the debt is issued. Board members also agreed that the proposed Implementation Issue is not dealing with a firm commitment to issue debt, but a forecasted transaction.

12. Mr. Linsmeier disagreed with the Committee's conclusion and presented a fact pattern to support his dissent. For example, at the forecast date, a U.S. dollar functional currency entity forecasts the issuance of a 5-year zero-coupon bond denominated in Euros. At issuance, the entity expects to receive 300 Euros. At maturity, the bond will pay 1,000 Euro. At the forecast date, the exchange rate is $1:1 Euro. To lock in the receipt of the U.S. dollar equivalent amount of $300 (the net proceeds), the entity purchases a derivative, with a notional amount of $300, to lock in the receipt of $300 U.S. dollar equivalent amount of proceeds. At the issuance date, the exchange rate is $2:1 Euro. Therefore, the amount of cash in U.S. dollar terms at the date of issuance is $600 and the payment at maturity will be $2,000. If the entity did not hedge its exposure to changes in foreign currency exchange rates, the entity would be exposed to $300 ($600 - $300) less functional-currency-equivalent interest on the same amount of Euro proceeds. The extra $300 functional-currency-equivalent

interest arising from the hedge is an additional financing cost that the entity would recognize as interest expense over the life of the debt.

13. Mr. Trott stated that the issue is the amount of principal the entity records and not the interest expense associated with that principal. In the case of a zero-coupon bond, the discount represents a deferral of the interest payments that is earned over time, which bears no relationship to the principal amount of the bond. The fact that the cash received changed because of the change in the spot rate has no impact to reported earnings because the zero coupon debt will be paid off at maturity at a zero gain or loss.

14. Mr. Linsmeier replied that, in his example, paragraph 29(c) is met because the effect on reported earnings is the interest expense associated with receiving less net cash flows and not the zero gain or loss on the settlement of the debt at maturity. He stated that his scenario is similar to a cash flow hedge of an anticipated purchase of a machine and that the interest expense in his example is similar to the depreciation expense on a machine. Mr. Trott disagreed and stated that the debt is a monetary item, which is the focus of this issue, and the inventory and machine are nonmonetary items. Mr. Linsmeier opined that whether the issue involves a monetary or nonmonetary item is unimportant because there is no change in the spot rate from the date of issuance until the date of maturity. In the case of the machine, the gain or loss from the derivative would be used to offset depreciation expense over the useful life of the machine. Hence, the question is raised as to why the use of that gain or loss to offset interest expense should be treated any differently.

15. Ms. Seidman stated that Mr. Trott views this issue as the receipt of proceeds while she views it as the issuance of debt, and accounting for debt does have various earnings effects. Ms. Seidman believes that the variable amount of functional currency equivalent proceeds to be received has a direct effect on earnings via the functional-currency-equivalent amount of interest expense, even if interest rates never change. She added that foreign currency

transaction gains or losses and the gains or losses on extinguishment are other possible earnings effects. Mr. Trott noted that the main issue in this question is how will the debt liability (or asset) be realized and will that realization result in a gain or loss. Interest expense is not a realization of debt. Ms. Seidman questioned why a forecasted purchase of a machine would qualify for a foreign currency cash flow hedge but the functional-currency-equivalent proceeds to be received from a forecasted issuance of foreign-currency-denominated debt would not qualify. How is depreciation on the machine related to the foreign currency derivative?

16. Mr. Trott replied that in the case of a forecasted purchase of a machine, the entity is attempting to lock in the nonmonetary value that is ascribed to that machine. The impact on earnings in a cash flow hedge of a forecasted purchase of a machine is realized through depreciation or the gain or loss from the sale of the machine. It is the realization of the asset that has been recorded. In contrast, the proceeds from the issuance of the debt have no earnings impact as prescribed in paragraph 29(c) as the realization of the impact of eliminating the bond principal (liability) does not result in a gain or loss. In the case of the machine, the recorded amount (that is, the value ascribed to the machine) is reduced to zero via depreciation expense (which represents realization of the asset), which impacts the income statement. However, the principal amount of the debt is not reduced to zero in the same manner (that is, the principal amount is not reduced to zero via interest expense). Therefore, deprecation expense is not similar to the interest expense in Mr. Linsmeier's example.

17. Ms. Seidman responded that the difference between the hedged and unhedged proceeds received on the debt has a direct effect on earnings because interest expense and foreign currency transaction gains or losses will be calculated based on a higher or lower amount of proceeds. She referred to Statement 133 Implementation Issue No. H15 "Foreign Currency Hedges: Using a Forward Contract to Hedge a Forecasted Foreign Currency Transaction That

Becomes Recognized," as an example of how the gain or loss would be recorded in earnings.

18. Mr. Leisenring stated that this issue is not dealing with an interest rate hedge. He further stated that Mr. Linsmeier's proposal to accumulate the gain or loss from the aforementioned cash flow derivative in other comprehensive income and recognize that gain or loss as an adjustment to interest expense, as interest expense is recognized over the life of the bond, is not the method in which entities would account for that type of derivative. The way those entities would like to account for the derivative, if they were to qualify for hedge accounting, is to recognize the gain or loss in income when the entity remeasures the debt at the spot rate. The gain or loss in other comprehensive income should not be used to adjust the interest expense over the life of the loan because it is not an interest rate hedge.

19. Mr. Smith stated that in the zero-coupon bond example, the amount of the gain or loss from the derivative would be the same regardless of whether the bond has a 30-day or 30-year maturity. As such, there would be very different effective yields on the bond depending on the period of time the amounts in other comprehensive income will be amortized into earnings. Therefore, there is no correlation between the gain or loss on the derivative during the forecast period and future interest rates. Mr. Linsmeier countered by stating that in the case of a machine, the gain or loss on the derivative has no correlation to the depreciation of an asset, whether it is 6 months or 30 years, depending on its useful life.

20. Mr. Batavick stated that paragraph 29(c) could be viewed broadly enough to encompass the abovementioned situations that were articulated by Mr. Linsmeier and Ms. Seidman. However, the forecasted transaction could also be viewed narrowly enough to only address the point in time when an entity receives the functional-currency-equivalent proceeds from the foreign-currency-denominated debt issuance, and not any accounting consequences thereafter. He believes that there is ambiguity in the language in paragraph 29(c).

21. Mr. Herz suggested that the staff further explore Ms. Seidman and Mr. Linsmeier's arguments and provide analyses of the issuance of a foreign-currency-denominated zero-coupon bond and a foreign currency interest-bearing financial instrument. Additionally, the staff should provide a similar analysis for the purchase of a depreciable asset or debt security, to ensure that consistent principles are being applied.

Follow-Up Items:

The staff plans to further analyze the issue and examples and present its findings at a future Board meeting.

General Announcements:

None.