MINUTES

Financial Accounting Standards Board

To: Board Members

From: Chesney (ext. 447)

Subject: Minutes of the November 7, 2007 Board Meeting: Statement 133 Hedging: Fair Value Hedge Accounting Model for Cash Flow Hedges and Accounting for Hedges of an Entity's Own Debt

Date: November 13, 2007

cc: Leisenring, Bielstein, Golden, Cassel, Derivatives Implementation Team, Financial Instruments Team, Lott, Chookaszian, Posta, MacDonald, Mayrhofer, FASB Intranet (e-mail)

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, Interpretation, or FSP.

Topic:	Statement 133 Hedging: Fair Value Hedge Accounting Model for Fair Value Hedges and Accounting for an Entity's Own Debt within the Fair Value Approach for Fair Value Hedges and Cash Flow Hedges
Basis for Discussion:	Board Memorandum No. 3 Board Memorandum No. 4
Length of Discussion:	10:00–11:00 a.m.
Attendance:	
Board members present:	Herz, Batavick, Linsmeier, Seidman, Smith, and Young
Board members absent:	Crooch
IASB members present:	Leisenring
Staff in charge of topic:	Malcolm
Other staff at Board table:	Golden, Stoklosa, Wilkins, C. Smith, and Chesney
Outside participants:	None

<u>Summary of Decisions Reached:</u>

The Board continued its discussions of a fair value hedge accounting approach that would fundamentally change the current hedge accounting model in FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*. The Board discussed the fair value hedge accounting approach for cash flow hedges in the context of scope, requirements for hedge accounting, and measuring and reporting hedge ineffectiveness. Additionally, the Board discussed the accounting for an entity's own existing recognized debt within the fair value hedge accounting approach for both fair value hedges and cash flow hedges.

The Board decided to retain cash flow hedge accounting for items currently within the scope of Statement 133. The Board decided to require that the balance of accumulated other comprehensive income reflect the cumulative change in the fair value of a perfect derivative, effectively requiring that ineffectiveness be reported in earnings for both overhedges and underhedges.

For situations in which an entity enters into a derivative to synthetically create variable-rate debt, the Board decided to permit the ability to hedge changes in fair value of the hedged item attributable to changes in the benchmark interest rate if the hedge is designated at the time the hedged item is initially recognized. For situations in which an entity enters into a derivative to synthetically create fixed-rate debt, the Board decided to permit the ability to designate the derivative as hedging the exposure to variability in expected future interest cash flows that is attributable to changes in the designated benchmark rate if the hedge is designated at the time the issued debt is recognized.

The Board directed the staff to further research dedesignation and redesignation issues as it relates to forecasted transactions within the cash flow hedging model.

<u>Objective of Meeting:</u>

The objective of the meeting was for the Board to discuss a fair value approach to cash flow hedge accounting and make decisions related to scope, requirements for hedge accounting, and

measuring and reporting hedge ineffectiveness. The objective also was for the Board to discuss accounting for hedges of an entity's own debt within the fair value approach for both fair value hedges and cash flow hedges. The objective was met.

Matters Discussed and Decisions Reached:

1. Ms. Malcolm summarized the events and discussions that led to the Board's decision to undertake a project to fundamentally change the hedge accounting guidance in FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*. Ms. Malcolm reminded the Board that it instructed the staff to develop a fair value approach to hedge accounting, which would not allow for bifurcation-by-risk, the shortcut method, or critical terms match. The Board discussed the fair value approach for fair value hedges at the October 17, 2007 meeting.

Scope

2. Ms. Malcolm summarized the input received from resource group members relating to the need for cash flow hedge accounting. Preparers generally agreed that cash flow hedge accounting should be allowed and that cash flow hedge accounting is the predominant type of hedge accounting used for nonfinancial items. The majority of users believed that the fair value measurement attribute should be required for financial and nonfinancial assets and liabilities. These users stated that hedge accounting would not be needed if fair value measurement was required. However, because fair value measurement is not required, users believed that cash flow hedge accounting should be allowed to hedge the variability in future interest cash flows of variable-rate debt.

Staff Recommendation

3. The staff recommended that cash flow hedge accounting be retained for items currently within the scope of Statement 133. This proposed scope would include variable-rate assets and liabilities, the forecasted issuance of financial assets and liabilities, and forecasted purchases and sales of nonfinancial assets. The hedged risk would be variability in cash flows attributable to all risks associated with the hedged transaction.

Board Vote

4. Messrs. Batavick, Crooch, Herz, Linsmeier, Smith and Young supported the staff's recommendation. Ms. Seidman did not support the staff's recommendation.

Board Comments

5. Messrs. Batavick, Herz, and Smith clarified that they agreed with the scope to the extent that it is consistent with the scope for fair value hedges decided at the October 17, 2007 meeting.
6. Mr. Linsmeier agreed with the scope for the proposed approach, but added that the argument for the removal of cash flow hedge accounting is valid.
7. Ms. Seidman stated that the variability should be limited to changes in the interest rate exposure if the interest rate is the risk being hedged. The staff's proposed model would require entities to consider the variability attributable to changes in credit rather than considering credit as part of the probability assessment for the hedged transaction. Ms. Seidman noted that she would rather simplify current cash flow hedge accounting rather than change or limit the risks that would be hedged using cash flow hedge accounting.

Requirements for Hedge Accounting

8. Ms. Malcolm said that the main issues relating to the requirements for hedge accounting in cash flow hedges are the same issues that the Board discussed and decided upon when it addressed fair value hedges. Those issues are (a) whether assessing effectiveness should be required, and if so, (i) whether it should be based on a quantitative approach or a qualitative approach and (ii) when and how often an entity should be required to assess effectiveness, and (b) whether hedge accounting should be revocable (ability to dedesignate and redesignate). Since there are no fundamental differences between fair value hedges and cash flow hedges as it relates to those issues, the decisions previously made by the Board on those issues in the context of fair value hedges also apply to cash flow hedges.
9. Ms. Malcolm acknowledged the Board's previous concern regarding the use of the words "business relationship" to describe the required relationship between the hedged transaction and the hedging instrument. The staff is currently developing alternative wording regarding this requirement for hedge accounting.
10. Mr. Herz said that one issue he has relating to the requirements for hedge accounting as it pertains to cash flow hedges is that dedesignation and redesignation should not be allowed for forecasted transactions. Mr. Linsmeier said that there should be consistency between fair value hedges and cash flow hedges for when dedesignation and

redesignation should be permitted. Mr. Stoklosa said that the staff will further develop this issue for discussion at a future meeting. He said that the staff also plans to bring to the Board an issue on how amounts in OCI should be reclassified to earnings when a hedging relationship is dedesignated.

Accounting for An Entity's Own Debt within the Context of Fair Value Hedges and Cash Flow Hedges

11. Ms. Malcolm summarized the discussion at the last meeting regarding a potential scope-out from the requirement that an entity recognize in earnings gains and losses attributable to changes in its own credit when it issues and hedges it own debt. She said that the staff developed the following approach for accounting for the changes in fair value or cash flows when an entity hedges its own debt:
    a. For situations in which an entity synthetically creates variable-rate debt by issuing fixed-rate debt and entering into a receive fixed/pay variable interest rate swap, (or fixed-rate debt by issuing variable-rate debt and entering into a receive variable/pay fixed interest rate swap) the interest rate swap may be designated as hedging the exposure to changes in fair value (or cash flows) of the debt attributable to changes in the designated benchmark interest rate. The ability to hedge changes in fair value (or cash flows) attributable to changes in the benchmark interest rate applies only when there is formal, contemporaneous documentation of the hedging relationship which includes:
        (1) Identification of the hedging instrument
        (2) Identification of the hedged item
        (3) Designation of the hedging relationship on the trade date of the debt. Differences between the trade date and the date the debt is recognized for accounting purposes (settlement date) would not prohibit the ability to hedge changes in fair value attributable to changes in the benchmark interest rate provided that the period of time between the trade date and the settlement date are within established conventions for that marketplace.
        (4) A qualitative evaluation of the nature of the risk that the entity is attempting to hedge and why the derivative should be effective in offsetting changes in

fair value (cash flows) of the hedged item (transaction) that result from the hedged risk.

(5) Designating changes in fair value (cash flows) of the debt attributable to changes in the designated benchmark interest rate is not permitted if the hedging relationship is entered into subsequent to the initial recognition of the hedged item (transaction).

Staff Recommendation

12. The staff recommended that an entity be allowed to hedge changes in fair value attributable to changes in the benchmark interest rate or the variability in future interest cash flows attributable to changes in the benchmark rate. The designation of the hedging relationship would be available only when the debt is initially recognized by the entity; an entity that terminated such a hedge would not be allowed to apply this exception at a later date.
13. Mr. Stoklosa clarified that this exception would not allow synthetic instrument accounting, but instead would allow an entity to account for the combination of the issued debt and the interest rate swap as if it synthetically created variable-rate debt or synthetically created fixed-rate debt. This exception to the proposed fair value model would give a bifurcation-by-risk result for those situations.

Board vote

14. Messrs. Batavick, Crooch, Herz, Linsmeier, Smith and Young supported the staff's recommendation. Ms. Seidman did not support the staff's recommendation.

Board Comments

15. Ms. Seidman noted that she would apply the bifurcation-by-risk type of accounting proposed in this exception to all hedging relationships. She said that hedge accounting should reflect the risk(s) the entity is hedging. Mr. Batavick noted that the financial statements should reflect only the risks the entity is managing.
16. Mr. Herz said that he supports the exception within the context of the fair value model. However, Mr. Herz said that he advocates a general rule that until the measurement attributes for certain instruments have been decided upon, basis adjustment accounting should be the model for hedge accounting. He added that in the interest of convergence, he would not object to the fair value approach.

17. Mr. Linsmeier said that in addition to simplifying hedge accounting so that it is easier for preparers to apply, another objective of the project is to improve financial reporting so that it is easier for users to understand the effects of hedging. Ms. Seidman added that a fair value hedging approach would not necessarily allow users to more easily understand the effects of hedges. Ms. Smith said that input from a majority of users indicated that they do not support a bifurcation-by risk hedging model. Mr. Stoklosa further stated that users indicated that they would prefer fair value for financial instruments and no hedge accounting, but if hedge accounting were to exist then a fair value hedge accounting approach is preferred.

Measuring and Reporting Ineffectiveness

18. Ms. Malcolm said that the staff is presenting the Board with two alternatives for recording ineffectiveness in a cash flow hedge:

    Alternative 1 – Require that the balance of accumulated other comprehensive income reflect the lesser of either the cumulative change in the fair value of the actual derivative or the cumulative change in the fair value of a perfect hypothetical derivative. (Record ineffectiveness for only overhedges.)

    Alternative 2 – Require that the balance of accumulated other comprehensive income reflect the cumulative change in the fair value of a perfect hypothetical derivative. (Record ineffectiveness for both overhedges and underhedges.)

Staff Recommendation

19. The majority of the staff recommended that the balance of accumulated other comprehensive income reflect the cumulative change in the fair value of the perfect derivative; ineffectiveness would be reported in earnings for both overhedges and underhedges. One staff member recommended that the balance of accumulated other comprehensive income reflect the lesser of the cumulative change in fair value of the perfect derivative and the cumulative change in fair value of the actual derivative; ineffectiveness would be reported in earnings only for overhedges.

Board Vote

20. The Board unanimously supported the staff's majority recommendation.

Board Comments

21. Ms. Seidman said the perfect derivative method is only one of a number of methods currently used to determine ineffectiveness. She also said that she did not object to the

perfect derivative method, but she did not necessarily agree with what the perfect derivative would need to be in certain cash flow hedging situations. Ms. Seidman noted that IAS 39 requires that ineffectiveness be reported in earnings for both overhedges and underhedges. Ms. Seidman noted that she supports the majority recommendation primarily on the basis of convergence.

22. Mr. Linsmeier said that the words "perfect derivative" might be misleading because it focuses on a derivative rather than the measurement of the cumulative change in expected cash flows of the forecasted transaction. Mr. Stoklosa said that the perfect derivative is a proxy for the cumulative change in expected cash flows of the forecasted hedged transaction.

Additional Items

23. Before continuing with the fair value hedge accounting approach, Mr. Stoklosa asked which Board members will object to the issuance of an Exposure Draft that includes that approach. Ms. Seidman and Mr. Batavick said that they would object to the approach as they support a bifurcation-by-risk approach. Mr. Herz said that while he prefers a basis adjustment hedge accounting approach, he would not object to the fair value approach pending a satisfactory outcome on the dedesignation/redesignation issues. Mr. Smith said that he would not object to the fair value approach, but he is very interested in what users will say in the comment letter process. Mr. Linsmeier, Mr. Young, and Mr. Crooch would not object to the fair value approach.

Follow-up Items

24. In addition to coming to the Board with how foreign currency hedging fits into the fair value hedge accounting approach, the staff will further research (a) dedesignation and redesignation issues as it relates to forecasted transactions within the cash flow hedging model and consistency between fair value hedges and cash flow hedges, and (b) how amounts recorded in OCI should be reclassified to earnings.