MINUTES

Financial Accounting Standards Board

To: Board Members

From: Cornett (ext. 442)

Subject: Minutes of the May 23, 2007 Board Meeting: Agenda Decision: Hedging **Date:** May 23, 2007

cc: Leisenring, Bielstein, Smith, MacDonald, Golden, Chookaszian, Lott, Polley, Klimek, Stoklosa, Wilkins, Stevens, Jacobs, Richter, Cornett, Gabriele, Allen, FASB Intranet

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Topics:	Agenda Decision: Hedging
Basis for Discussion:	Board Memorandum No. 1 Supplemental Memorandum to Memorandum 1
Length of Discussion:	9:45 to 10:45 a.m.
Attendance:	
Board members present:	Herz, Batavick, Crooch, Linsmeier, Seidman, Trott (by phone), and Young
Staff in charge of topic:	Stoklosa
Other staff at Board table:	Smith, Golden, Lott, Stoklosa, Cornett
Outside participants:	None

Summary of Decisions Reached:

The Board added a project to its agenda to address the accounting for hedging activities in FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities.* The Board directed the staff initially to develop further a fair value approach. The Board may also consider at a later date whether to develop further a bifurcation-by-risk approach.

Objective of Meeting:

The objective of the meeting was for the Board to consider adding a project to its agenda to address the accounting for hedging activities, and to consider which potential methods, if any, to develop for further consideration. The objective was met.

Matters Discussed and Decisions Reached:

1. Mr. Stoklosa opened the meeting by stating that the purpose of the meeting was to discuss (a) practice issues related to the hedge accounting guidance in FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*, (b) possible approaches for accounting for hedging activities, and (c) whether to add a project to the Board's agenda to address accounting for hedging activities.

2. With regard to practice issues, Mr. Stoklosa stated that since the effective date of Statement 133, the Board has been asked to address numerous issues on many aspects of hedge accounting. As a result, at the January 31, 2007 Board meeting, the Board instructed the staff to undertake research that would identify issues causing difficulty in complying with and understanding the current accounting for hedging activities. Mr. Stoklosa said that the following issues were identified as part of the research effort:

    a. Documentation requirements: constituents indicated that documentation requirements are too strict and that shortcomings in specificity results in denial of hedge accounting for an otherwise effective hedging relationship

b. Designation, dedesignation, redesignation: entities struggle with when dedesignation/redesignation is necessary. For example, if an entity is hedging a $500,000 debt instrument with a swap having the same notional and then $100,000 of the debt instrument gets repaid, does that require dedesignation/redesignation of the hedging relationship or could the entity just use 80 percent of the derivative as the hedging instrument going forward?

c. Identification of hedged item or hedged transaction: the challenge in this area is around hedging of groups of items or transactions. Paragraphs 461 and 462 of Statement 133 seems to allow for flexibility in what could be included in the group, whereas interpretations by the FASB, SEC, and auditors seem to be overly exact in what could be included in the group.

d. Assessing effectiveness: entities struggle with when to use qualitative assessments versus quantitative assessments. Entities also struggle with how the credit aspect of the discount rate enters into the assessment process for instruments in which interest rate risk is being hedged.

e. Measuring the change in value attributable solely to the hedged risk in a fair value hedge: similar to the assessment challenges, entities struggle with how the cash flows and credit aspect of the discount rate should be incorporated into the measurement of the change in value attributable to interest rate risk.

f. Measuring ineffectiveness in a cash flow hedge and identification of a hypothetical derivative: there is difficulty in determining what features to include in the perfect hypothetical derivative.

g. Failure to meet the criteria for hedge accounting: entities are concerned about restatements for failing to meet strict hedge accounting rules when a good faith effort was made to implement the guidance.

3. Mr. Stoklosa then described possible approaches contemplated by the staff for accounting for hedging activities. Those approaches were:

   a. Not permitting hedge accounting.

b. Bifurcation-by-Risk Approach 1A: this approach would (a) continue to permit bifurcation-by-risk, (b) eliminate the shortcut method, and (c) broaden the concept of critical terms match to potentially include all hedging relationships.

c. Bifurcation-by-Risk Approach 1B: this approach would continue to permit bifurcation-by-risk but would eliminate the shortcut method, critical term match, and assessing effectiveness. This approach also would require independently measuring the hedging instrument and hedged item attributable to the hedged risk and would not require any entry or ongoing tests to qualify for hedge accounting.

d. Fair Value Approach (Approach 2): this approach would eliminate bifurcation-by-risk, the shortcut method, critical term match, and assessing effectiveness. The approach also would not require any entry or ongoing tests to qualify for hedge accounting and would require independently measuring the hedging instrument and hedged item for all changes in value.

4. Mr. Stoklosa said that to assist in identifying an approach for accounting for hedging activities, the staff developed the following objectives. He said that the staff believes incorporating these objectives into the decision process will help identify an approach for accounting for hedging activities that best reflects the economics of those activities.

   a. Resolve the identified practice issues

   b. Simplify accounting for hedging activities

   c. Improve financial reporting relating to hedging activities

   d. Address differences in accounting for derivative hedging instruments and hedged items or transactions.

5. Mr. Stoklosa asked the Board two questions:

a. Should the Board add to its agenda a project to address the accounting in Statement 133 for hedging activities?

b. If a project is added, should any of the above approaches not be pursued and developed by the staff ?

6. Mr. Stoklosa said that the staff recommends that the Board add a project to its agenda and that Approach 1A not be further developed. He stated that the staff believes that Approach 1A would not simplify hedge accounting and improve financial reporting in a manner that would justify reopening the accounting for hedging in Statement 133.

7. Mr. Batavick asked why the staff believes Approach 1A would not simplify hedge accounting. Mr. Stoklosa said that complex guidance is needed anytime there are choices in how to account for a particular instrument and that Approach 1A provides for two methods (critical terms match and individually measuring each instrument) of accounting for the same transaction. He also said that providing two methods of accounting for the same transaction does not improve financial reporting.

8. Mr. Linsmeier noted that many preparers are frustrated and have expressed the view that good-faith efforts to comply with Statement 133 are being second-guessed by auditors and regulators. He believed they would welcome a resolution of that uncertainty. He noted that Approach 1A does not resolve that tension because it provides for two methods of accounting for similar transactions.

9. Mr. Batavick questioned whether Approach 1B would be operational, and whether companies were able to readily measure changes in the fair value of hedged items attributable to specific risks. Mr. Stoklosa acknowledged the difficulty inherent in such measurements, and noted that the staff intended to provide additional measurement guidance as a part of Approach 1B.

10. Ms. Seidman questioned how Approach 2 differed from the application of the fair value option under Statement 159. Mr. Stoklosa noted that it would be similar, though Approach 2 would presumably apply to a broader range of instruments. Additionally, instruments within the scope of FASB Statement No. 159, *The Fair*

Value Option for Financial Assets and Financial Liabilities, would be precluded from applying fair value hedge accounting under Approach 2.

11. Mr Trott said that he believes the Fair Value Approach is the best solution for resolving practive issues and improving financial reporting. Additionally, he indicated how difficult it is in practice to separate changes in value due to changes in credit risk from the overall changes in value of assets and liabilities. Finally, he believes that eliminating bifurcation-by-risk would lead to more understandable financial statements, because the current approach leads to the reporting of assets and liabilities which lack a clear measurement attribute.

12. Ms. Seidman noted that the ability to dedesignate and redesignate hedging relationships creates a similar problem. Mr. Linsmeier questioned whether the staff had considered disallowing dedesignation and redesignation under any of the approaches. Mr. Stoklosa stated that the staff was considering all options at the current time.

13. Mr. Crooch believed that Approach 1A was potentially too complex to be a solution to current practice issues. He supported the staff's recommendation to pursue Approaches 1B and 2.

14. Mr. Young questioned the staff as to whether users expressed any views regarding hedge accounting, and what those views were. Mr. Stoklosa stated that the majority of users seemed to support a fair value approach, but preferred full fair value accounting for all financial instruments to any hedge accounting project at all.

15. Mr. Young specifically questioned whether users expressed a preference on cash flow hedges. Mr Stoklosa noted that users generally preferred no hedge accounting for forecasted transactions, though a minority desired some type of deferral and matching of gains/losses on the derivative with the consummation of the transaction.

16. Mr. Young questioned whether users supported a bifurcation-by-risk approach. Ms. Smith noted that a majority of users expressed a preference for full fair value method of hedge accounting, as mentioned previously, but that a minority would accept a

bifurcation-by-risk approach until the Board requires full fair value for all financial instruments.

17. Ms. Seidman noted that the upcoming meeting in June of the Investors' Technical Advisory Committee (ITAC) would be an ideal forum in which to discuss any potential hedge accounting approaches with other users.

18. Mr. Linsmeier noted that the Board, along with the IASB, planned on releasing a due process document by the end of the year regarding the ultimate goal of requiring all financial instruments to be accounted for at fair value. He noted that Approach 2 would put us a on path that more closely resembles the ultimate goal. Mr. Stoklosa agreed that Approach 2 was most consistent with both Boards' stated goal, but noted that Approach 1B was more consistent with the current accounting for derivatives under IFRS.

19. Mr. Trott said that Approach 2 was the only method that would significantly reduce complexity for all parties to the process. He noted that Approach 1B would mandate a modified version of the current measurement methodology, which has proven difficult to implement in practice. He further noted that disallowing a bifurcation-by-risk approach might prompt many companies to modify their hedging strategies if those companies were concerned about the financial statements reflecting unhedged risks.

20. Mr. Young believed that allowing or expanding a bifurcation-by-risk approach did not improve financial reporting. He questioned whether developing Approaches 1A or 1B would delay eventually achieving full fair value for all financial instruments.

21. Ms. Seidman expressed her concern over the potential resource drain that the Board and staff would incur by adding a project. She noted that the Board's long-term goal was achieving full fair value for all financial instruments. However, she doubted that would be possible without a comprehensive measurement framework for both financial and nonfinancial instruments. She believed that hedge accounting served an important role in the absence of such a framework. She preferred that the Board and staff not pursue wholesale changes to the hedge accounting model at this time, but

rather, try to work with the basic framework of Statement 133 and IAS 39 to make standards more principles-based and operational while the staff works on a comprehensive solution to the problem.

22. Mr. Herz believed that the current accounting system suffered from a major defect in that it was incapable of distinguishing in many circumstances between gains and losses due to flows of economic value between entities and those due to changes in fair values of assets and liabilities. He believed that each of the contemplated approaches offered certain advantages in terms of presenting some aspects of the economics of the transactions well, but that no single approach was perfect under the current framework.

23. Messrs. Crooch, Linsmeier, Trott, and Young voted to add an agenda project and preferred that the staff only develop Approach 2. After listening to the views of other Board members, Mr. Crooch altered his earlier vote.

24. Mr. Batavick voted to add an agenda project and preferred that the staff develop Approaches 1B and 2.

25. Messrs. Herz and Seidman voted to add a project and preferred that the staff develop all three proposed approaches.

26. Ms. Seidman questioned Mr. Smith as to how he would vote if given the opportunity. Mr. Smith stated that he would favor instructing the staff to pursue all three approaches. He further encouraged the Board to take steps to address the perceived shortcomings of Statement 133, in light of the overwhelming criticism of the complexity of the statement by many constituents.

27. Based on the views of the Board members, it was decided by a vote of 7-0 to add a project to the Board's agenda on accounting for hedging activities in Statement 133. Based on the views of four Board members, which represents a majority, the staff was instructed to develop only the Fair Value Approach at this time. In addition, the Board instructed the staff to prepare illustrative examples of both a bifurcation-by-

risk approach and a fair value approach for discussion with users at the June ITAC meeting.

Follow-Up Items:

None.

General Announcements:

None.