MINUTES

To:	Board Members
From:	Derivatives & Hedging Team (Cronin, ext. 443)
Subject:	Minutes of the February 15, 2006 Board Meeting: FASB Statement No. 133—Agenda Request (Various Topics)
Date:	February 23, 2006
cc:	FASB: Bielstein, Smith, MacDonald, Leisenring, Petrone, Polley, Gabriele, Project Team, Sutay, Carney, Mahoney, Intranet; GASB: Attmore, Bean

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Topic: FASB Statement No. 133—Agenda Request (Various Topics)

Basis for Discussion: Board Memorandum No. 1 dated January 26, 2006

Length of Discussion: 9:15 a.m. to 11:10 a.m.

Attendance:

Board members present: Batavick, Crooch, Herz, Schipper, Seidman, Trott, and Young

Staff in charge of topic: Belcher and Jacobs

Other staff at Board table: L. Smith, Golden, Lott, Wilkins, and Cronin

Outside participants: None

Summary of Decisions Reached:

The Board discussed whether to add various current practice issues related to the implementation of FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*, to its agenda. The Board decided to add the following issues to its agenda:

1. Whether a conversion option that incorporates foreign currency risk qualifies for the scope exception related to being indexed to the reporting entity's own stock, thereby precluding the need to bifurcate the entity's convertible debt.
2. 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 to be hedged in a cash flow hedge of foreign currency risk
3. Clarification of existing guidance as to when it is permissible to designate the risk of changes in cash flows attributable to the changes in the designated benchmark interest rate as the hedged risk in a cash flow hedge of a variable-rate financial asset or liability (for example, auction rate notes issued by a health care entity)
4. Clarification of existing guidance related to the application of the shortcut method.

The Board decided not to add a project to amend Statement 133 to permit the bifurcation-by-risk approach for both fair value and cash flow hedges of nonfinancial assets and liabilities.

Objective of Meeting:

The meeting's objective was for the Board to discuss whether to add to its agenda various current practice issues related to the implementation of Statement 133. This objective was met.

Matters Discussed and Decisions Reached:

1. Mr. Belcher stated that the FASB staff and the Board are made aware of current practice issues relating to the implementation of Statement 133, through the FASB's technical inquiry process and interactions with preparers, users, and the audit community. He noted that the majority of the issues related to Statement 133 that have arisen in the past few years have been resolved by constituents without formal guidance being issued by the FASB and have not

resulted, to the staff's knowledge, in a significant diversity in practice. Additionally, the staff and the Board have received formal and informal requests to amend certain aspects of Statement 133 to make its provisions easier to apply or to make the resulting accounting easier for users to understand.

2. Mr. Belcher noted that the meeting's purpose was to ask the Board to decide whether to add one or more of the following Statement 133 issues to its agenda:

- **Issue 1:** Whether foreign currency risk causes an embedded equity option in certain convertible debt instruments to no longer be considered indexed to that reporting entity's own stock
- **Issue 2:** Whether the proceeds from a forecasted issuance of debt denominated in a currency other than the reporting entity's functional currency is eligible for designation as a hedged transaction in a cash flow hedge
- **Issue 3:** Whether interest cash flows on variable-rate liabilities are explicitly based on an index that is not a benchmark interest rate
- **Issue 4:** Clarification of existing guidance related to the application of the shortcut method
- **Issue 5:** Whether to permit the bifurcation of risk for both fair value and cash flow hedges of nonfinancial assets and liabilities.

Mr. Belcher stated that the first four represent current practice issues, which the staff believes can be resolved in a relatively short timeframe by clarifying the Board's intent with respect to the application of those particular provisions of the Statement. The final issue relates to a formal request recently submitted to the FASB to amend Statement 133 with respect to the ability of a reporting entity to hedge components of a nonfinancial asset or liability.

Discussion of Issues 1 and 2

3. The Board unanimously agreed to add Issues 1 and 2. With regard to Issue 1, Mr. Trott stated that convertible debt carried at market value does not have foreign currency risk comparable to owning land in a foreign country that will likely be sold in a foreign currency. He noted that if confusion persists in this area, he would not object to addressing this issue in a Statement 133 Implementation Issue. Ms. Seidman agreed that the Board needs to address these prevalent practice issues; however, she remains open-minded as to what

the most appropriate format will be. She questioned if it might be appropriate to view this matter in a manner similar to paragraph 38 of Statement 133, which talks about the ability to hedge foreign currency risk in equity securities. She stated her preference to create guidance that is principle-based and will not unnecessarily restrict what is viewed as an economic hedging strategy.

Discussion of Issue 3

4. Mr. Belcher stated that Issue 3 involves designating a benchmark rate as the hedged risk in variable-rate liabilities. He stated that this issue is prevalent in the health care industry specifically with the use of auction rate notes. Mr. Jacobs noted that diversity in practice currently exists and that having the Board formally address this issue will ensure that entities will treat these instruments the same for hedging purposes. Mr. Trott noted that an analysis of existing literature clearly shows that an auction rate is not a benchmark interest rate. Mr. Jacobs agreed but added that confusion arises from a literal reading of the guidance in Statement 133, which states that the cash flows of the hedged transaction are not allowed to be explicitly based on an index that is different from the benchmark rate. These auction rate notes are not explicitly based on *any* rate, or index, but, instead, are based on an auction process.

5. Six Board members voted to have this item added to the agenda. Ms. Schipper noted that her affirmative vote is predicated on the staff addressing this issue as a specific and narrow implementation issue that is not intended to amend, alter, or change any aspect of Statement 133.

Discussion of Issue 4

6. Mr. Belcher stated that Issue 4 deals with the need for clarification of the application of the shortcut method in Statement 133. Mr. Batavick asked the staff if addressing this issue would represent an attempt to reduce complexity in a way that makes it easier for preparers to understand the application of the shortcut method. Mr. Golden stated that this project would represent an attempt to address existing confusion as to when an entity qualifies for the shortcut method.

Ms. Schipper clarified that the intent would not be to actually change the conditions that have to be met to qualify for the shortcut method but, instead, only to explain what some of the qualifying conditions mean. Messrs. Crooch and Trott voted not to add this issue to the agenda due to concern that it will likely expand well beyond a mere clarification of existing guidance.

7. Messrs. Batavick, Herz, and Young and Mses. Schipper and Seidman voted to add this project to the Board's agenda. Mr. Batavick supports adding this issue and is willing to give the staff some latitude to perform an initial analysis on the implementation of the shortcut method. Ms. Seidman voted to add this project because it has been a primary source of restatements, and she noted the importance of clarifying the ground rules going forward for qualifying for the shortcut method. Mr. Young does not support taking on a project simply for the purpose of preparer accommodation; however, he noted that a legitimate case can be made to address the issue of matching the principal amount.

Discussion of Issue 5

8. Mr. Jacobs stated that Issue 5 is an agenda request to hedge separate risks of nonfinancial assets and liabilities and that this request was previously rejected by the Board in May 2004. Messrs. Herz and Young and Ms. Seidman voted in favor of adding this project to the agenda. Mr. Young supported adding this project and noted his concern that the current accounting practice could affect management behavior in a way that would be detrimental to the capital markets and shareholder value. Mr. Herz agreed and noted that a non-neutral discriminatory basis has been created for hedge accounting with respect to financial and nonfinancial items. He stated that while there is a difference in physical aspects and because various basis risks are involved, many of these risks are market-based and are therefore able to be effectively hedged. Ms. Seidman stated that this issue represents another consequence of the mixed-attribute model. She noted the difficulty in justifying the different approach that Statement 133 pursues with respect to hedges of nonfinancial items versus financial risks, and believes that the application of this guidance creates a non-

level playing field. Ms. Seidman proposed addressing this issue either by permitting broader hedging under Statement 133 or by permitting a fair value option for some nonfinancial items.

9. Messrs. Batavick, Crooch, and Trott and Ms. Schipper voted against adding this project to the agenda. Ms. Schipper noted two options that would result in a level playing field for a hedging by risk approach: (a) expand this approach to include nonfinancial assets and liabilities or (b) prohibit hedging by risk for financial instruments. Ms. Schipper stated her reluctance to forge ahead with a decision to either expand or contract the hedging by risk approach without first considering the IASB's position, and stated that she does not support adding this project to the agenda based on an evaluation of the agenda acceptance criteria. Mr. Crooch agreed and stated three reasons for voting against the proposal to add the project: (a) no new information has been presented in this area that was not previously considered prior to the issuance of Statement 133, (b) a change from existing guidance would not be convergent with IASB standards, and (c) this topic should not take precedence over other topics to be considered by the Board. Mr. Trott noted that the scope of this potential project would likely be wider than a Statement 133 Implementation Issue and, therefore, would not choose to tie up the resources that would be necessary to take on such a project. Instead, he proposed to use the resources in this area to reduce the need for special hedge accounting and to more clearly communicate the impact of derivatives in the financial statements (for example, in the Board's project on derivative disclosures). He noted his preference to address issues around nonfinancial assets and liabilities within the discussion of phase two of the fair value option project.

Follow-up Items:

10. None.

General Announcements:

11. None.