REVISED MINUTES

Financial Accounting Standards Board

To: Board Members

From: Beneficial Interests Team (Hamilton, ext. 330)

Subject: Revised Minutes of the October 27, 2004 Board Meeting **Date:** November 1, 2004

cc: Bielstein, L. Smith, Petrone, Wilkins, Lott, E. Smith, Laurenzano, Hamilton, Varian, Bullen, Donoghue, Lusniak, Gagon, Hoermann, Thompson, Gabriele, Sutay, 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.

Topics:	Which instrument should be provided a fair value option: hybrid instruments with embedded derivatives requiring bifurcation or beneficial interests in securitized financial assets?
Basis for Discussion:	Board memorandum dated October 15, 2004
Length of Discussion:	9:00 a.m. to 9:30 a.m.
Attendance:	
Board members present:	Herz, Batavick, Crooch, Schipper, Seidman, Trott
IASB Board/Staff present:	None
Board members absent:	Schieneman, Leisenring
Staff in charge of topics:	E. Smith
Other Staff at Board table:	L. Smith, Lott, Wilkins, Laurenzano, Hamilton, Varian
Outside Participants:	None

Summary of Decisions Reached:

The Board decided that the fair value election previously discussed in this project should be applied to any hybrid instrument with embedded derivative features that would otherwise be required to be separated from the host contract and accounted for separately under FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*, rather than only to beneficial interests in securitized financial assets with embedded features that would otherwise require separate accounting as derivatives.

Objective of the Meeting:

The objective of the meeting was for the Board to decide which instrument should be provided a fair value option: hybrid instruments with embedded derivative features that would otherwise be required to be separated from the host contract or beneficial interests in securitized financial assets with embedded derivative features that would otherwise be required to be separated from the host contract.

Matters Discussed:

Mr. E. Smith stated that the objective of this project is to reconsider the interim guidance in Statement 133 Implementation Issue No. D1, "Application of Statement 133 to Beneficial Interests in Securitized Financial Assets," which provides that beneficial interests in securitized financial assets are not subject to the provisions of FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities.* He stated that the Board has tentatively decided that providing a fair value option for beneficial interests in securitized financial assets with embedded derivatives requiring bifurcation would be a practical alternative to constituent objections regarding the difficulties and consequences of bifurcating such instruments.

Mr. E. Smith stated that, at an education session on September 22, 2004, the staff proposed revised guidance relative to what constitutes a securitization. He stated that at the education session, certain Board members expressed support for a proposed alternative to the tentative decisions reached in the project. He stated that the proposed alternative would provide a fair value option to any hybrid instrument with an embedded derivative features that would otherwise be required to be separated from the host contract rather than to just beneficial interests in securitized financial assets with embedded derivative features that would otherwise be required to be separated from the host contract. Mr. E. Smith stated that the staff has evaluated this alternative and supports it.

Mr. E. Smith stated that this alternative provides a fair value reporting option for a broader population of interests. He stated that while treatment alternatives increase noncomparability and inconsistency, little incremental non-comparability and inconsistency should result from choosing this alternative considering the elective nature of FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities*; likewise, the elective nature of Statement 115 does not require restrictive criteria for choosing among alternatives as other elective accounting does.

Mr. E. Smith stated that this alternative also allows the Board to move ahead with the other projects related to FASB Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities,* servicing rights and qualifying special-purpose entities and isolation of transferred assets, without further delay as a result of this project. He advised Board members that there is a risk that decisions in this project could still impact Statement 140, specifically as it relates to the identification of embedded derivatives in beneficial interests and the qualified status of special-purpose entities. Mr. E. Smith recommended that the decision in this project to initially value retained interests at fair value be included in one of the other Statement 140 projects.

Mr. E. Smith stated that this alternative does not eliminate the need to consider whether to provide additional guidance on how beneficial interests in securitized financial assets should be evaluated to determine whether embedded derivative features that would otherwise be required to be separated from the host contract are present and that this issue will still need to be discussed by the Board.

Mr. E. Smith noted that choosing this alternative will satisfy constituents who have been recommending this approach for several years. He also noted that this alternative effectively encompasses part of the fair value option project that the Board added to its agenda in May.

Mr. E. Smith stated that the staff recommends that the Board approve providing a fair value option for hybrid instruments with embedded derivative features that would otherwise be required to be separated from the host contract.

Mr. E. Smith stated that additional issues, such as whether the election should be a policy election and how to amend paragraph 14 of Statement 140 and Statement 133, will still need to be discussed at future meetings.

Mr. Trott stated that when the fair value election was discussed in the past, specifically through amending paragraph 16 of Statement 133, Board members expressed concern that a derivative could be embedded in an asset or liability that would otherwise be carried at historical cost in order to achieve fair value measurement for those assets or liabilities. Mr. E. Smith acknowledged that, absent additional guidance provided by the Board, amending paragraph 16 of Statement 133 in the suggested manner would allow situations like this to occur, but commented that separate accounting for the embedded derivative would have to be required under the existing requirements of paragraph 12 of Statement 133 in order to achieve fair value measurement. Mr. E. Smith stated that either assets or liabilities could be structured to include embedded derivatives that would require bifurcation so that fair value accounting for the entire instrument could be obtained.

Ms. Schipper asked Mr. Wilkins to address when the Board created paragraph 12 of Statement 133, with reference to the scope exception provided in paragraph 16 of Statement 133, whether it was more concerned with the embedding of large derivatives in interests that are scoped out of applying Statement 133 in order to carry both the derivative and interest at amortized cost, or with the embedding of small derivatives in interests that are **not** scoped out of applying Statement 133 in order to measure such interests at fair value. Mr. Wilkins responded that during deliberations the Board was more concerned with the embedding of large derivatives in interests that are scoped out of applying Statement 133 in order to carry both the derivative and interest at amortized cost. Ms. Schipper stated that amending paragraph 16 of Statement 133 will provide a fair value option for **any** instrument that contains an embedded derivative.

Mr. Wilkins stated that if an embedded derivative is required to be bifurcated per the guidance provided in paragraph 12 of Statement 133, regardless of its size, the related instrument would be allowed to elect to measure the instrument and the embedded derivative at fair value based on the staff recommendation. Ms. Seidman stated that this issue could be addressed in the disclosures related to this project.

Mr. E. Smith recommended that the fair value option be provided only to hybrid financial instruments and not all hybrid instruments. Ms. Seidman stated that she would prefer that the decisions reached in this project apply to all hybrid instruments, specifically nonfinancial instruments with characteristics of financial instruments.

Mr. Herz asked if any Board members objected to the staff recommendation that the decisions reached in this project will apply to holders and issuers of hybrid instruments with embedded derivatives requiring bifurcation. No Board members objected. (Mr. Herz reported that Mr. Schieneman had indicated support for the staff's recommendation).

Ms. Schipper stated that she does not believe additional treatment alternatives should be introduced into the literature. However, in light of the Board's previous decision to introduce a treatment alternative for certain arrangements involving embedded derivatives, she does not object to the staff's recommendation to apply the treatment alternative to all hybrid instruments with embedded derivatives requiring bifurcation.

Mr. E. Smith stated that at a future meeting, he will present the Board with a memorandum that provides additional detail as to whether the election should be limited to apply only to hybrid financial instruments. He stated that he will also present information relative to the determination of what cash flows should be evaluated when determining how to apply paragraph 12 of Statement 133 to beneficial interests issued in a securitization transaction.

Mr. Trott requested that the staff provide, by memorandum, a revised project plan of the beneficial interests in securitized financial assets project.

Mr. Batavick asked Mr. L. Smith whether the staff intends to separately issue an Exposure Draft for this project and the other Statement 140 projects, servicing rights and qualifying special-purpose entities and isolation of transferred assets. Mr. L. Smith stated that, based on the Board's response to an administrative memorandum distributed in October, he believes that the projects should be exposed separately but issued concurrently.

Mr. Lott pointed out that the Board decided to pursue an amendment of paragraph 16 of Statement 133 because it could not reach agreement on the interests included in the scope of the term *beneficial interests in securitized financial assets.*

Mr. Trott stated that EITF Issue No. 99-20, "Recognition of Interest Income and Impairment on Purchased and Retained Beneficial Interests in Securitized Financial Assets," will need to be addressed at a future meeting, either in this project or in one of the other Statement 140 projects.

Follow-up Items:
Mr. E. Smith will deliver a revised version of the beneficial interests in securitized financial assets project plan to Board members for their review.

General Announcements:
None