MINUTES

Financial Accounting Standards Board

To:	Board Members
From:	Bennett, Ext. 229
Subject:	Minutes of the November 21, 2006 Board Meeting—Statement 133 Implementation Issue—Hedging Proceeds to Be Received from a Forecasted Foreign Currency Denominated Debt Issuance
Date:	November 29, 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 dated November 9, 2006
Length of Discussion:	9:00 to 9:15 a.m.

Attendance:

Board members present:	FASB: Batavick, Herz, Seidman, Trott, and Young; Crooch and Linsmeier (by phone) IASB: Leisenring
Staff in charge of topic:	Fanzini and Bennett
Other staff at Board table:	Smith, Golden, Stoklosa, Jacobs, and Wilkins

Summary of Decisions Reached:

The Board decided to proceed with the exposure of a proposed Statement 133 Implementation Issue: "Hedging Functional-Currency-Equivalent Proceeds to Be Received from a Forecasted Foreign-Currency-Denominated Debt Issuance." The proposed Implementation Issue will state that 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 **not** eligible to be hedged in a cash flow hedge of foreign currency risk because the forecasted transaction does not meet the criterion in paragraph 29(c) of FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities,* that the forecasted transaction (that is, the receipt of proceeds) presents an exposure to variations in cash flows for the hedged risk that could affect reported earnings. The Board directed the staff to proceed to a draft of a proposed Implementation Issue for vote by written ballot.

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 met.

Matters Discussed and Decisions Reached:

Background

1. Ms. Bennett stated that at the August 16, 2006 Board meeting, the staff presented the TA&I Committee's recommendation to the Board on the following question, which was added to the Board's agenda at the February 15, 2006 Board meeting:

> 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. Specifically, the staff asked if the receipt of foreign-currency-denominated proceeds to be received in a forecasted issuance of debt met the requirement in paragraph 29(c) of the Statement 133 cash flow hedging model that the forecasted transaction presents an exposure to variations in cash flows for the hedged risk (in this case, foreign currency risk) that could affect reported earnings.

2. Ms. Bennett noted that during the discussion at the August 16, 2006 Board meeting, there was some disagreement as to the application of paragraph 29(c) of the cash flow hedge model to this specific fact pattern. Due to this disagreement, the Board requested that the staff provide additional examples on the application of paragraph 29(c) and compare how those examples differ from the application in a hedge of the functional-currency-equivalent proceeds to be received in a forecasted issuance of foreign-currency-denominated debt. The Board suggested that the staff provide analyses of the issuance of a foreign-currency-denominated zero-coupon bond and a foreign currency interest-bearing financial instrument. Additionally, the Board requested that the staff provide a similar analysis for the purchase of a depreciable asset or debt security to demonstrate that consistent principles are being applied. The staff has provided the Board with the requested examples and the staff's analysis. The Board has held several small group meetings and an education session since the August Board meeting. Different views have arisen during those meetings:

a. Some Board members believe the issue in question meets the criterion in paragraph 29(c) because the forecasted transaction (that is, the receipt of proceeds) could affect reported earnings. Those Board members provided three different reasons:

   (1) Statement 52 transaction gains/losses once the debt has been recognized on the entity's books

   (2) Extinguishment gain/loss once the debt is a recognized liability

(3) The change in net cash flows received creates an **implied** discount or premium that should be amortized to interest expense over the life of the debt.

b. Other Board members believe that this transaction does not meet the criterion in paragraph 29(c). The currency risk does not impact the entity's reported earnings because future transaction gains or losses bear no relationship to the difference in functional-currency-equivalent proceeds received due to changes in exchange rates between the forecasted date and the issuance date. Those Board members noted that the functional-currency-equivalent difference in proceeds received does not impact earnings by the amount of the gain or loss on the derivative either through future foreign currency transaction gains or losses attributable to future exchange rate changes or interest expense. Additionally, 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. In addition, those Board members noted that in a hedge of interest rate risk, the variation in the proceeds received creates a premium or discount which is recognized on the entity's books. This premium or discount impacts earnings through the effective yield on the debt. In contrast, issuance of forecasted functional-currency-equivalent debt does not create a premium or discount and therefore does not impact earnings.

c. One Board member agreed with the staff that the issue in question is not eligible for cash flow hedge accounting, but **not** because the forecasted transaction does not meet the requirements in paragraph 29(c). Rather, that Board member believes that an entity cannot designate foreign currency risk as a **stand-alone risk** in this instance. That Board member believes that the net functional-currency-equivalent cash flows to be received upon future issuance of debt denominated in other than the functional currency will be affected by changes in two underlyings between the date the derivative is purchased and the date the debt is issued: (1) changes between the foreign currency and functional currency exchange rates and (2) changes in the interest rates of those two currencies (that is, it is the changes in interest rates that drive the changes in exchange rates).

3. Ms. Bennett asked if the Board believes that 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 the hedged transaction in a cash flow hedge of foreign currency risk. Specifically, does the Board believe that the forecasted transaction itself (that is, the receipt of proceeds) affects earnings as required under paragraph 29(c)?

Discussion of Implementation Issue

4. Mr. Batavick stated that in analyzing the basis for conclusions in Statement 133 and interpreting that Statement as it relates to paragraph 29(c), he believes that the guidance in Statement 133 supports the staff's analysis and recommendation. He agreed with the staff's analysis that the effect on reported earnings must be directly related to the forecasted transaction because the primary purpose of a cash flow hedge is to link a hedging instrument with a hedging transaction whose changes in cash flows are expected to offset each other when the hedged transaction affects earnings. Therefore, he agrees with the staff recommendation that the variability in functional-currency-equivalent proceeds attributable to foreign exchange risk that is to be received from 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. Messrs. Crooch, Trott, and Young agreed with Mr. Batavick.

5. Ms. Seidman stated that she disagrees with the staff's analysis and recommendation on this Issue. She believes that the forecasted issuance of a

debt instrument in a currency other than the reporting entity's functional currency does give rise to a risk that can result in an effect on earnings. She noted that paragraph 29(d) of Statement 133 states that the forecasted transaction cannot be the acquisition of an asset or the incurrence of a liability that will subsequently be remeasured with changes in fair value attributable to the risk being hedged if it is reported currently in earnings. She explained that there is a restriction against what types of items can be designated as the hedged item in a cash flow hedge and paragraph 29(d) is describing those forecasted transactions with changes in fair value. In the context of foreign currency hedges, paragraph 36 of Statement 133 describes the requirements to remeasure certain items at spot rates in earnings pursuant to FASB Statement No. 52, *Foreign Currency Translation.* Paragraph 36 further states that the criteria in paragraph 29(d) are not impediments to a foreign currency cash flow hedge of a forecasted incurrence of a foreign-currency-denominated liability whose carrying amount will be remeasured at spot rates in accordance with Statement 52. Therefore, she believes that in assessing a specific type of remeasurement (that is, a remeasurement to spot rate pursuant to Statement 52), the Board that cleared Statement 133 was stating that partial remeasurement will not disqualify foreign-currency-denominated debt instruments from being eligible as the hedged item in a cash flow hedge. Ms. Seidman noted that remeasurement is one risk associated with foreign-currency-denominated debt instruments, but there are other types of risks that would give rise to an earnings effect. Hence, she believes that the requirement in paragraph 29(c) is met and she disagrees with the staff that the earnings effect from the hedged items needs to relate to the cash flows that are being hedged. The effectiveness of the cash flow hedge is assessed based on whether the derivative provides offsetting cash flows related to the risk being hedged. There is no requirement that the derivative's gain or loss relates directly to the income statement effect on the hedged item. Ms. Seidman concluded by stating that she would permit the forecasted transaction in this Issue to qualify for hedge accounting provided that the transaction meets the other criteria in Statement 133. She added that she would allow practitioners to apply judgment in identifying effective strategies in implementing paragraph 30(d) of Statement 133 relating to the reclassification of the gain or loss from the hedging derivative out of other comprehensive income. She believes that it would be inappropriate for the Board to prescribe requirements for qualifying for hedge accounting in this Issue. Mr. Herz agrees with Ms. Seidman. He added that he believes the Board should not be addressing these types of narrow issues.

6. Mr. Linsmeier stated that he generally agrees with Ms. Seidman and believes that the requirement in paragraph 29(c) has been met because there could be an earnings effect based on the three reasons as stated by Ms. Bennett. However, he noted that in order to qualify for hedge accounting in this Issue, an entity would need to designate the appropriate risk that is being hedged, which should be the overall risk of the cash flow variability, and the entity would also be required to apply the effectiveness test. Therefore, he disagrees with the staff's analysis.

7. Mr. Fanzini asked and noted that the three dissenting Board members would be including an alternative view in the proposed Implementation Issue. Ms. Bennett asked if the Board approves the issuance of the proposed Statement 133 Implementation Issue for a 35-day comment period (all Board members agreed). Ms. Bennett asked if the Board agrees with the staff that this 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. Additionally, she asked if the Board agreed that the effective date for this 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. All Board members agreed with the transition and effective date.

Follow-Up Items:

8. Draft proposed Implementation Issue for vote by written ballot.

General Announcements:

None.