Board Meeting Handout
STATEMENT 133 HEDGING

December 20, 2007

PURPOSE

The purpose of this meeting is to discuss (a) the fair value hedging approach in the context of foreign currency hedges, (b) what is meant by dedesignation for cash flow and fair value hedges, (c) how amounts in OCI would be reclassified to earnings upon dedesignation, termination, and occurrence of the forecasted transaction in cash flow hedging situations, (d) what disclosures would be required, and (e) effective date and transition.

FOREIGN CURRENCY HEDGES

FASB Statement No. 52, *Foreign Currency Translation*, creates the need for an exception to the proposed fair value approach to hedge accounting. As a result, the staff is proposing the following for foreign currency hedging.

Foreign Currency Fair Value Hedges

a. An entity may designate a fair value hedge of an unrecognized firm commitment or a recognized asset or liability (including an available-for-sale security). This is consistent with the current guidance in Statement 133 for foreign currency fair value hedges.

b. Except for an entity designating its own issued debt as the hedged item, the risk being hedged is (1) the risk of changes in the overall fair value of the hedged item or (2) the risk of changes in fair value attributable to changes in the related foreign currency exchange rates. The ability to designate a

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combination of individual risks, such as interest rate risk and foreign currency exchange risk, or credit risk and foreign currency exchange risk, would not be permitted. For an entity designating its own issued debt at inception, the risk being hedged is (1) the risk of changes in the overall fair value of the hedged item, (2) the risk of changes in fair value attributable to changes in the related foreign currency exchange rates, or (3) the risk of changes in fair value attributable to changes in both foreign currency exchange risk and interest rate risk.

Foreign Currency Cash Flow Hedges

a. An entity may designate a cash flow hedge of an unrecognized firm commitment, a forecasted transaction, the forecasted functional-currency-equivalent cash flows associated with a recognized asset or liability, or a forecasted intercompany transaction. This is consistent with the current guidance in Statement 133 for foreign currency cash flow hedges.

b. Except for an entity designating variability in cash flows associated with its own issued debt as the hedged transaction, the risk being hedged is (1) the risk of **overall** changes (variability) in the hedged future cash flows or (2) the risk of changes in the functional-currency-equivalent cash flows attributable to changes in the related foreign currency exchange rates. The ability to designate a combination of individual risks, such as interest rate risk and foreign currency exchange risk, or credit risk and foreign currency exchange risk, would not be permitted. For an entity designating variability in cash flows associated with its own issued debt as the hedged transaction, the risk being hedged is (1) the risk of **overall** changes (variability) in the hedged future cash flows, (2) the risk of changes in the functional-currency-equivalent cash flows attributable to changes in the related foreign currency exchange rate, or (3) the risk of changes in the functional-currency-equivalent cash flows attributable to changes in the related foreign currency exchange rate and the benchmark interest rate.

Foreign Currency Net Investment Hedges

a. The staff is not recommending any changes to the current guidance in Statement 133 related to net investment hedges.

Question for the Board

Does the Board agree with the proposed foreign currency hedge accounting model?

DEDESIGNATION OF HEDGING RELATIONSHIPS AND RECLASSIFICATION OF OCI AMOUNTS

Statement 133 currently allows prospective discontinuation of hedge accounting for both fair value and cash flow hedges if the entity removes the designation of the hedging relationship. Under Statement 133, hedge accounting is discontinued prospectively in the following circumstances:

a. The requirements for hedge accounting are no longer met, that is:

    (1) For fair value hedges, the hedged item is derecognized (though settlement, sale, etc.) or the hedging relationship no longer meets the effectiveness threshold

    (2) For cash flow hedges, the hedged transaction is no longer probable of occurring or the hedging relationship no longer meets the effectiveness threshold

b. The derivative expires or is sold, terminated or exercised

c. The entity removes the designation of the hedge.

Currently, all of the above circumstances in which hedge accounting is discontinued have been considered a dedesignation event. The staff is proposing classifying the above circumstances into two categories. The first category is *terminated hedges* and the circumstances in a and b above would fall into this category. The second category is *dedesignated hedges* and the circumstances in c above would fall into this category.

Cash Flow Hedges

For situations that fall within the terminated hedges category, the staff believes there are no issues or concerns with the existing Statement 133 guidance, and therefore, recommends no changes to that existing guidance.

For situations in which an entity currently is permitted to discontinue hedge accounting by removing the designation of the hedge (dedesignated hedge), the issue is whether that type of discontinuance should be permitted. The staff is presenting two alternatives for Board members consideration.

a. Alternative 1 would permit entities to dedesignate cash flow hedge accounting and account prospectively for gains and losses on the derivative through earnings.

   Under this alternative there are two approaches for reclassifying the gains and losses that occurred on the hedging instrument during the hedged period and that were deferred in OCI. One approach would require the gains and losses to remain in OCI until the hedged transaction impacts earnings (current Statement 133 approach). The second approach would require those deferred gains or losses to be reclassified to earnings upon dedesignation. Based on previous decisions to permit late hedging, an entity would be permitted to designate a new hedging relationship using the derivative that was formerly designated as the hedging instrument in the dedesignated hedging relationship.

b. Alternative 2 would not permit entities to dedesignate cash flow hedge accounting.

The staff recommends Alternative 2 and that the Board should eliminate the ability to dedesignate cash flow hedge accounting through removing the hedge designation. If, however, the Board decides that dedesignation should be permitted (Alternative 1), the staff recommends that the gains and losses remain in OCI until the hedged transaction impacts earnings (current Statement 133 approach).

Question for the Board

Should entities be permitted to discontinue cash flow hedge accounting by removing the designation of the hedge (i.e. dedesignating the hedge)? If yes, how should reclassification from OCI occur?

Reclassification of Amounts in OCI

For cash flow hedges, Statement 133 currently requires that amounts in OCI be reclassified to earnings when the hedged transaction impacts earnings. Additionally, if the hedged transaction becomes probable of not occurring, amounts in OCI are reclassified to earnings and disclosed. An issue has arisen between the OCI reclassification guidance in Statement 133 and FASB Statement No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities*. It is necessary to consider the appropriate accounting if an entity designates a derivative as hedging variability in the cash flows associated with the anticipated issuance or purchase of a financial instrument and then subsequently elects the fair value option upon initial recognition of the instrument.

For items that are not eligible for the fair value election, the staff proposes to retain the guidance in Statement 133 as it relates to reclassification of amounts in OCI.

For a forecasted issuance of debt that is eligible for the fair value option upon its issuance, the staff is proposing three alternatives for accounting for the gains and losses that occurred on the hedging instrument during the hedged period and were deferred in OCI.

a. If an entity elected the fair value option upon the issuance of the debt, Alternative 1 would require that gains and losses be immediately reclassified to earnings and disclosed.

b. Alternative 2 would require the entity to determine how the instrument would have impacted earnings if the fair value option was not elected and reclassify the amounts from OCI based on that schedule.

c. Alternative 3 would require entities to make a decision on the date the entity designates the hedging relationship to not elect the fair value option for the debt upon its issuance.

The staff recommends Alternative 3. Alternative 3 avoids the potential earnings manipulation issue that exists in Alternative 1 and the need to reclassify on a scheduled basis under Alternative 2.

Question for the Board

Which alternative does the Board support?

Fair Value Hedges

For situations that fall within the terminated hedges category, the staff recommends no changes to the existing guidance in Statement 133. That is, upon the termination event, special fair value hedge accounting would not be permitted prospectively.

For situations in which an entity is currently permitted to discontinue hedge accounting by removing the designation of the hedge (dedesignated hedge), the issue is whether that type of discontinuance should be permitted. The staff is presenting two alternatives for Board member consideration.

a. Alternative 1 would permit entities to dedesignate fair value hedge accounting and prospectively cease adjusting the hedged item for changes in fair value.

b. Alternative 2 would not permit entities to dedesignate fair value hedge accounting.

The staff recommends Alternative 2 and that the Board should eliminate the ability to suspend fair value hedge accounting through removing the hedge designation. The staff also believes there should be consistency between the dedesignation guidance for cash flow hedges and fair value hedges.

Question for the Board

Should entities be permitted to discontinue fair value hedge accounting by removing the designation of the hedge (i.e. dedesignating the hedge)?

DISCLOSURES

The staff is presenting two disclosures for the Board to consider. The first is a tabular disclosure that would help users better understand the impact of adjusting the carrying amount of fair value hedged items. The proposed table is included in the Appendix. For each balance sheet line item, it provides a reconciliation between the carrying value at the end of the reporting period and what the carrying value would have been prior to any cumulative fair value adjustments.

The second disclosure relates to situations in which an entity hedges its own debt in a fair value hedge or cash flow hedge. When an entity synthetically creates variable-rate debt by issuing fixed-rate debt and entering into a receive fixed/pay variable interest rate swap or synthetically creates fixed-rate debt by issuing variable-rate debt and entering into a receive variable/pay fixed interest rate swap, information about that synthetically created debt would be useful to users. The staff is proposing that an entity be required to disclose, as part of their debt disclosure, (a) that it uses derivative contracts (interest rate swaps) to convert a portion of its fixed rate debt to variable rate debt and variable rate debt to fixed rate debt, (b) how the maturity structure of the derivatives correspond to the maturity structure of the debt being hedged, and (c) the overall weighted average interest rate on a contractual basis and including the effects of derivatives.

Questions for the Board

Should the proposed table be included as a disclosure requirement in this project?

Should entities be required to disclose, as part of their debt disclosure, the information proposed in the above paragraph?

EFFECTIVE DATE AND TRANSITION

The staff is proposing that the proposed Statement would be effective for all fiscal years beginning after November 15, 2008. Upon initial application, all hedging relationships (except as indicated in the next sentence) would be dedesignated and a new hedging relationship (with an appropriate perfect derivative for a cash flow hedge) would be designated pursuant to the provisions of the proposed Statement. Hedging relationships in which an entity is hedging its own debt and for which only interest rate risk or interest rate risk and foreign currency risk is designated as the risk(s) being hedged do not have to be dedesignated upon initial adoption. Earlier application would not be permitted.

Question for the Board

Does the Board agree that the proposed Statement should be effective for fiscal years beginning after November 15, 2008 and that earlier application not be permitted?

Transition

The staff recommends that prospective application be required for fair value hedges and hedges of an entity's own debt and that limited retrospective application be required for cash flow hedges.

Questions for the Board – Should (1) prospective application of the guidance in the proposed Statement be required for fair value hedges and (2) limited

retrospective application of the guidance in the proposed Statement be required for cash flow hedges?

Fair Value Option Election

An entity may not qualify for or may not designate a new fair value hedging relationship after dedesignating a fair value hedging relationship upon the initial adoption of the proposed Statement. As a result, the staff recommends that a one-time fair value option election be permitted for all eligible assets and liabilities at the date of initial application of the proposed Statement.

Question for the Board

Should a one-time fair value option election be permitted at the initial adoption of the proposed Statement, and if so, should it be permitted for (1) eligible assets and liabilities currently hedged under Statement 133 or (2) all eligible assets and liabilities?

Appendix

Cumulative Adjustment of Hedged Items in Statement 133 Fair Value Hedges

In millions of dollars	Assets							
As of December 31	2009				2008			
	Balance Sheet Amount	Statement 133 Cumulative Fair Value Adjustments	All Other Fair Value Adjustments	Amount Prior to Cumulative Fair Value Adjustments	Balance Sheet Amount	Statement 133 Cumulative Fair Value Adjustments	All Other Fair Value Adjustments	Amount Prior to Cumulative Fair Value Adjustments
Line Items That Include Fair Value of Hedged Items under Statement 133								
Inventory	XX,XXX	XX,XXX	XX,XXX	XX,XXX	XX,XXX	(XX,XXX)	(XX,XXX)	XX,XXX
Fixed-rate loans	XX,XXX	XX,XXX	XX,XXX	XX,XXX	XX,XXX	XX,XXX	XX,XXX	XX,XXX
Firm Commitments	XX	XX	XX	$0	XX	XX	XX	$0
Other Assets	XX,XXX	(XX,XXX)	(XX,XXX)	XX,XXX	XX,XXX	XX,XXX	XX,XXX	XX,XXX
Total	XX,XXX	XX,XXX	XX,XXX	XX,XXX	XX,XXX	XX,XXX	XX,XXX	XX,XXX

In millions of dollars	Liabilities							
As of December 31	2009				2008			
	Balance Sheet Amount	Statement 133 Cumulative Fair Value Adjustments	All Other Fair Value Adjustments	Amount Prior to Cumulative Fair Value Adjustments	Balance Sheet Amount	Statement 133 Cumulative Fair Value Adjustments	All Other Fair Value Adjustments	Amount Prior to Cumulative Fair Value Adjustments
Line Items That Include Fair Value of Hedged Items under Statement 133								
Fixed-rate Debt	XX,XXX	(XX,XXX)	(XX,XXX)	XX,XXX	XX,XXX	XX,XXX	XX,XXX	XX,XXX
Other Liabilities	XX,XXX	XX,XXX	XX,XXX	XX,XXX	XX,XXX	(XX,XXX)	(XX,XXX)	XX,XXX
Total	XX,XXX	XX,XXX	XX,XXX	XX,XXX	XX,XXX	XX,XXX	XX,XXX	XX,XXX

Financial Accounting
Standards Board

Board Meeting Handout
Statement 133 Implementation Issue E23
December 20, 2007

At the December 20, 2007 meeting, the Board will decide whether to issue final guidance on the proposed Statement 133 Implementation Issue No. E23: Issues Involving the Application of the *Shortcut Method* under Paragraph 68 (ED), and if so, begin redeliberation of significant issues raised in the comment letters. Issues to be discussed include applying the shortcut method to:

a. Swaps that have a non-zero fair value at inception, as long as the difference between the transaction price (zero) and the fair value (exit price), as defined by FASB Statement No. 157, *Fair Value Measurements*, is solely attributable to a bid-ask spread (Paragraph 68(b))

b. Hedging relationships beginning after the inception of the hedged item (Paragraph 68(e))

c. Hedged items that have a settlement date subsequent to the swap trade date (Paragraph 68(b))

d. Hedged items that are subject to principal pay-downs prior to maturity (Paragraph 68(a))

e. Swaps and hedged items that are a) typical and b) do not invalidate the assumption of no ineffectiveness (Paragraph 68(e))

f. Hedged items with discounts or premiums at inception of the hedging relationship attributable solely to the market convention of rounding the coupon rate (Paragraph 68(e))

g. Hedged items that are zero-coupon financial instruments (Paragraph 68(e))

The Board will also discuss possible transition guidance to be provided upon issuance of Issue E23.

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