**MINUTES**

Financial Accounting Standards Board

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| **To:** | Board Members | | |
| **From:** | Murphy (ext. 208) | | |
| **Subject:** | Minutes of the June 1, 2005 Board Meeting: Proposed FSP Relating to Statement 133 | **Date:** | June 6, 2005 |
| **cc:** | Bielstein, L. Smith, Petrone, Fair Value Team, Revenue Recognition Team, Business Combinations Team, Polley, Gabriele, Getz, Mahoney, Sutay, Leisenring (IASB), J. Paul (IASB), G. Ryltsova (IASB), P. Martin (CICA), 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.*

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| Topic: | Agenda Decision: Proposed FSP relating to Statement 133 |
| Basis for Discussion: | Memorandums dated May 19, 2005, and May 30, 2005, and audience handout (attached) |
| Length of Discussion: | 10:00 a.m. to 11:00 a.m. |

Attendance:

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| Board members present: | FASB: Crooch, Herz, Schipper, Seidman, Trott, and Young<br>IASB: Leisenring |
| Board members absent: | Batavick |
| Staff in charge of topic: | MacDonald |
| Other staff at Board table: | Bielstein, Lott, McBride, Murphy, E. Smith, L. Smith, Thuener, and Wilkins |
| Outside participants: | None |

**Summary of Decisions Reached**

The Board decided to add a project to its agenda to issue a FASB Staff Position (FSP) relating to derivative contracts that are marked-to market under FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*. The project will reconsider the guidance in EITF Issue No. 02-3, “Issues Involved in Accounting for Derivative Contracts Held for Trading Purposes and Contracts Involved in Energy Trading and Risk Management Activities,” in the context of the guidance developed to date in its fair value measurement project. The Board discussed but did not reach any decisions on the project issues. The Board plans to discuss those issues at a future meeting.

**Objective of Meeting**

The primary objective of the meeting was to decide whether to add a project to the Board’s agenda to issue a FSP relating to derivatives that are marked-to-market under Statement 133.

**Matters Discussed and Decisions Reached**

1. Ms. MacDonald said that many respondents to the FVM ED raised significant issues relating to the guidance in Issue 02-3 and its interaction with the related guidance developed by the Board to date. She said that those issues are pervasive. Specifically, because the guidance in Issue 02-3 does not address subsequent accounting (fair value remeasurements and revenue recognition), the practice that has evolved under Issue 02-3 is diverse. She added that as a basis for resolving those issues, alternative solutions are possible that are technically feasible.

2. Ms. MacDonald said that the staff recommends that the Board add a project to its agenda to address those issues. In that regard, she emphasized that the issues themselves are significant. Moreover, addressing those issues in the context of the guidance developed by the Board to date in the FVM Statement will, in effect, allow the Board an opportunity to “test” key aspects of that guidance before issuing a final FVM Statement.

3. All Board members agreed with that staff recommendation.

**Significant Project Issues**

4. Ms. MacDonald said that the significant project issues and possible approaches for resolving those issues are outlined in the audience handout. She explained that the staff is not asking the Board to reach decisions on any of those issues. However, as a basis for moving forward, the staff seeks preliminary Board views on all (or some) of those issues.

5. Ms. Schipper said that at initial recognition, the transaction price provides evidence of the fair value of the arrangement, not necessarily the fair value of the instrument. Thus, the threshold question is whether at initial recognition, the fair value of the arrangement also represents the fair value of the instrument, such that the transaction price, not the entity's estimate using a model, should be used to estimate the fair value of the instrument.

6. In response, Ms. Schipper said that a difference between the transaction price and the entity's estimate would provide evidence that the transaction is, in effect, a multiple elements transaction that, in addition to the instrument, includes an incremental profit (revenue) element. By way of example, she referred to a situation where the instrument is highly structured (complicated and difficult to put together). She explained that in that situation, the transaction would include two separate elements, specifically (a) a revenue element that, at least in part, reflects the effort and expertise required to create the instrument and put the transaction together and (b) the instrument itself.

7. Ms. Schipper indicated that where the transaction is a multiple elements transaction, the entity's estimate should be used to estimate fair value (at initial recognition and in all subsequent periods). She clarified that at initial recognition, the entity's estimate does not explicitly "rebut" the transaction price presumption because the transaction price and the entity's estimate measure different things (the arrangement in its entirety versus the instrument).

8. Ms. Schipper said that the difference between the transaction price and the entity's estimate (the revenue element) should be recognized in earnings at

initial recognition. At the same time, however, she acknowledged the Board's concerns about measurement error with respect to the revenue element in the absence of other similar arrangements where the measurement error is not centered on zero (having a wide dispersion), in other words, concerns about recognizing a revenue item that might include substantial measurement error.

9. As a compromise, Ms. Schipper said that a minimum reliability threshold could be applied for purposes of determining when to recognize the revenue element (whether at initial recognition or in a subsequent period). In that case, the difference between the transaction price and the entity's estimate (revenue element) at initial recognition would be deferred (held some place) until such time as information becomes available that indicates how much of that difference, if any, is measurement error. She noted that the alternative would be to amortize the difference into earnings over the term of the instrument. However, she said that she does not support that approach because the only way to deal with measurement error is to obtain more information, not systematically allocate it to different periods.

10. Ms. Schipper emphasized that compromise approach (minimum reliability threshold approach) lacks conceptual basis (is suboptimal), referring to an earlier staff memorandum discussed by the Board in it's separate revenue recognition project that advised against imposing asymmetric reliability thresholds on revenue recognition. She said that based on the reasoning in that memorandum, it would be appropriate to recognize revenue at inception of the instrument if the arrangement contains a separate revenue element at inception and the entity has "performed." However, in the interest of achieving consensus on the issues, she would agree to move forward along those lines.

11. More specifically, Ms. Schipper said that she would support the approach in paragraph 2(b)(1) of the audience handout, emphasizing that the minimum reliability threshold would only apply for purposes of determining when to recognize the revenue element, not for purposes of determining how to estimate fair value.

12. Ms. Schipper said that in all subsequent periods, she would require the instrument to be remeasured at fair value like all other derivative instruments under Statement 133. She clarified that the issues in this FSP project relate only to a class of derivative instruments under Statement 133 that give rise to potential revenue recognition at inception (initial recognition), not all derivative instruments. Thus, the issue is not about a minimum reliability threshold for derivatives. Rather, it is about a minimum reliability threshold for revenue recognition. Accordingly, it is important that the Board separate the revenue piece of this problem from the derivative piece of this problem and continue to require any arrangement that qualifies as a derivative to be measured like any other derivative. She said that if the Board has concerns about reliability, it should communicate those concerns directly, that is, as concerns about the reliability of revenue.

13. With respect to where within the fair value hierarchy a minimum reliability threshold (for purposes of revenue recognition) should fall, Ms. Schipper contrasted contemporaneous proxies (valuation models) that provide information that is relatively verifiable, and long-dated extrapolations or forecasts that are more difficult to verify without contemporaneous proxies because one does not know the thing that is forming the input with the same degree of likely agreement. She suggested that in exploring a minimum reliability threshold approach, the Board draw a line between contemporaneous proxies and long-dated extrapolations.

14. Mr. Trott agreed with Ms. Schipper. He said that going forward, the substantial improvements made through the FVM Statement would mitigate the reliability dilemma (the definition of fair value, as clarified, and the enhanced disclosures about fair value remeasurements, in particular, disclosures about valuation techniques and the effect of certain fair value remeasurements on earnings).

15. Mr. Trott said that in view of those improvements going forward, he is reluctant to impose a minimum reliability threshold. He added that in the context of the conceptual framework, imposing a minimum reliability threshold only when

net assets are increased, and not reduced, is not neutral. However, he said that like Ms. Schipper, in the interest of achieving consensus on the issues, he would agree to move forward along those lines, provided that a minimum reliability threshold applies only for purposes of determining when to recognize the difference between the transaction price and the entity's estimate (revenue element) in earnings. In that regard, Mr. Trott emphasized the need for an approach that would do the least "harm" to Statement 133. To him, the compromise approach would achieve that objective. Specifically, it would hold (freeze) the revenue element and mark the derivative to market using the model value, that is, remeasure and recognize all changes in fair value in earnings as currently under Statement 133 ("freeze and remeasure approach").

16. Similarly, Mr. Crooch said that his starting point in considering this issue is that under Statement 133, all derivatives are required to be measured at fair value with changes in fair value recognized in earnings, irrespective of where within the fair value hierarchy the estimate falls. In other words, the estimate must represent the best estimate of the derivative in the circumstances.

17. Mr. Herz agreed that one could interpret the approach in Issue 02-3 as forcing measurements that are not fair value measurements, but said that in his view, the initial (Day 1) fair value estimate is "approximately" correct. However, in the absence of direct or observable market inputs (the standard of reliability in Issue 02-3), he would be willing to consider other persuasive evidence as rebutting the transaction price presumption. In that regard, he referred to other market-based evidence described by some constituents, where data is so highly correlated with the instrument being measured that logical and convincing connections can be made between that data and the instrument.

18. Mr. Trott asked Mr. Herz to clarify his views with respect to fair value estimates in subsequent periods. Mr. Herz responded that in subsequent periods, he is leaning toward the "freeze and remeasure approach," but is unclear at what point the deferred revenue element would be "relieved." He said that he needs to consider further the ability to fully value all aspects of the instrument at initial recognition. He added, however, that he would not support

the alternative whereby the difference would be amortized into earnings over the term of the instrument unless the amortization somehow reflected an element of discernable value change.

19. Ms. Seidman agreed with Mr. Herz that in the absence of direct or observable market inputs (the standard of reliability in Issue 02-3), persuasive evidence that would rebut the transaction price presumption might include other market-based evidence. However, she indicated that at least preliminarily, she believes that same evidence should be used in subsequent periods for purposes of determining whether to update the initial fair value estimate and recognize the corresponding changes in earnings. She clarified that the transaction price presumption would not be rebutted at initial recognition or updated in subsequent periods in the absence of such market data. In other words, an entity would not mark the derivative to market within the lowest level of the fair value hierarchy using entity-based inputs.

20. Mr. Leisenring expressed concerns about a mark-to-market approach that would ignore information obtained from entity-based inputs. He said that would be contrary to the requirements of Statement 133, which requires a "best" estimate of fair value in the circumstances. Moreover, the practical effect would be to "freeze" fair value estimates for the more risky and volatile derivative contracts, forcing a measurement other than fair value. Ms. Seidman clarified that at this time, she believes that an estimate based on a transaction price that is updated only where market data provides evidence of a change is a "best" estimate of fair value in the circumstances.

21. Mr. Young did not express his views on this issue.

**Follow-up Items:**

22. None.

**General Announcements:**

23. None.

Financial Accounting Standards Board

**Board Meeting Handout**

ATTACHMENT

**PROPOSED FSP RELATING TO STATEMENT 133**
**June 1, 2005 Board Meeting**

## AGENDA DECISION

The Board will discuss whether to add to its agenda a project to issue a FASB Staff Position (FSP) relating to derivative contracts that are marked-to market under FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*, including those under EITF Issue No. 02-3, "Issues Involved in Accounting for Derivative Contracts Held for Trading Purposes and Contracts Involved in Energy Trading and Risk Management Activities."

## SIGNIFICANT PROJECT ISSUES

If applicable, the Board will consider significant project issues and possible approaches for discussion at a future meeting.

### 1. Initial Fair Value Estimate and Revenue Recognition

The threshold issues relate to the initial fair value estimate and revenue recognition. Specifically:

a. Whether at initial recognition, the transaction price presumption is rebutted by the model value and, if so, whether the model value should be used for the initial fair value estimate

b. Whether the difference between the transaction price and the model value (dealer profit) should be recognized in earnings (1) in all cases or (2) only in some cases, for example, if a minimum reliability threshold is met. As a basis for applying a minimum reliability threshold approach, the Board will consider possible clarifications to the fair value hierarchy (attached).

### 2. Subsequent Fair Value Estimate and Revenue Recognition

Related issues relate to subsequent changes in fair value and revenue recognition with respect to dealer profit (if any) that is deferred. Specifically:

a. Whether the initial fair value estimate should be updated for changes indicated by the model value (1) in all cases or (2) only in some cases, for example, if a minimum reliability threshold is met for the related model input

b. Whether dealer profit, if any, that is deferred at initial recognition should be subsequently recognized in earnings using (1) a minimum reliability threshold approach or (2) an amortization approach.

**POSSIBLE CLARIFICATIONS TO FAIR VALUE HIERARCHY**

Possible clarifications to the fair value hierarchy discussed by the Board in the fair value measurement project follow as a basis for considering initial and subsequent fair value estimates.

**Level 1**—Quoted prices for identical assets or liabilities in active markets

**Level 2**—Quoted prices for similar assets or liabilities in active markets, adjusted as appropriate for differences between the asset or liability and the similar assets or liabilities

**Level 3 (as would be clarified)**—Other observable market inputs that relate directly to the asset or liability (direct market inputs), including correlation or implied measures that can be directly observed over the full term of the asset or liability (Level 3 would allow for little, if any, extrapolation)

**Level 4 (as would be clarified)**—Substantive objective evidence developed from market-based inputs that relate either directly or indirectly to the asset or liability (indirect market inputs), including correlation or implied measures that are corroborated by market-based inputs over the full term of asset or liability (Level 4 would allow for extrapolation, but only if corroborated by market-based inputs)

**Level 5 (as would be added)**—Entity-based inputs reflecting the entity’s own internal estimates and assumptions (in limited situations in which quoted prices in active markets and both direct and indirect market inputs are not available).