

REVISED MINUTES



To: Board Members

From: Salo, ext. 312

Subject: Minutes of May 5, 2004 Board Meeting

Date: May 17, 2004

cc: Bielstein, Smith, Petrone, Polley, Swift, Leisenring, Sutay, Thompson, Gabriele, Intranet, Project Team

Topic: Derivatives and Hedging: Agenda Decision regarding Request to Be Able to Bifurcate Hedged Risks for Nonfinancial Assets and Liabilities

Basis for Discussion: Memorandum dated April 21, 2004

Length of Discussion: 1:50 p.m. to 2:05 p.m.

Attendance:

Board members present: Herz, Batavick, Crooch, Schieneman, Schipper, Seidman, Trott

Board members absent: None

Staff in charge of topic: Wilkins

Other staff at Board table: Smith, Golden, Laurenzano, Salo

Outside participants: None

Summary of Decisions Reached:

The Board discussed a request to amend FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*, to permit (a) hedging entities to designate the risk of changes in only certain aspects of a nonfinancial asset's fair value as the hedged risk in a fair value hedge and (b) a similar bifurcation of risks

for cash flow hedge accounting related to nonfinancial assets. The Board directed the staff to obtain more information from the constituents who had requested the amendment. The Board will continue its discussion at the May 12, 2004 Board meeting.

Objective of the Meeting:

The Board was to consider whether to add a project to the Board's technical agenda to permit (a) hedging entities to designate the risk of changes in only certain aspects of a nonfinancial asset's fair value as the hedged risk in a fair value hedge and (b) a similar bifurcation of risks for cash flow hedge accounting related to nonfinancial assets.

Matters Discussed and Decisions Reached:

Mr. Wilkins began the discussion by stating that the staff received an agenda request to amend Statement 133 to permit (a) hedging entities to designate the risk of changes in only certain aspects of a nonfinancial asset's fair value as the hedged risk in a fair value hedge and (b) entities to designate the risk of changes in the cash flows relating to only certain aspects of the purchase price or sales price of a physical asset as the hedged risk in a cash flow hedge. He stated that the Board memorandum outlined the relevant literature and the staff's concerns regarding the apparent inconsistencies with Statement 133 and hazards of the requested approach. He stated that the staff recommended not adding this project to the Board's technical agenda.

Two Board members supported the staff's recommendation. Mr. Trott stated that he agreed with the staff recommendation principally because the requested amendment would create an additional difference between Statement 133 and IAS 39, *Financial Instruments: Recognition and Measurement*, and thus would not further convergence. He stated that in the future, the two Boards will have to reexamine hedge accounting and accounting for derivatives, and he would wait to discuss the issues included in the agenda request until a comprehensive project is added to the FASB agenda. Ms. Seidman stated that although she believes that the issues raised in the request are valid, she agreed with Mr. Trott's assertion that it should not be an immediate priority of the Board to add a project to the agenda that is not convergent. However, Ms. Seidman stated that the issues included in the agenda request should be discussed when accounting

for financial instruments is reexamined by the Board, as the situations presented in the agenda request illustrate a continuing need for hedge accounting, that is, because the transactions in question are not financial instruments, there would still be a mismatch between the accounting for the derivative and the accounting for the nonfinancial item.

Mr. Herz stated that his decision was dependent upon whether the price changes of the components have predictable, separately measurable effects on the final product (as asserted by the requesters) or whether the price changes of the components do not necessarily have predictable, separately measurable effects on the final product (as asserted by the staff). Mr. Wilkins stated that designating the risk of changes in the price of wheat as the hedged risk in a fair value hedge of flour can cause a distortion of fair value hedge accounting because wheat is used to produce two products concurrently (flour and mill feed). He stated that a change in the price of wheat futures would not necessarily be indicative of a change in the fair value of flour, nor would it necessarily be indicative of a change in the fair value of mill feed. He stated that the requesters' conclusions ignored the fact that the price of mill feed might be modified by the change in the price of the basic major ingredient. Mr. Wilkins was also troubled by the request to allow entities to hedge the price of wheat in a different location than where the wheat is actually located. He stated that if that request were allowed, entities would assume that the hedge is perfectly effective and ignore the basis, which is not currently permitted by Statement 133. Mr. Wilkins stated that in the agenda request, it appeared as though the requesters wanted to be testing effectiveness based on the changes in the price of wheat at a different location, not based on the total change in the price of flour actually owned by the hedging entity.

Ms. Schipper stated that the staff may be correct in asserting that the price changes of the components are not completely separable and, therefore, there is an interaction effect. However, she believes that the interaction effect would be small due to the disproportionate weights placed on each item in the equation provided by the requesters. She believes that Mr. Herz would like to know if there is an interaction effect and, if so, how large it is.

Mr. Herz suggested that since there appeared to be a difference in opinion between the requesters and the staff regarding some of the assertions set forth by the requesters, the staff should further discuss those issues with the requesters.

Follow-up Items:

The Board directed the staff to discuss follow-up points regarding the assertions set forth by the requesters of the agenda request. The staff will present the results of the discussion at the May 12, 2004 Board meeting.

The objective of the meeting was not met. The Board did not make a final decision whether or not to add the project to the Board's technical agenda.

General Announcements:

None.