MINUTES

To:	Board Members
From:	Derivative Disclosure—Bergstrom (ext. 296)
Subject:	Minutes of the July 6, 2005 Board Meeting (Derivative Disclosure)
Date:	July 18, 2005
cc:	L. Smith, Bielstein, Leisenring, Petrone, Golden, Moss, Wilkins, Polley, Gabriele, Laurenzano, Belcher, Brady, FASB Intranet, Mahoney, Carney, Getz

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: Derivative Disclosure: Project Scope

Basis for Discussion: Board memorandum dated June 23, 2005
Length of Discussion: 9:00 a.m. to 10:00 a.m.

Attendance:

Board members present: FASB: Herz, Batavick, Crooch, Schipper, Seidman, Trott, and Young (by phone)

IASB: Leisenring

Board members absent: None

Staff in charge of topic: Moss
Other staff at Board table: Golden, Belcher, Wilkins, and Bergstrom

Outside participants: None

Summary of Decisions Reached:

The Board discussed what instruments would be included within the scope of the project. The Board decided that at this time, the scope of the project would be limited to disclosure relating to:

- All derivatives accounted for under FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*

- All related hedged items, including those that are not part of a designated and qualifying hedging relationship in accordance with Statement 133, sometimes referred to as "economic hedges."

The Board supported considering at a future date, but not within the project, whether to provide additional disclosures relating to all financial instruments, regardless of whether they are part of a hedging relationship. The Board also agreed that further research should be performed related to the presentation and classification within the balance sheet and income statement for instruments included in the project's scope. The Board directed the staff to continue research in these areas.

Objective of Meeting:

The objective of the meeting was for the Board to decide on the scope of the derivative disclosure project. This objective was accomplished.

Matters Discussed and Decisions Reached:

1. Mr. Moss opened the meeting by explaining the background of the project, stating that, at the March 9, 2005 Board meeting, the Board agreed to add a project to its agenda to provide guidance on enhanced disclosure requirements and balance sheet and income statement presentation of derivatives accounted for in accordance with Statement 133. At that meeting, the Board directed the staff to consider whether the scope of the project should be limited to derivatives accounted for under Statement 133 or expanded to include all financial instruments.

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2. Subsequent to that Board meeting, the FASB staff assembled a user group in order to solicit its input on recommended scope alternatives. Additionally, the staff obtained feedback on the scope alternatives from members of the Financial Accounting Standards Advisory Council at the quarterly meeting held on June 21, 2005. These groups were presented with several alternatives:

a. Limit the project scope to derivatives accounted for under Statement 133

b. Convergence with the IASB Exposure Draft, *Financial Instruments and Disclosures* (ED 7)

c. Expand the scope to include all financial instruments.

3. Mr. Moss noted that the user groups did not reach a consensus view on any of the scope alternatives; however, they did provide a number of common themes that related to the project. The main input received was that enhanced disclosure for all derivatives should be provided. The user groups also believed that there should be enhanced disclosure for underlying hedged items in order to show an entity's overall risk profile, and failure to give the additional information would reduce transparency of the entity's overall risk.

4. Concerning convergence, Mr. Moss stated that many respondents expressed concerns that the IASB's stance on derivative disclosure was too broad in ED 7 and that the FASB should require more detailed disclosures than those required by the IASB. Generally, those surveyed believed that the disclosures should provide insight into an entity's risks and how they are managed to assist the user in assessing an entity's financial position and performance, as well as provide insight into the timing, amount, and uncertainty of an entity's future cash flows.

5. Based on this input, the staff has developed the following alternatives:

a. Alternatives 1a–1d below limit the scope of the project to derivatives accounted for under Statement 133 and for certain alternatives, the underlying item that is being hedged.

Alterative 1a—Derivatives Accounted for under Statement 133. The scope under this alternative would be limited to providing enhanced disclosures for derivatives accounted for in accordance with Statement 133. This scope would not include

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disclosure guidance for hedged items. The staff would consider, among other resources, the following for enhanced disclosures:

(1) Disclosure requirements included in the June 1996 Exposure Draft and August 1997 Task Force Draft of Statement 133 that were not carried forward to the final Statement

(2) Disclosure requirements not carried forward from FASB Statement No. 119, *Disclosure about Derivative Financial Instruments and Fair Value of Financial Instruments*, to Statement 133

(3) Suggested disclosures from a resource group and other constituents

(4) SEC disclosure requirements (including those required in the MD&A)

(5) Existing disclosure requirements of Statement 133, reexamined.

Alternative 1b—Derivatives Accounted for under Statement 133 and Hedged Items That Have Been Designated and a Qualified Hedging Relationship Exists. The scope under this alternative would be the same as Alternative 1a, but it would include providing disclosure guidance (including balance sheet and income statement presentation[1]) for hedged items that have been designated and a qualified hedging relationship exists.

Alternative 1c—Derivatives Accounted for under Statement 133 and all Hedged Items.[2] The scope under this alternative would be the same as Alternative 1b, but it would include providing disclosure guidance (including balance sheet and income statement presentation) for all potential hedged items. This would include both items that are specifically designated and qualifying as hedged and items that are deemed to be economic hedges (e.g., derivatives used to mitigate the effects of foreign exchange translation adjustments).

Alternative 1d—Derivatives Accounted for under Statement 133, All Hedged Items,[2] and Balance Sheet and Income Statement Classification. The scope under this alternative would be the same as Alternative 1c, but it would also include

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[1] The staff intends that "presentation" include enhanced guidance for which classification is already prescribed under Statement 133. For example, in a fair value hedge, Statement 133 requires that the hedged item is adjusted for changes in fair value. Under this scope, the staff would reconsider the presentation requirements for the underlying hedged item.

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guidance on income statement and balance sheet classification for derivatives. That is, this alternative would include guidance on "where" derivatives and corresponding changes in their fair value should be recorded on the balance sheet and income statement.

b. Alternative 2— Convergence with the IASB. The objective of this alternative would be to achieve international convergence with the IASB. This would involve examining the requirements under ED 7 (and the final standard once issued), IAS 32, *Financial Instruments: Disclosure and Presentation*, and IAS 39, *Financial Instruments: Recognition and Measurement*, in order to determine whether any of the provisions should be included in the US GAAP literature. Additionally, this alternative would focus on disclosures related to financial instruments that require accounting unique to US GAAP, which have not been addressed by the IASB (e.g., use of the shortcut method).

c. Alternative 3— All Financial Instruments. This alternative would include elements of Alternatives 1a–1d, but it would be expanded to include all financial instruments, regardless of whether there is an existing hedging relationship.

6. Mr. Moss stated that the staff supports Alternative 1d and asked the Board for its input.

7. Although many respondents had concerns that ED 7 was too broad, Mr. Crooch expressed his desire to converge with the international community wherever possible and believed that the staff's Alternative 1d would fit within the framework of ED 7 and yet provide the added disclosure that the user groups had requested. Mr. Crooch noted that it was not yet clear how Alternative 1d and ED 7 would overlap, but he believed that if Alternative 1d was implemented correctly, then convergence would come from the side of the international community.

8. Mr. Batavick concluded that Alternative 1b was the best alternative. He stated that looking at this project with respect to all of the other projects that are going on at the FASB, the Board

[2] This includes both (a) hedges that have been designated and a qualified hedging relationship exists under Statement 133 and (b) those that have not been designated and do not qualify for hedge accounting under Statement 133.

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should minimize the scope; that is, make some incremental change and improvements as opposed to extensive change and improvements. Mr. Batavick expressed his desire for the project to be concluded in a reasonable amount of time. He noted that his concern with Alternative 1c was how to define an *economic hedge* and felt that attempting to do so would require more staff resources than are currently available. He also expressed his concern that Alterative 1d appeared to be too prescriptive in nature and would require the Board to tell preparers exactly what entries to book to balance sheet and income statement accounts in certain situations and that such an attempt would take too long to address the informational needs of financial statement users. Mr. Batavick also stated that he would prefer a more principles-based approach.

9. Mr. Trott supported Alternative 1d, stating that it would supply the information most needed that is missing from current disclosures and presentations, which is, if an entity has derivatives, what are they doing with them? Are they increasing, decreasing, or modifying the risks that the entity is facing? Especially, how are these derivatives going to affect certain future cash flows? He noted that from the input that the FASB has received from constituents and user groups, it is clear that the preparer community is not communicating the impact of their decision to buy derivatives and disclose how those derivatives are impacting the risk and the future cash flows of the entity. He also stated that it is clear that in some instances, the act of buying derivatives is by design; not being accounted for as derivatives and therefore using Alternative 1b would result only in information regarding a very small slice of the risk modification strategy a company is using. Mr. Trott stated that the project should be limited to derivatives covered under the accounting guidance in Statement 133, but not to just those that are designated as hedges. He noted that current accounting guidance requires disclosure of ineffectiveness in hedging relationships, but it only shows the effectiveness of those hedges that are being accounted for as a hedge under the requirements of Statement 133. However, Mr. Trott believed that codifying disclosure requirements for all financial instruments as contained in Alternative 3 would simply be too time consuming and unnecessary.

10. Ms. Schipper believed that Alternative 3 would be the best answer to meet user needs, but she supported a phased approach that would begin with Alternative 1d and then expand to

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include all financial instruments. Ms. Schipper stated that she supported starting with Alternative 1d because it would require linking a derivative with something that is not already required by the accounting literature, and that information is necessary to determine the risk profile of an entity. She noted that the advantage of Alternative 1b is that the requirements are already in place in the current accounting guidance as 1b would only apply to qualified hedging derivatives, which would mean no new Board decisions would be required in terms of linkage and would speed up the process. However, Ms. Schipper noted that the Board could implement an Alternative 1d approach in two ways. The Board could either take a management intent approach in which an entity's management would decide what a derivative pertains to and how to best account for both the derivative and the item it is linked to with certain broad guidance, or the Board could try to write prescriptive guidance. With regard to the display and classification guidance, again there are two possible approaches. The board could deliberate and decide, possibly in conjunction with the performance reporting project, on explicit guidance that states that certain information goes in this specific spot in the financial statements, or the board could allow management to choose where that information is displayed, subject to Statement 133 and other relative guidance, and then disclose what they've done. The management intent approach is a way to make this project go faster, which is to let management make the decision and disclose in the financial statement and in the notes to the financial statement what they have decided. Addressing the concern that Alternative 1d would be too time consuming, Ms. Schipper noted that there are ways that the Board could speed up the process and still include all of the items in Alternative 1d within the scope of the project.

11. Mr. Leisenring of the IASB explained that ED 7 was intended to look something like Alternative 1d because not including all derivatives was thought to be potentially misleading because the un-hedged items were thought to be more risk generating and far more significant to the user of the financial statement than the hedged items. Mr. Leisenring brought up the question of how to deal with embedded derivatives and the related bifurcation issues and questioned if the scope of the project included all derivative financial instruments. Mr. Leisenring expressed his opinion that Alternative 3 was the only way to accurately describe what is happening because risks an entity fails to hedge are just as important as the risks they have purposely attempted to hedge, and in order to get that information to the

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users, information about all cash instruments and financial instruments needs to be included in the scope of this project.

12. Ms. Schipper noted that she did not feel that anybody disagreed with Mr. Leisenring's opinion that, if properly implemented, Alternative 3 would provide the best information for users; however, she felt that the Board members disagreed about the cost/benefit of such a large project. Mr. Trott added that Alternative 3, as it is described, would require bringing into one document the disclosures that are already required by other accounting literature, and he did not think that was necessary. However, Mr. Trott did note that in the future, users would have more information if the Board increased the scope of the project to other financial instruments not accounted for separately under Statement 133.

13. Mr. Young stated that he supported Alternative 3, commenting that without a comprehensive approach, users are left with not enough information, and, at the end of the day, the organization of the information in one place for the user to see is about the only way to effectively communicate. Mr. Young noted that a project of that magnitude would take longer than some might like, but he felt that the project and the information that it would provide is important enough to put in the necessary time and resources.

14. Ms. Seidman was supportive of a phased approach for derivative disclosures in this project. She stated that she would put in the near term or "urgent phase" an objective to improve the clarity of disclosures about the nature and extent of the entity's use of derivatives and how they are reported in the financial statements, including disclosure of the reasons for their use, their effect on the balance sheet, income statement, and statement of cash flows for three categories of derivatives: (a) those that were designated as hedges and effective, (b) those that were designated as hedges and not effective, and (c) those that were not designated as hedges. Her concern about a project scope broader than that at this time is the difficulty in defining an *economic hedge*. She also believed that there is significant overlap between the notion of an economic hedge and the type of transactions that the Board expects to be accounted for under the fair value option. In other words, the fair value option is, in part, designed to provide symmetrical accounting for entities that don't choose to or don't qualify for hedge accounting but want some kind of economic offsetting results in the financial

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statements. In that case, the Board decided not to be prescriptive by not telling entities how to qualify for the option but, rather, let the accounting designations speak for themselves. Ms. Seidman added that although the fair value option project has not covered disclosure yet, she expects that the type of disclosure package the Board will include in that guidance will be quite similar to the type of disclosure that she would want to see for any economic hedge. With respect to those derivatives that are not designated or do not qualify as a hedge, she recommended waiting for the next phase and to try to coordinate that phase with the fair value option project. Ms. Seidman added that it is important that the approach be based on a management approach because of the elective nature of hedge accounting; that is, the fact that an entity can choose to execute a hedge either by hedging the long or the short side of a transaction, as well as the prevalent use of macro hedging strategies. Ms. Seidman was supportive of Alternative 1b as the near term objective, without prescriptive classification requirements, whereas a second phase could address the overall economic position of the entity, such as an Alternative 3 approach.

15. Mr. Herz stated that his first preference would be Alternative 3. He stated that derivatives are very powerful instruments in their own regard, but they are only part of the story; particularly in financial institutions. However, he noted the resource complications that a project of that scope would include. He also agreed with Ms. Seidman's concern about the interaction with the fair value option project. With that having been said, Mr. Herz stated that he supported a "soft" Alternative 1d, noting that he would have been supportive of Alternative 1b if it included derivatives that are not designated as hedges or don't qualify as hedges under Statement 133. He stated that he believed the scope of the project should explore balance sheet and income statement classification for the items that are qualified or designated as hedges under Statement 133. However, Mr. Herz stated that whether classification should just be disclosure of where they've been presented or go so far as to prescribe how they should appear financial statements has not yet been decided. Mr. Herz supported a management approach for determining the nature of the derivative and related hedge (i.e., economic hedges versus speculative or trading activities). He indicated that the Board should not try to be prescriptive in terms of classification in the financial statements; rather, the Board should simply develop a framework for management to disclose how they have treated these derivatives and what the impact on the financial statements will be.

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16. Mr. Trott commented that the real question is whether the scope of this project should include all derivatives and, if so, how the information about those derivatives should be disclosed or presented. The Board unanimously agreed that all derivative instruments should be included in the scope of the project. The Board also agreed that all hedged items, including those that have not been designated or do not qualify for hedge accounting under Statement 133, should be included as part of the scope.

17. A majority of the Board agreed with a "building blocks" or phased approach for the project, leaving it open to the possibility of expanding the scope of the project in the future to other financial instruments. Mr. Golden clarified the Board's position, stating that the Board agrees to the possibility of expanding the project scope in the future, possibly in a phased approach, making the question: What is the current scope or first cut off point of this project, and how do we get there?

18. Mr. Herz commented that the main difference in the project scope is the extent to which the Board should prescribe guidance for financial statement classification of derivatives. He clarified that the current goal of the meeting is to decide what instruments should be included in the project. Once that is determined, then the staff can explore different possible classification options, which may or may not result in any additional prescriptive guidance.

19. Mr. Golden clarified that Alternative 1d would include research about financial statement presentation of derivatives; however, the ultimate conclusion may be that the Board elects not to prescribe financial presentation guidance for some or all derivatives.

20. Mr. Herz stated that the Board and staff need to be cognizant that since derivatives can be part of a bigger hedging or risk management strategy, we are making an artificial distinction in portraying derivative information. In some cases, we only end up telling half the story, which may be a misleading story. Also, Mr. Herz stated that financial instrument disclosures are spread throughout the accounting literature, which often go hand in hand with derivative disclosures, and it would helpful to everyone to have these disclosures in a more integrated way.

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21. Mr. Moss summarized the Board's decision regarding the scope of the derivative disclosure project. He stated that the scope will include all derivative financial instruments as well as all hedged items, including those that have not been designated and do not qualify under Statement 133, and the staff will explore possible presentation and classification within the balance sheet and income statement for instruments included in the project's scope.

Follow-up Items:

None.

General Announcements:

None.

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