MINUTES

Financial Accounting Standards Board

To:	Board Members		
From:	Fanzini (ext. 264), Cornett (442)		
Subject:	Minutes of the January 31, 2007 Board Meeting: Statement 133 Implementation Issue—Clarification of the Application of the *Shortcut Method*	**Date:**	January 31, 2007
cc:	Leisenring, Bielstein, Smith, MacDonald, Golden, Chookaszian, Lott, Polley, Carney, Stoklosa, Wilkins, Trench, Cornett, Jacobs, Richter, Gabriele, 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, Interpretation, or FASB Staff Position.

Topics:	Statement 133 Implementation Issue - Clarification of the Application of the *Shortcut Method*
Basis for Discussion:	Board Memorandum No. 2
Length of Discussion:	9:30 to 10:30 a.m.
Attendance:	
Board members present:	FASB: Herz, Batavick, Crooch, Linsmeier, Seidman, Trott, and Young
IASB:	Leisenring
Staff in charge of topic:	Fanzini
Other staff at Board table:	Smith, Golden, Lott, Jacobs, Cornett

Summary of Decisions Reached:

The Board decided to proceed with the exposure of a proposed Statement 133 Implementation Issue, "Clarification of the Application of the *Shortcut Method*." The proposed Implementation Issue will provide guidance on the following practice issues surrounding the application of the shortcut method in paragraph 68 of FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*:

1. Amortizing Debt: qualifies for the shortcut method provided that the notional amount of the swap matches the principal amount of the debt throughout the hedging relationship

2. Zero-coupon Debt: violates paragraph 68(a) and 68(e), and thus does not qualify for the shortcut method

3. Trade-date/Settlement-date: changes in value of the swap between the trade-date of the swap (commitment date of the debt) and the settlement date of the debt would not disqualify the hedging relationship from applying the shortcut method, provided the timing difference was no more than the typical settlement period seen in the market (which for the U.S. is three days)

4. Market Convention Rounding: for instances in which the fair value of debt at issuance differs slightly from its par amount due to a rounding-down of the coupon rate effected by normal market conventions, the shortcut method would be allowed

5. Paragraph 68(e): the application of paragraph 68(e) will be clarified to indicate that terms must be neither atypical, nor invalidate the assumption of no ineffectiveness, to meet the paragraph’s criteria

6. Late-hedging: hedging relationships entered into subsequent to the issuance of debt would fail paragraph 68(e) because the fair value of the debt instrument would not equal its principal amount.

Transition guidance will resemble the approach found in Statement 133 Implementation Issue K5: *Transition Provisions for Applying the Guidance in Statement 133 Implementation Issues*. The Board directed the staff to proceed to a draft of a proposed Implementation Issue for vote by written ballot.

<u>Objective of Meeting</u>:

The objective of the meeting was for the Board to consider the drafting of a Statement 133 DIG Issue to address certain practice issues identified by the staff. The objective was met.

<u>Matters Discussed and Decisions Reached</u>:

1. Mr. Fanzini stated that the staff intended to address two broad issues during the Board meeting: (a) whether the Board approved the release of additional clarifying guidance on the application of paragraph 68 in certain narrow circumstances identified as issues in practice, and (b) whether the Board would instruct the staff to begin tentative research into a potential future project addressing additional practice issues in hedge accounting outside the scope of the shortcut method.

2. Mr. Cornett stated that the staff's recommendations were based on the view that the shortcut method was originally intended to apply only to the most straight-forward, or "plain vanilla", hedges of interest rate risk with interest rate swaps. Accordingly, the staff believed that it was inappropriate to apply the shortcut method to hedging relationships involving an "engineered" interest rate swap, even if such a swap resulted in no ineffectiveness.

3. Mr. Cornett stated that the practice issues identified by the staff were previously discussed with the Board in the November 15, 2006, and January 24, 2007, education sessions.

4. Mr. Cornett identified two issues relating to paragraph 68(a) that the staff believed required clarification: hedges of amortizing debt and zero-coupon debt. The staff's views

were that hedges of amortizing debt would qualify for the shortcut method if the notional amount of the swap was set to perfectly adjust with the principal amount of the debt, and that hedging of zero-coupon debt would not qualify for the shortcut method.

5. Ms. Seidman and Mr. Linsmeier noted that many of the practice issues identified by the staff were related, and required consistent treatment. Ms. Seidman elaborated that she views many of these issues as an interpretation of whether the hedged item has to have a fair value equal to par at the inception of the hedging relationship. A secondary question is how to apply the "settlement formula" mentioned in paragraph 68(c).

6. Mr. Linsmeier, Ms. Seidman, and Mr. Trott indicated that they would support some limited guidance under the scope of the current project, but believed that the staff should consider other issues within the scope of a longer-term project.

7. The Board voted 5-2 (Linsmeier, Young) and 6-1 (Seidman) to support the staff's views on amortizing debt and zero-coupon debt, respectively.

8. Mr. Linsmeier and Ms. Seidman expressed the view that the Board was not being consistent in its decision making. Specifically, the staff recommendation on amortizing debt implicitly accepts that the settlement formula could change over time and that a "customized mirror swap" could be used, yet the staff reached the opposite conclusion for zero-coupon instruments which automatically ratchet up instead of down.

9. Mr. Batavick stated that he was concerned that the decisions reached by the Board regarding the current issues would end up contradicting any principles-based solution arrived at in the longer term.

10. Mr. Cornett identified the issue of changes in the basis of the hedged item resulting from a difference in the trade-date of the swap and the settlement date of the debt. The staff's recommendation was that these slight differences should not preclude shortcut treatment, provided the timing difference between the two dates was no more than the typical settlement period seen in the market (which for the U.S. is three days).

11. Ms. Seidman stated that she believed the staff's recommendation was a practical accommodation to the realities of the market.

12. Mr. Cornett identified the issue of whether or not the fair value of a hedged item must equal its par value at the inception of the hedge to meet the criterion in paragraph 68. The staff's view was that the Board should issue guidance to clarify whether the fair value of a hedged item must equal its par value at the inception of the hedge to be eligible for the shortcut method. However, as a practical expcetion, small rounding differences attributable to market conventions should not preclude shortcut treatment. The Board agreed unanimously with the staff's view.

13. Mr. Cornett stated that the staff believed paragraph 68(e) was viewed by some practitioners as vague and unclear. Specifically, the staff believed that the wording had led some to believe that only atypical terms within hedging instruments needed to be evaluated to determine whether they violated the assumption of no ineffectiveness, and the staff did not believe that this was the original intent of the standard. The staff recommended that the wording be clarified to state that each condition should be evaluated independently when determining whether a term violates paragraph 68(e).

14. Mr. Herz stated that he would not disagree with the staff's recommendation, but he expressed his concern that the phrase "typical" was difficult to define in practice, when markets change in response to participant demands and innovation.

15. The Board agreed to review the proposed wording change in the final exposure draft.

16. Mr. Cornett identified the late-hedging issue, wherein a hedging relationship was established after inception, and the question arises whether such a relationship can qualify for the shortcut method. The staff viewed such relationships as being outside the contemplated scope of paragraph 68. As such, the staff recommended that the issue be considered in a subsequent project that would address issues in a broader context.

17. The Board voted 4 to 3 (Batavick, Seidman, and Herz) to issue guidance under the current project that would preclude application of the shortcut method to late hedges.

18. Ms. Seidman noted that the late hedging decision depends on whether the fair value of the hedged item had to equal par at the inception of the hedging relationship. She does not believe that issue is addressed in Statement 133, and she believes that conceptually, it is the same issue as the coupon rounding issue and the trade date settlement issue (both market conventions); only the amount of the premium or discount might be larger. She supported coming to a conclusion on that issue and applying it consistently.

19. Mr. Trott questioned whether fair value hedges were needed once the fair-value option was approved. He noted that eliminating fair value hedging would resolve the complexity of bifurcating changes in the fair value of the hedged item by specific risks.

20. Mr. Linsmeier noted that he believed late-hedging and the trade-date/settlement-date issues were related, in that they both involved basis differences at inception. He supported the staff's views, but believed that consistency could have been improved.

21. The Board then discussed whether to instruct the staff to begin research on a solution to practice problems observed outside of the scope of paragraph 68.

22. Ms. Seidman expressed the view that any approach to tackling practice issues associated with paragraph 65 should be applied consistently and be principles-based. She posited that some of the words in paragraph 65 (such as use of the phrase *the same* as it relates to critical terms and timing) could be causing similar practice issues as the shortcut method in light of various market conventions.

23. Mr. Herz stated that he believed that whatever approach the Board adopted to resolve the practice issues would likely encompass paragraph 68 as well.

24. Mr. Linsmeier noted that the decisions to issue additional guidance on the shortcut

method had effectively increased the complexity of existing guidance by adding additional rules. He encouraged the staff to consider Mr. Trott's earlier proposal to eliminate fair-value hedging. Additionally, he requested that any future project to address practice issues related to paragraph 65 should aim to provide principle-based guidance and not additional rules.

25. Mr. Trott encouraged the staff to consider the IASB's position on hedge accounting. Specifically, he pointed out that the IASB and FASB had previously agreed that their mutual objective was the full fair value of all financial instruments, and that any actions the Board contemplated should move toward that objective.

26. The Board unanimously agreed that the transition guidance should be based on the approach taken in Statement 133 Implementation Issue No. K5.

27. Mr. Smith recommended extending the comment period for the exposure draft to 60 days, to provide sufficient time for constitiuent to thoughtfully consider the guidance during this busy time of the year.

Follow-Up Items:

The Board directed the staff to proceed to a draft of a proposed Implementation Issue for vote by written ballot. Additionally, the staff will research additional implementation issues surrounding paragraph 65 and present their findings to the Board in a future session.

General Announcements:

None.