**MINUTES**

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| **To:** | Board Members | | |
| **From:** | Chesney (ext. 447) | | |
| **Subject:** | Minutes of the April 30, 2008 Board Meeting: Statement 133 Hedging | **Date:** | May 29, 2008 |
| **cc:** | Leisenring, Bielstein, Golden, Derivatives Implementation Team, Financial Instruments Team, Lott, Chookaszian, Posta, MacDonald, Mayrhofer, FASB Intranet (e-mail) | | |

*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 FSP.*

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| Topic: | Statement 133 Hedging |
| Basis for Discussion: | Board Memorandum No. 6 |
| Length of Discussion: | 9:30–11:15 a.m. |
| Attendance: | |
| Board members present: | Batavick, Herz, Linsmeier, Seidman, Smith, and Young |
| Board members absent: | Crooch |
| Staff in charge of topic: | Chesney |
| Other staff at Board table: | Golden, Malcolm, C. Smith, Stoklosa, and Wilkins |
| Outside participants: | None |

Summary of Decisions Reached:

The Board discussed three technical issues that arose while drafting the Exposure Draft of the proposed Statement to amend the hedging guidance in FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*, and made the following decisions:

1. When calculating ineffectiveness in a cash flow hedging relationship, an entity is permitted to compare the actual derivative with a derivative that would perfectly offset the cash flows of the hedged transactions. When using such a derivative, an entity is permitted to use the same credit risk adjustment for the nonperformance risk that is used for calculating the fair value of the actual derivative hedging instrument.
2. If an entity designates a group of transactions expected to occur within a specific time frame as the hedged forecasted transaction in a cash flow hedge (such as the variability in cash flows on the first $1 million of sales proceeds to be received in the month of January), an entity may measure ineffectiveness by comparing the change in fair value of the actual derivative designated as the hedging instrument with the change in fair value of a derivative that would settle within a reasonable time period of the cash flows related to the hedged transactions. That time period is reasonable if the difference is minimal between the forward rate on that derivative and the forward rate on a derivative or derivatives that would perfectly offset the changes in cash flows of the forecasted transactions.
3. If an entity designates a purchased option as the hedging instrument in a cash flow hedge to provide one-sided offset against the hedged risk, an entity may use, as a benchmark to calculate ineffectiveness, a purchased option derivative that would mature on the date of the forecasted transaction and provide cash flows that would perfectly offset the one-sided change in the hedged cash flows. When measuring a purchased option derivative that would mature on the date of the forecasted transaction and provide cash flows that would perfectly offset the one-sided change in the hedged cash flows to determine ineffectiveness to be reported in earnings, an entity may use total changes in the option's cash flows. The initial time value component of the option's fair value should be reclassified to earnings on a rational basis.

The Board decided that the proposed Statement should be effective for fiscal years beginning after June 15, 2009, and interim periods within those fiscal years and that earlier application not be permitted. Additionally, the Board decided that the Exposure Draft should have a comment period ending August 15, 2008.

Objective of Meeting:

The objective of the meeting was for the Board to discuss three technical issues that arose while drafting the Exposure Draft of the proposed Statement to amend the hedging guidance in Statement 133, the effective date for the proposed Statement, and the comment period for the Exposure Draft. The objective was met.

Matters Discussed and Decisions Reached:

**ISSUE 1—CREDIT RISK ADJUSTMENT FOR CALCULATING THE FAIR VALUE OF THE DERIVATIVE THAT WOULD PERFECTLY OFFSET THE CASH FLOWS OF THE HEDGED FORECASTED TRANSACTION FOR CASH FLOW HEDGES**

1. Ms. Chesney said that the Board's decision in this project to permit an entity to compare the actual derivative with a derivative that would perfectly offset the cash flows of the hedged transactions raises a question about what the nonperformance risk adjustment should be used to calculate the fair value of the derivative that would perfectly offset the cash flows. Differences between the credit adjustment used for calculating the fair value of the actual derivative hedging instrument and that used for calculating the fair value of the derivative that would perfectly offset the cash flows of the hedged transaction would cause ineffectiveness to be reported in earnings. Ms. Chesney said that the staff believes that this ineffectiveness would not provide information useful for determining the degree to which the forecasted hedged cash flows will be offset.

**Issue 1—Staff Recommendation**

2. The staff recommended that the credit risk adjustment related to nonperformance of the party in a liability position to the derivative used for calculating the fair value of the actual derivative hedging instrument be permitted to be used for calculating the fair value of the derivative that would perfectly offset the hedged cash flows when it is probable that default under the derivative would not occur. If it is not probable that default under the derivative would not occur, an entity should be required to use a credit risk adjustment that would reflect risk-free credit rating.

**Issue 1—Board Vote**

3. The Board voted to permit entities to use the credit risk adjustment for the nonperformance risk of the party in a liability position that is used for calculating the fair value of the actual

derivative hedging instrument when calculating the fair value of the derivative that would perfectly offset the hedged cash flows in all cases.

**Issue 1—Board Comments**

4. Mr. Linsmeier said that the staff's recommendation seemed complicated and would prefer that entities be permitted to use the credit adjustment on the actual derivative in all cases. Ms. Seidman added that the probability notion in the recommendation is not needed since hedge accounting would not be applicable if it is not probable that default under the derivative would not occur. Mr. Herz agreed and asserted that the proposed Statement state the Board's decision as a principle that would be easily understandable.

**ISSUE 2—ASSESSING EFFECTIVENESS AND MEASURING INEFFECTIVENESS IN CASH FLOW HEDGES FOR A FORECASTED GROUP OF TRANSACTIONS WITHIN A SPECIFIC TIME FRAME**

5. Ms. Chesney said that Statement 133 currently allows an entity to designate as the hedged transaction in a cash flow hedge a group of individual transactions that share the same risk exposure for which they are designated as being hedged. While the proposed hedge accounting guidance would not change the ability to designate a group of transactions, it would require more guidance on how to calculate ineffectiveness in such a hedging relationship. Mr. Stoklosa said that this issue is related to a speech given by a member of the Securities and Exchange Commission (SEC) staff in December 2007. After that speech, the SEC and staff developed an approach for determining ineffectiveness, which is captured in the recommendation.

**Issue 2—Staff Recommendation**

6. The staff recommended that the proposed Statement permit an entity to measure ineffectiveness by comparing the change in fair value of the actual derivative designated as the hedging instrument with the change in fair value of a derivative that would settle within one month of the cash flows related to the hedged transactions.

**Issue 2—Board Vote**

7. The Board voted to permit an entity to measure ineffectiveness by comparing the change in fair value of the actual derivative designated as the hedging instrument with the change in fair value of a derivative that would settle on a single date if the hedge ineffectiveness that is

expected to result from the timing differences between settlement of the actual derivative and the forecasted transaction is minimal.

**Issue 2—Board Comments**

8. Mr. Linsmeier agreed with the recommended principle, but he did not support specifying a time limit. He suggested that the proposed Statement describe the time period as "reasonable" or something similar to avoid specific requirements. Mr. Smith added that presenting the time period as a principle rather than as a bright-line requirement would result in more accurate assumptions of what would be considered a reasonable time period. For example, a reasonable time period may be less than one month when markets are extremely volatile over a short time period. Ms. Seidman stated that a difference in the number of days would not matter as long as the volatility occurs in the same time period as the hedged transactions.
9. Mr. Wilkins said that the staff recommended the one-month period to simplify implementation. Further, this time limit would be consistent with other specific time limits currently in Statement 133. Mr. Golden said that constituents would ask for more guidance on what constitutes a reasonable time period. Even if a principle were to be included in the proposed Statement, practice would likely maintain the one-month time period it currently uses. However, depending on changes in circumstances that would possibly lessen the amount of time that would be considered reasonable, a principle could alter current practice. If the Board did not wish to change practice, Mr. Golden suggested that it be silent on this issue. Mr. Herz said that he preferred to let practice develop around a principle, which might possibly result in changes from current practice. Mr. Batavick added that the Board and staff could explain to constituents in speeches and conversations that the intent was not necessarily to change practice, but to encourage the use of principles in hedge accounting.
10. Mr. Linsmeier said that this entire issue was based on an SEC speech related to qualifying for hedge accounting. Since this model separates qualifying for hedge accounting from measuring ineffectiveness, Mr. Linsmeier believed that the speech did not affect measurement under hedge accounting. Mr. Stoklosa said that the speech was about both qualifying for hedge accounting and measuring hedge ineffectiveness because they are linked. Ms. Seidman agreed that the two are linked and noted that the timing issue has the same effect as the critical terms match criteria discussed in the SEC speech. If a regulator or

auditor did not agree with the time period assumed to be reasonable, hedge accounting would not be allowed.

11. Ms. Seidman said that confusion could arise in this area since a derivative settling within a reasonable period of time of the hedged cash flows would not be one that perfectly offsets the hedged cash flows. Mr. Wilkins said that the derivative would be expected to be perfectly offsetting in other areas besides timing. Mr. Linsmeier cautioned against saying that the derivative would be required to be perfect in other areas and noted that all issues brought to the Board for the meeting were related to exceptions to the derivative's perfection. Mr. Stoklosa indicated that the staff would address the description of the derivative in drafting.

**ISSUE 3—MEASURING INEFFECTIVENESS FOR A PURCHASED OPTION USED IN A CASH FLOW HEDGE TO PROVIDE ONLY ONE-SIDED OFFSET**

12. Ms. Chesney said that Implementation Issue G20, "Assessing and Measuring the Effectiveness of a Purchased Option Used in a Cash Flow Hedge," currently allows an entity to defer the time value component of a purchased option used in a cash flow hedge to other comprehensive income and record no ineffectiveness in earnings related to the time value component if certain criteria are met, including critical terms matching of the hedging instrument and the hedged transaction. However, the proposed Statement would not permit the notion of critical terms matching and would supersede Implementation Issue G20. Since many constituents currently utilize Implementation Issue G20 to measure and record ineffectiveness for cash flow hedges using a purchased option, eliminating this guidance would result implementation difficulties and changes in current practice.

13. Additionally, Ms. Chesney said that Statement 133 currently permits the deferral of the time value for cash flow hedges using forwards as the hedging instrument. The initial spot-forward difference representing the time value of the derivative is deferred and reflected in the financial statements in the same period that the forecasted transaction impacts earnings.

**Issue 3—Staff Recommendation**

14. The staff recommended that, for simplicity, ease of implementation, and consistency with the hedge accounting guidance for forwards, if an entity uses a purchased option contract as the hedging instrument in a cash flow hedge to provide only one-sided offset against the hedged risk, the derivative to be used for determining ineffectiveness to be reported in earnings can include total changes in the option's cash flows.

**Issue 3—Board Vote**

15. The Board agreed with the staff's recommendation. While Ms. Seidman did not agree that an option could be the derivative that would provide perfect offset in a cash flow hedge under the proposed guidance, she did not object to the staff's recommendation.

**Issue 3—Board Comments**

16. Ms. Seidman did not agree with the analogy to forwards since an option represents a right and a forward represents an obligation. The premium for an option represents a transfer of risk from one party to the other, while both parties to a forward have risk exposure. Mr. Stoklosa said that, while the risk exposures of an option and a forward may be different, they both entail a cost that must be accounted for.

17. Ms. Seidman further said that the derivative that would perfectly offset the variability should be one that hedges all risks since the proposed Statement has a fair value basis. Therefore, an option would not be an eligible perfect derivative. If the proposed Statement provided for the hedging of certain risks, Ms. Seidman said that an option would be allowable. Messrs. Batavick, Herz, Linsmeier, Smith, and Young agreed that the derivative that would perfectly offset the variability in the hedged cash flows could be an option.

18. Mr. Herz agreed that the option premium should be expensed over the hedge period since it represents the cost of the hedge. Mr. Linsmeier said that the time value component should be deferred to other comprehensive income and reclassed when the forecasted hedged transaction impacts earnings. Ms. Malcolm clarified that the proposed Statement would require the initial time value component to be reclassed to earnings on a rational basis, which may not necessarily be over the life of the hedge. The main point is that the volatility in time value from period to period would not be recognized in earnings.

**ISSUE 4—EFFECTIVE DATE**

**Issue 4—Staff Recommendation**

19. The staff recommended that the proposed Statement be effective for fiscal years beginning after November 15, 2009, and that earlier application not be permitted.

**Issue 4—Board Vote**

20. The Board decided that the proposed Statement should be effective for fiscal years beginning after June 15, 2009 and interim periods within those fiscal years and that earlier application

not be permitted. Mr. Batavick supported the staff's recommended November 15, 2009, effective date.

**Issue 4—Board Comments**

21. Mr. Batavick disagreed with the Board's vote, given the expected issuance of the final Statement and the time required to implement the proposed changes.

**ISSUE 5—COMMENT PERIOD**

**Issue 5—Staff Recommendation**

22. The staff recommended a comment period of approximately 75 days, through August 15, 2008.

**Issue 5—Board Vote**

23. The Board agreed with the staff's recommendation.

<u>Additional Items:</u>

None

<u>Follow-up Items:</u>

The staff will continue drafting an Exposure Draft for vote by written ballot.