MINUTES

To: Board Members

From: FVM Team (Murphy x208)

Subject: Minutes of the June 29, 2005 Board Meeting: Proposed FSP Relating to EITF Issue No. 02-3 **Date:** July 7, 2005

cc: Bielstein, L. Smith, Petrone, Fair Value Team, Revenue Recognition Team, Business Combinations Team, Polley, Gabriele, Getz, Carney, Mahoney, Sutay, Leisenring (IASB), P. Martin (CICA), Vernuccio, 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.

Topic:	Proposed FSP relating to EITF Issue No. 02-3
Basis for Discussion:	Memorandum dated June 16, 2005, and audience handout (attached)
Length of Discussion:	10:00 a.m. to 11:30 a.m.
Attendance:	
Board members present:	FASB: Batavick, Crooch, Herz, Schipper, Seidman, Trott, and Young
Board members absent:	None
Staff in charge of topic:	MacDonald
Other staff at Board table:	Belcher, Johnson, McBride, Murphy, E. Smith, L. Smith, and Todorova
Outside participants:	None

Summary of Decisions Reached

The Board reconsidered 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 the fair value measurement project.

The Board decided that at initial recognition and in all subsequent periods, the fair value of the derivative instrument that arises in an Issue 02-3 transaction should reflect the entity's best estimate of the price (layoff amount) in the most advantageous market for the derivative instrument. A difference between the transaction price and the entity's initial fair value estimate should be recognized in earnings when the estimate is derived principally by market-based inputs, whether such inputs are directly observable or otherwise derived. Until that time, the difference should be deferred (for example, as a deferred credit).

At initial recognition, an entity should disclose (1) the fair value estimate, (2) the data used to derive the estimate, for example, whether the estimate is based on a transaction price or is estimated using a model, indicating whether the model inputs are directly observable or otherwise derived, and (3) unrealized gains (or losses) recognized in earnings. In all periods, an entity should disclose deferred amounts (in the period and cumulative) and a description of where those amounts are reported in the statement of financial position.

Objective of Meeting

The purpose of the meeting was for the Board to consider issues relating to Issue 02-3 in the context of decisions made to date in the FVM project.

Matters Discussed and Decisions Reached

Fair Value Estimate

1. Ms. MacDonald said that for an Issue 02-3 transaction, the threshold issue relates to the fair value estimate at initial recognition (contract inception). In that regard, there are two staff views.

2. The first staff view is that the transaction price provides the best evidence of the fair value of the derivative instrument in all cases. In subsequent periods, however, the transaction price used for the estimate would be updated for changes indicated by a model value that reflects the entity's best estimate of the price (layoff amount) in the most advantageous market for the derivative instrument.

3. The second staff view is that a model value that reflects the entity's best estimate of the price (layoff amount) in the most advantageous market provides the best evidence of the fair value of the derivative instrument, thereby rebutting the transaction price presumption. Presumptively, the entity would not willingly assume the risk inherent in an Issue 02-3 transaction absent possible layoff alternatives in a more advantageous market. Accordingly, an entity would mark-to-model at initial recognition and in all subsequent periods (mark-to-model approach).

4. Ms. MacDonald said that the majority of the staff recommends the mark-to-model approach. That approach is consistent with the fair value framework in the FVM Statement and its reference market approach (as clarified).

5. No Board members objected to the staff recommendation, that is, a mark-to-model approach for the fair value estimate at initial recognition and in all subsequent periods.

6. Ms. Seidman emphasized, however, that she would prefer an approach similar to the approach in Issue 02-3, where the transaction price presumption would be rebutted only if the model value is derived principally from market inputs. In that regard, however, she said that she would lower the Issue 02-3 minimum reliability threshold at initial recognition to allow market inputs that are directly observable (within Level 3 of the fair value hierarchy) as well as market inputs that are otherwise derived (within Level 4 of the fair value hierarchy).

Day 1 Dealer Profit

7. Ms. MacDonald said that at initial recognition, a mark-to-model approach for the fair value estimate could result in a difference at initial recognition, that is,

a difference between the transaction price and a model value (Day 1 dealer profit). Thus, a related issue is how to recognize Day 1 dealer profit.

8. Ms. MacDonald said that conceptually, the staff members who support a mark-to-model approach for the fair value estimate also support an earnings approach for the Day 1 dealer profit, in other words, recognize the Day 1 dealer profit in earnings at initial recognition. At the same time, however, she acknowledged related concerns about the possibility of measurement error in the absence of market inputs. She said that the alternative "deferral" approach for the Day 1 dealer profit would address those concerns, deferring the Day 1 dealer profit until such time as the model value is supported by market inputs. She asked the Board for its view.

9. Mr. Trott said that he prefers the earnings approach. He added, however, that because this issue is, in effect, a revenue recognition issue, he would be willing to compromise by deferring the Day 1 dealer profit and recognizing it in earnings when the model value is supported by market inputs (within Level 3 or Level 4 of the fair value hierarchy). In other words, by way of compromise, he would support the deferral approach.

10. Ms. Schipper said that like Mr. Trott, she prefers the earnings approach but that by way of compromise she would support the deferral approach. She would recognize the deferred Day 1 dealer profit as a deferred credit (or debit), not in accumulated other comprehensive income.

11. Ms. Seidman said that she supports the deferral approach. She said that in applying that approach, she would set the minimum reliability threshold for recognition of the Day 1 dealer profit in earnings within Level 4, provided that the market inputs derived within Level 4 provide persuasive market evidence. She added, however, that she would not establish a bright-line between or among the levels within the fair value hierarchy, allowing for judgment in that regard.

12. Mr. Crooch said that in his view, the deferral approach lacks conceptual basis. He expressed concerns that the resulting deferred credit (or debit) would create conflicts with the Board's conceptual framework. Ms. MacDonald agreed

that it might. However, she emphasized that at this time, having developed a Statement focusing on fair value measurements, an objective should be to establish fair value measurement guidance consistent with that Statement and separately address the revenue recognition (and the resulting deferred credits and debits) issues later, as guidance in that regard evolves.

13. No Board members objected to a deferral approach for the Day 1 dealer profit with a minimum reliability threshold within Level 4 of the fair value hierarchy, allowing for judgment in determining whether the market inputs derived within Level 4 provide persuasive market evidence. The deferred amount should be recognized as a deferred credit (or debit), not in accumulated other comprehensive income.

Changes in Fair Value

14. Ms. MacDonald said that in view of the Board's decision to require a deferral approach for the Day 1 dealer profit, a related issue is whether to require a similar deferral approach for changes in fair value.

15. Ms. MacDonald said that the staff does not support a similar deferral approach for changes in fair value. In the staff's view, a deferral approach for changes in fair value would represent a fundamental amendment to FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*, which requires that all changes in fair value be recognized in earnings in the period of change without exception (that is, regardless of the inputs used to estimate fair value). Further, such an amendment could have significant implications under other existing and proposed pronouncements that require remeasurements at fair value. She said that the staff recommends that all changes in fair value be recognized in earnings in the period of change (consistent with a mark-to-model approach for the fair value estimates in all periods).

16. Mr. Herz said that he would prefer a deferral approach for subsequent changes in fair value. However, he acknowledged that a requirement to monitor where within the fair value hierarchy each model input and subsequent changes

fall in each reporting period could be unduly burdensome. Further, as a practical matter, concerns about measurement error relate principally to initial fair value estimates (that rebut a transaction price), not subsequent fair value estimates. Therefore, he would support the staff recommendation, with appropriate disclosure. He said that the emphasis in subsequent periods should be on consistency with respect to the use of the model.

17. By way of example, Mr. Herz referred to a situation in which there is no basis to forecast or predict inputs that would be used in a model (including Level 5 inputs). Specifically:

> A foreign sovereign government of a developing country borrows money (in dollars) for infrastructure investments. Its interest rate and repayments of principle are denominated in dollars and the repayments of principle are long-dated (35–40 years). The government enters into an arrangement with a derivatives products dealer for 35 or 40 years in a cross-currency cross-interest rate swap. The underlying bond in the currency markets extends for two years at that time. The government agrees to receive the dollar interest and principal payments in return for paying the derivatives product dealer (that is, the reporting enterprise) foreign currency over the period, which includes a variable rate of interest based on the short-term variable interest rate in that developing country.

18. Mr. Herz observed that that situation is an extreme situation in which there is no objective basis on which to estimate the fair value of the derivative instrument. In other words, verifiability is so lacking that it is impossible to conclude whether or not one can get a faithful representation of the fair value construct. In view of the possibility of other similar situations, he would prefer not to mandate a minimum reliability threshold for changes in fair value. Rather, the decision of whether to recognize changes in fair value should be made on a case by case basis, considering the persuasiveness of the available evidence.

19. Ms. Schipper and Mssrs. Crooch and Trott agreed with the staff recommendation. Mr. Trott emphasized that a deferral approach for changes in fair value would represent a significant amendment to Statement 133 and would be inconsistent with fair value remeasurements under other existing and

proposed pronouncements. Ms. Schipper said that the Board should not change the existing requirements of Statement 133 in that regard.

20. Ms. Seidman and Mssrs. Batavik and Young initially disagreed with the staff recommendation. They said that the fair value estimate should be updated only when a change in the model value is supported by market inputs.

21. In response, Ms. Schipper said that a deferral approach for changes in fair value in this proposed FSP would create internal inconsistencies, adding to the complexity in generally accepted accounting principles (GAAP). By way of example, she referred to the situation in which an entity invests in many small start-up companies, including development stage enterprises, that it is required to measure at fair value at the reporting date. She said that in many cases, the entity likely will only have Level 5 inputs with which to measure those fair values. She said that for those derivatives that have similar attributes, it is important that the Board decide on an internally consistent measurement approach.

22. Similarly, Mr. Trott pointed out that a significant Board initiative is simplification. He emphasized that a deferral approach for subsequent changes in fair value would be contrary to that initiative. In particular, it would put tremendous pressure on the levels within the fair value hierarchy, making compliance with the requirements of the proposed FSP far more complex than necessary.

23. No Board members objected to the staff recommendation, thereby retaining the current requirement of Statement 133 to recognize all changes in fair value in earnings in the period of change.

Disclosures

24. Ms. MacDonald said that the staff recommends that the proposed FSP require related disclosures at initial recognition that are generally consistent with the disclosures that would be required in the FVM Statement in periods subsequent to initial recognition, specifically:

a. Fair value amounts and the inputs used to determine those amounts, indicating where a transaction price versus a model value is used to estimate fair value at initial recognition

b. Unrealized gains or losses recognized in earnings at initial recognition (if applicable)

c. Deferred amounts (in the period and cumulative to date) and a description of where those amounts are reported in the statement of financial position.

25. All Board members agreed with the staff recommendation.

Follow-up Items:

26. None.

General Announcements:

27. None.

Board Meeting Handout

ATTACHMENT

PROPOSED FSP RELATING TO EITF ISSUE NO. 02-3
June 29, 2005 Board Meeting

The Board will discuss issues relating to 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."

1. FAIR VALUE ESTIMATES

Statement 133 requires that derivative instruments be measured at fair value at initial recognition and in all subsequent periods. For an Issue 02-3 derivative transaction, the threshold issue is whether at initial recognition, the transaction price presumption is rebutted by a model value that reflects the entity's estimate of the amount that would be paid to layoff the risk inherent in the transaction.

One view is that conceptually, the transaction price presumption would be rebutted in all cases. Presumptively, the market in which the transaction occurs is not the reference market for the asset or liability. An entity that originates an Issue 02-3 derivative transaction (in a retail market) will not willingly assume the risk inherent in the transaction absent possible layoff alternatives (in a more advantageous market). Therefore, the entity would mark-to-model at initial recognition and in all subsequent periods.

An alternative view is that the transaction price presumption would not be rebutted in the absence of other market data supporting the model value. The transaction price would represent the best estimate of the fair value of the derivative instrument at initial recognition.

2. DAY 1 DEALER PROFIT

Statement 133 does not specify how to recognize a difference, if any, between a transaction price and a model value used to estimate fair value at initial recognition (Day 1 dealer profit). That is a threshold issue if the Board believes that the transaction price presumption is rebutted by a model value that reflects the entity's estimate of the amount that would be paid to layoff the risk inherent in the transaction. Recognition approaches follow.

Earnings approach. Under an earnings approach, the Day 1 dealer profit would be recognized in earnings (with appropriate disclosure). In that case, the transaction is, in effect, a multiple elements transaction. In addition to the derivative instrument, the transaction includes a revenue component specific to the entity that originates (structures) the transaction. An earnings approach would separately recognize each of those elements, providing more complete information to users of financial statements than under Issue 02-3 currently. However, in the absence of other market data supporting the model value, some (or all) of that difference might represent measurement error, raising concerns about the "quality" of earnings. Default approaches follow.

Amortization approach. Under an amortization approach, the Day 1 dealer profit would be deferred at initial recognition and amortized into earnings over the term of the instrument.

Deferral approach. Under a deferral approach, the Day 1 dealer profit would be recognized in earnings when a minimum reliability threshold for the model value is met, whether at initial recognition or subsequently. Until that time, the Day 1 dealer profit would be deferred and either (1) recognized as a "deferred credit" or (2) included in OCI. In that regard, the Board will consider thresholds within Level 3 (direct market inputs that are observable over the full term of the instrument) or Level 4 (indirect market inputs that are corroborated by direct market inputs that are observable over the full term of the instrument).

3. CHANGES IN FAIR VALUE

In subsequent periods, the initial fair value estimate would be updated for all changes indicated by the model value. Statement 133 requires that changes in fair value be recognized in earnings in the period of change, regardless of where within the fair value hierarchy the estimate (model value) falls. If the Board establishes a minimum reliability threshold for purposes of determining when to recognize Day 1 dealer profit in earnings, a related issue is whether that minimum reliability threshold also should apply for purposes of determining when to recognize changes in fair value in earnings.

If so, changes in fair value would be similarly deferred or included in OCI (and not recognized in earnings) until the minimum reliability threshold for the model value is met.

If not, changes in fair value would be recognized in earnings in the period of change, regardless of whether the Board decides to establish a minimum reliability threshold for Day 1 dealer profit. In the staff's view, a minimum reliability threshold for changes in fair value would represent a fundamental amendment to Statement 133, having implications under other existing and proposed pronouncements.

4. DISCLOSURES

The Board will consider related disclosures in the context of the disclosure framework in the FVM Statement. (The Board currently has on its agenda a project to separately consider other disclosures specific to derivatives.)

Fair value amounts. The FVM Statement would require disclosure of the fair value amounts and the inputs used to determine those amounts (by disclosure level), but only for fair value estimates in periods subsequent to initial recognition. The Board will consider whether the FSP should require those same disclosures at initial recognition (indicating where a model value is used for the estimate, the transaction price presumption having been rebutted).

Unrealized gains or losses. The FVM Statement would require disclosure of unrealized gains or losses relating to fair value estimates that fall below Level 3 of the fair value hierarchy, but only in periods subsequent to initial recognition.

- If the Board decides that Day 1 dealer profit should be recognized in earnings at initial recognition (earnings approach), the Board will consider whether the FSP should require that same disclosure at initial recognition. If so, the Day 1 dealer profit would be separately disclosed when the model value falls below Level 3, mitigating quality of earnings concerns.

- If the Board decides that Day 1 dealer profit should be deferred until a minimum reliability threshold is met, the Board will consider whether the FSP should require disclosure of deferred amounts.