

FASB Emerging Issues Task Force

Issue No: 04-13

Title: Accounting for Purchases and Sales of Inventory with the Same Counterparty

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Previously Distributed EITF Materials: Issue Summary No. 1, dated November 8, 2004;
Issue Summary No. 1, Supplement No. 1, dated March 1, 2005

References:

FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities* (FAS 133)

FASB Statement No. 49, *Accounting for Product Financing Arrangements* (FAS 49)

FASB Statement No. 153, *Exchanges of Nonmonetary Assets* (FAS 153)

APB Opinion No. 29, *Accounting for Nonmonetary Transactions* (APB 29)

Statement 133 Implementation Issue No. K1, "Miscellaneous: Determining Whether Separate Transactions Should Be Viewed as a Unit" (DIG Issue K1)

EITF Issue No. 99-19, "Reporting Revenue Gross as a Principle verses Net as an Agent" (Issue 99-19)

EITF Issue No. 01-2, "Interpretations of APB Opinion No. 29" (Issue 01-2)

* The alternative views presented in this Working Group Report are for purposes of discussion by the EITF. No individual views are to be presumed to be acceptable or unacceptable applications of Generally Accepted Accounting Principles until the Task Force makes such a determination and it is ratified by the Board.

EITF Issue No. 02-2, "When Certain Contracts That Meet the Definition of Financial Instruments Should Be Combined for Accounting Purposes" (Issue 02-2)

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" (Issue 02-3)

EITF Issue No. 03-11, "Reporting Realized Gains and Losses on Derivative Instruments That Are Subject to FASB Statement No. 133 and Not 'Held for Trading Purposes' as Defined in Issue No. 02-3" (Issue 03-11)

Background

1. Two questions were originally presented to the EITF Agenda Committee that address purchase and sales transactions with the same counterparty. Those questions were:

Question 1: Under what circumstances should two or more transactions with the same counterparty (counterparties) be viewed as a single nonmonetary transaction within the scope of APB 29?

Question 2: If nonmonetary transactions within the scope of APB 29 involve inventory, are there any circumstances under which the transactions should be recognized at fair value?

2. The questions were presented to the Task Force because of the diverse accounting that exists in the oil and gas industry for certain buy/sell arrangements. However, application of the issues was deemed to be broader than to just the oil and gas industry and, therefore, all types of inventory transactions were considered. This Working Group Report provides a description of the crude oil buy/sell arrangements that were originally considered by the Agenda Committee.

3. Crude oil buy/sell arrangements are arrangements in which an entity agrees to buy a specified quantity and grade of oil to be delivered at a specified location while simultaneously agreeing to sell a specified quantity and grade of oil at a different location with the same counterparty. Entities commonly enter into buy/sell arrangements to facilitate (a) the sale of oil that will not be used in refining operations, (b) the purchase of the appropriate grade of oil in a location to supply refining operations, or (c) the fulfillment of contractual obligations to deliver oil of a specified grade or to a specified location (or both) in the most cost-efficient manner.

4. Generally, contractual obligations associated with the purchase and sales sides of a buy/sell arrangement are not legally contingent upon the completion of the other side of the arrangement. That is, failure by one party under either side of the arrangement does not relieve the other party's obligation to perform under its side of the arrangement. Therefore, the oil is physically

delivered, title passes for each individual transaction, and each entity is required to pay the full purchase price for the oil that it receives.

5. Entities may also enter into multiple-linked buy/sell arrangements. For example: Company A produces heavy crude oil (dense, viscous crude oil) in California and has refining operations in West Texas that are unable to process heavy crude oil. Company A would like to acquire West Texas crude oil in the most cost-efficient manner.

6. As part of Company A's analysis in determining the most cost-efficient approach to acquiring West Texas crude oil, it uses the following available information regarding the current oil needs (short capacity) and excess oil capacity (excess capacity) of the various oil companies:

Company	Short capacity/Location	Excess capacity/Location
Company A	West Texas crude oil/Texas	heavy crude oil/California
Company B	heavy crude oil/California	sweet crude oil/Oklahoma
Company C	sweet crude oil/Oklahoma	West Texas crude oil/Texas

7. Company A enters into an arrangement to sell Company B a specified quantity of its California production and purchases a similar quantity of Company B's crude oil production in Oklahoma. Company A also enters into an agreement with Company C to sell the crude oil in Oklahoma purchased from Company B to Company C, and acquires a similar quantity and quality of West Texas crude oil from Company C for its refining operations.

Previous Discussion

8. At the March 17, 2005 EITF meeting, the Task Force addressed Question 2 for inventory transactions that are deemed nonmonetary transactions within the scope of APB 29, and reached a tentative conclusion that a nonmonetary exchange, whereby finished goods inventory is transferred in exchange for the receipt of raw materials or work-in-process (WIP) inventory within the same line of business, should be recognized at fair value if (a) fair value is determinable within reasonable limits and (b) the transaction has commercial substance

(paragraphs 20 and 21 of APB 29, as amended by FAS 153¹). All other nonmonetary exchanges of inventory within the same line of business should be recognized at the carrying amount of the inventory transferred. That is, a nonmonetary exchange within the same line of business would not be recognized at fair value if it involves either (a) the transfer of raw materials or WIP inventory in exchange for the receipt of raw materials, WIP inventory, or finished goods inventory, or (b) the transfer of finished goods inventory for the receipt of finished goods inventory.

9. The Task Force also reached a tentative conclusion that the classification of a type of inventory for purposes of applying APB 29 should be the same classification that an entity uses, or would be required to use, for external financial reporting purposes.

10. The Task Force also reached a tentative conclusion that an entity should disclose the amount of revenue and the cost of sales (or gains/losses) associated with inventory exchanges recognized at fair value. Additionally, if such revenues and costs (or gains/losses) are not disclosed as a separate component on the statement of operations, an entity should disclose in the notes to the financial statements where such amounts are included.

11. The Task Force deferred a final consensus on this Issue until after it considers Question 1.

12. The Task Force requested that the FASB staff further explore Question 1 with the assistance of a Working Group. The objective of the Working Group is to assist the Task Force in the development of a framework for determining when two or more inventory purchase and sales transactions with the same counterparty should be combined for purposes of applying APB 29.

¹ This tentative conclusion assumes that the effective date for a final consensus on this Issue will be after the effective date of FAS 153. FAS 153 amends APB 29 to require nonmonetary transactions to be accounted for at fair value unless (a) fair value is not determinable, (b) the exchange transaction is to facilitate sales to customers, which this Issue interprets, or (c) the exchange transaction lacks commercial substance.

Working Group Discussion

Scope

13. The Working Group and the FASB staff agreed that the scope of Issue 04-13 should exclude inventory transactions that involve software or real estate. Specific guidance exists for software and real estate exchange transactions that interprets the revenue recognition that is specific to those transactions. Accordingly, significant diversity in practice does not exist for inventory transactions in those industries. Additionally, the FASB staff is not aware of any requests to provide additional guidance for those transactions. Therefore, software and real estate transactions are not included in the scope of Issue 04-13.

14. In Phase 2 of the liabilities and equity project, the Board is considering a model for determining when it is appropriate to combine financial assets and/or liabilities. Accordingly, Issue 04-13 only addresses inventory transactions and does not address financial assets or liabilities. The FASB staff will continue to monitor the deliberations of the liabilities and equity project to determine whether any decisions or changes in the direction of that project would be helpful in considering whether inventory transactions should be combined.

15. The Working Group also agreed that Issue 04-13 should only apply to inventory buy/sell arrangements that are not accounted for as derivatives under FAS 133. However, some Working Group members observed that the FASB should separately consider presentation and disclosure issues associated with inventory arrangements that are accounted for as derivatives because certain inventory contracts, such as buy/sell inventory contracts of commodities, meet the definition of a derivative instrument. Other Working Group members did not believe that additional guidance was necessary.

Accounting Literature and Other Projects

The Working Group considered existing accounting literature that addresses circumstances in which separate transactions should be combined for accounting purposes. The Working Group also observed that two recent projects, Issue 02-2 and the International Financial Reporting Interpretations Committee (IFRIC) project on Linkage [IFRIC Agenda Paper 11], have

considered whether separate transactions with the same counterparty should be combined into a single transaction for accounting purposes. Discussions on Issue 02-2 ceased partly because of its potential interaction with Phase 2 of the FASB's liabilities and equity project. IFRIC's project on linkage also was discontinued for various reasons which included limited resources and the priority of other projects that were undertaken by IFRIC.

Recent Developments

16. In a letter dated February 11, 2005, the SEC staff stated that it would require registrants to disclose on the face of their financial statements the revenues and costs from buy/sell arrangements that are reported on a gross basis. The SEC staff also stated that it would require registrants to disclose, in an accounting policy footnote, the accounting literature that was relied on to arrive at gross reporting. The SEC staff stated that this disclosure is required for buy/sell arrangements that are entered into with the same counterparty either as one contract or as separate contracts concurrently or in contemplation of one another. The SEC staff did not limit these disclosures to the oil and gas industry.

Accounting Issue and Alternatives

In what circumstances should two or more inventory purchase and sales transactions with the same counterparty be combined as a single transaction for purposes of applying APB 29?

17. Some constituents believe that the purchase and sale of inventory with the same counterparty that involves the issuance of separate invoices and the exchange of cash should not be considered a nonmonetary exchange of inventory. The Working Group considered whether the issuance of invoices and the exchange of cash was an important consideration for determining whether a purchase and sales transaction should be combined.

18. The Working Group generally agreed that the issuance of invoices and the exchange of cash is not a factor that should be considered. The Working Group believes that if an inventory transaction is, in substance, a nonmonetary exchange of inventory; it should not be accounted for as a monetary exchange because counterparties issued separate invoices and exchanged cash.

19. The Working Group discussed inventory transactions entered into in certain European countries in which separate invoices are issued to each counterparty for purposes of satisfying statutory requirements. Specifically, the Working Group discussed whether an inventory sales transaction would be considered legally contingent upon an inventory purchase transaction in those circumstances, and vice versa. A Working Group member believes that the inventory sales contract is legally contingent upon the inventory purchase contract and vice versa.

20. Some constituents believe that DIG Issue K-1 provides the appropriate guidance for determining whether inventory transactions should be combined. However, the Working Group agreed that the criteria in DIG Issue K1 should not be used in determining when to combine two or more inventory transactions for purposes of applying APB 29. DIG Issue K1 states:

The following indicators should be considered in the aggregate and, if present, should cause the transactions to be viewed as a unit and not separately:

- a. The transactions were entered into contemporaneously and in contemplation of one another.
- b. The transactions were executed with the same counterparty (or structured through an intermediary).
- c. The transactions relate to the same risk.
- d. There is no apparent economic need nor substantive business purpose for structuring the transactions separately that could not also have been accomplished in a single transaction.

21. The Working Group noted that the objective of DIG Issue K1 is different from the objective of determining whether to combine separate inventory purchase and sales transactions for purposes of applying APB 29. DIG Issue K1's objective is to identify when two transactions were entered into separately in an attempt to circumvent FAS 133 and, therefore, focuses on whether there was a valid business purpose or an economic need for structuring transactions separately. The Working Group believes a valid business purpose or economic need for structuring transactions separately should not be an indicator for determining when to combine two or more inventory transactions for purposes of applying APB 29.

22. In practice, counterparties may enter into agreements in which the quantities of inventory to be delivered are contingent upon the receipt of inventory. That is, the quantities of inventory delivered are legally contingent upon the counterparty's performance. These arrangements may provide a cash settlement provision for nonperformance.

23. Working Group members agreed that if a transaction to purchase inventory is legally contingent upon a transaction to sell inventory with the same counterparty; or vice-versa, then the transactions should be combined for purposes of applying APB 29. Furthermore, the Working Group agreed that a cash remedy feature for breach of contract (lack of physical delivery) would not affect the decision to combine two or more inventory transactions with the same counterparty unless it becomes probable that one party to the exchange would breach the contract.

24. Working Group members were split in their support on the following two alternative views for determining when to combine two or more inventory purchase and sales transactions for purposes of applying APB 29.

View A: Inventory purchase and sales transactions with the same counterparty should be combined for purposes of applying APB 29 only if physical delivery of the inventory is legally contingent upon counterparty performance.

25. Proponents of View A believe that in order for two or more separate inventory purchase and sales transactions to be combined for purposes of applying APB 29, the delivery of inventory should be legally contingent upon receipt of inventory, and vice-versa.

26. View A proponents believe that separate discrete inventory purchase and sales transactions in which the performance of one side of the arrangement is not legally contingent upon the performance of the other side of the arrangement should not be combined for purposes of applying APB 29, regardless of whether the transactions were entered into in contemplation of one another. View A proponents believe that only when a purchase of inventory is legally contingent upon the sale of inventory would the two separate transactions be, in substance, a

nonmonetary exchange of inventory, because the delivery of inventory is contractually predicated on the receipt of inventory, or vice versa.

27. Opponents of View A believe that View A's approach is too narrow. Opponents to View A believe that the determination of whether to combine two or more inventory transactions with the same counterparty should not be based solely on the legal form of the arrangement. They believe there are a number of circumstances in which an inventory purchase that is not legally contingent upon an inventory sales contract with the same counterparty achieves the same economic result as an inventory purchase that is legally contingent upon an inventory sales transaction. For instance, opponents to View A point to inventory purchase and sales transactions that are entered into in contemplation of and contemporaneously with the same counterparty where nonperformance is highly unlikely. Opponents to View A believe that if an inventory purchase and sales transaction with the same counterparty is highly likely to occur and both parties contemplated those transactions, then it is substantively no different from entering into an arrangement to purchase inventory that is legally contingent upon the sale of inventory, or vice versa, with the same counterparty. Therefore, opponents to View A believe the accounting should be the same.

28. Opponents to View A also point out that inventory transactions with the same counterparty that achieve the same economic result as a nonmonetary exchange could be inappropriately accounted for at fair value if the arrangement was structured such that the transactions were not legally contingent upon each other. Opponents of View A believe View A allows such structuring opportunities to occur.

View B: Inventory purchase and sales transactions with the same counterparty that are entered into in contemplation of one another should be combined for purposes of applying APB 29.

29. View B proponents believe that separate inventory purchase and sales transactions that are entered into with the same counterparty with the mutual understanding that the related inventory transactions will occur should be combined for purposes of applying APB 29.

30. View B proponents believe that judgment may be required to determine whether separate inventory transactions were in contemplation of each other. Clearly, an inventory transaction that is legally contingent upon the performance of another inventory transaction with the same counterparty (View A) are in contemplation of each other and should be combined for purposes of applying APB 29.

31. View B proponents believe that the following indicators should also be considered in making the determination as to whether a purchase transaction and a sales transaction were entered into in contemplation of one another and, therefore, combined for purposes of applying APB 29. These indicators are not determinative but should be considered and can be present in varying degrees in inventory purchase and sales transactions with the same counterparty:

- (1) *There is a legal right of offset of obligations between counterparties involved in inventory purchase and sales transactions.*

The ability to offset the receivable and payables related to the inventory transactions indicates that there is a link between the separate inventory transactions and, therefore, is an indicator that the inventory transactions were entered into in contemplation of one another. Past practice regarding such transactions would strengthen this indicator.

- (2) *Inventory purchase and sales transactions with the same counterparty are entered into contemporaneously with one another.*

The closer in time that an inventory purchase is entered into with an inventory sales transaction with the same counterparty, and vice versa, the stronger the indication that the transactions were entered into in contemplation of one another. This indicator may be more useful when fewer transactions between counterparties occur.

- (3) *Inventory purchase and sales transactions were at off-market terms.*

If a company enters into an off-market inventory transaction with a counterparty, then it is an indication that the transactions were linked and entered into in contemplation of another inventory transaction with that same counterparty. Proponents of View B believe that this indicator would be more relevant for transactions with products that

have readily determinable market prices, such as exchange-traded commodities, and less relevant for transactions with products that have greater discretionary pricing (for example, discounts for volume purchases).

(4) *Certainty that reciprocal inventory transactions with the same counterparty will occur.*

In some arrangements, a company may sell inventory to a counterparty and enter into another arrangement with the same counterparty whereby the counterparty may, but is not required to, deliver up to an agreed-upon inventory amount. The more certain it is that both inventory transactions will occur, the stronger the indication that the two inventory transactions were entered into in contemplation of one another for purposes of applying APB 29.

32. Proponents of View B believe that analogies can be made to existing guidance whereby two separate distinct transactions with a counterparty should be combined for accounting purposes if they are entered into in contemplation of one another because combining them better reflects the substance of the transaction. For instance, View B proponents look to FAS 49 for an analogy whereby separate inventory transactions with a counterparty are combined and treated as one financing transaction if certain criteria are met. FAS 49, paragraph 8(a), states,

If a sponsor [seller] sells the product to another entity and, in a related transaction, agrees to repurchase the product (or a substantially identical product) or processed goods of which the product is a component, the sponsor shall record a liability at the time the proceeds are received from the other entity to the extent that the product is covered by the financing arrangement. The sponsor shall not record the transaction as a sale and shall not remove the covered product from its balance sheet.

33. Proponents of View B emphasize that even though the above transaction is related to a buy/sell transaction of identical or substantially identical inventory, the principle for combining those two separate inventory transactions is that the combined transaction better reflects the substance of the transaction—that is, a financing transaction.

34. Opponents to View B believe that if a company sells inventory to a counterparty and selling that inventory is not legally contingent upon buying inventory from that same counterparty, then the two transactions should not be combined for purposes of applying APB 29. Opponents to View B believe there is a distinction between an inventory transaction that is legally contingent upon another inventory transaction and two inventory transactions that were entered into in contemplation of one another. View B opponents believe that the legal form of the arrangement should be honored and that only when the performance of one transaction is legally contingent upon the performance of the other transaction can the two be viewed as one transaction for purposes of applying APB 29.

35. In addition, opponents to View B believe that View B is not operational. For instance, opponents to View B point to the ambiguousness of the term contemporaneous (for example, transactions that are entered into at the same time or that occur within a certain period of time), and believe that it will be difficult to consistently apply in practice. In addition, these opponents also have concerns that View B, in many instances, will inappropriately require numerous inventory transactions that coincidentally were entered into with the same counterparty at the same time to be presumed to have been in contemplation of one another. These opponents look to View A as a more operational in determining when two or more inventory transactions should be combined for purposes of applying APB 29 because the separate inventory transactions are legally linked to each other. Opponents to View B believe that combining transactions beyond those that are legally linked to each other could be an arduous exercise that could require an analysis of all inventory transactions with counterparties to determine whether one was done in contemplation of the other. This could be difficult, in particular, for large multi-national companies that buy and sell inventory in significant volumes of transactions around the world to a number of different legal enterprises that are all a part of one consolidated entity (considered one counterparty).

36. Lastly, these opponents believe that disclosure on the face of the financial statements of the revenue and costs of sales for the inventory transactions that were entered into concurrently or in contemplation of one another with the same counterparty would provide sufficient transparency for the user of the financial statements.

Disclosures

37. Currently, paragraph 28 of APB 29 requires a company that engages in one or more nonmonetary transactions during the period to "disclose in financial statements of the period the nature of the transactions, the basis of accounting for the assets transferred, and gains and losses recognized on transfers." Additionally, as noted earlier in this Working Group Report, the SEC staff is requiring registrants to (a) disclose on the face of their financial statements the revenues and costs from buy/sell arrangements that are reported on a gross basis and (b) disclose in their accounting policy footnotes the accounting literature they relied on to arrive at gross reporting. The SEC staff stated that these disclosures are required for buy/sell arrangements that are entered into with the same counterparty either as one contract or as separate contracts that are entered into concurrently or in contemplation of one another.

38. The Working Group believes that if the Task Force reaches a consensus on View A in this Issue, an enterprise should disclose on the face of its financial statements the amount of revenue and cost of sales from inventory purchase and sales arrangements that were entered into with a counterparty and reported on a gross basis. This disclosure is required for inventory purchase and sales arrangements with the same counterparty that are entered into either as one contract or as separate contracts entered into concurrently or in contemplation of one another.

Transition

39. The Working Group recommends that any consensus in this Issue be applied to transactions completed in reporting periods beginning after December 15, 2005, whether pursuant to arrangements that were in place at the date of initial application of the consensus or arrangements executed subsequent to that date. The carrying amount of the inventory that was acquired under these types of arrangements prior to the initial application of the consensus and that still remains in an entity's statement of financial position at the date of initial application of the consensus should not be adjusted. Early application of the consensus should be permitted in periods for which financial statements have not been issued.