FASB Emerging Issues Task Force

Issue No. 04-13

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

Document: Issue Summary No. 1*

Date prepared: November 8, 2004

FASB Staff: Munro (ext. 350)/Westerlund (ext. 212)

Date previously discussed: None

Previously distributed EITF materials: None

References:

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

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

Statement 133 Implementation Issue No. K3, "Miscellaneous: Determination of Whether Combinations of Options with the Same Terms Must be Viewed as Separate Option Contracts or as a Single Forward Contract" (DIG Issue K3)

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

AICPA Accounting Research Bulletin No. 43, Chapter 4, *Inventory Pricing* (ARB 43)

AICPA Technical Practice Aids, Section 5100.46, "Nonmonetary Exchanges of Software (Part 1)" (TPA 5100.46)

AICPA Technical Practice Aids, Section 5100.47, "Nonmonetary Exchanges of Software (Part II)" (TPA 5100.47)

---

* **The alternative views presented in this Issue Summary 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. 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)

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. An entity may sell inventory to another entity in the same line of business from which it also purchases inventory. The purchase and sale transactions may be pursuant to a single contractual arrangement or separate contractual arrangements and the inventory purchased or sold may be in the form of raw materials, work-in-process, or finished goods. The following questions have been raised regarding the accounting for these types of transactions:

a. 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?

b. 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 Task Force will be asked to address the first question at a future meeting. Accordingly, this Issue Summary addresses only the second question. Therefore, the scope of this Issue Summary is limited to purchases and sales of inventory between entities in the same line of business that are deemed nonmonetary transactions within the scope of APB 29.[1] The fundamental issue is whether these types of transactions are within the scope of paragraph 21(a) of APB 29, which requires that the transactions be recognized based on recorded amounts rather than fair value. Because paragraph 21(a) is limited to exchanges of inventory to be sold in the same line of business, only nonmonetary exchanges of inventory between entities in the same line of business are being considered in this Issue Summary.

3. When this Issue was originally presented to the EITF Agenda Committee it specifically focused on purchase and sale transactions pursuant to crude oil buy/sell arrangements. Although this Issue applies broadly, the FASB staff suggests that when considering the alternative views for this Issue, the Task Force should consider crude oil buy/sell transactions as an example. Following is a discussion of those types of arrangements.[2] For purposes of this Issue Summary,

---

[1] If the amount of net monetary consideration in the exchange is at least 25 percent of the fair value of the exchange, the transactions should be accounted for as monetary transactions outside the scope of APB 29, in accordance with Issue 8(a) in Issue 01-2.

[2] When considering crude oil buy/sell arrangements, assume that they are not accounted for as derivatives under FAS 133 (for example, because the entity has designated the contracts as normal purchases and normal sales pursuant to paragraph 10(b) of FAS 133 and related interpretations).

assume that transactions pursuant to these arrangements are nonmonetary transactions within the scope of APB 29.

4. Oil and gas companies (including both integrated companies that engage in crude oil producing, refining, and marketing activities and independent producers and refiners) may enter into buy/sell arrangements to procure and market crude oil. The specific nature of the arrangement used depends on factors that include, but that are not limited to: (a) the location of the crude oil relative to the refinery and/or end customer, and (b) the quality (grade) of the crude oil. The location of the crude oil may impact the price of the crude oil due to transportation costs and/or local supply and demand. The grade of the crude oil (which is affected by its density and/or sulfur content) may vary depending on the oil's production location and may also impact the price.

5. Many suppliers that physically hold crude oil inventory or produce crude oil will not sell their crude oil without the purchaser agreeing to sell crude oil back to the supplier at another location.

6. Crude oil buy/sell arrangements are arrangements in which an entity agrees to buy a specific quantity and grade of oil at a specified price to be delivered at a specific 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 its refining operations because of the location of producing wells or the grade of oil, (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 at a specific location (or both) in the most cost-efficient manner.

7. Generally, the purchase and sale sides of a buy/sell arrangement are not contingent on the completion of the other side of the arrangement. However, a counterparty may be permitted to reduce the amount that it delivers if the other party delivers less than the specified quantity. In those arrangements, purchased volumes often do not equal sales volumes. In all cases, the oil is

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

8. Entities may 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 enters into an arrangement with Company B, which has light, sweet crude oil (low viscosity oil with low sulfur content) production in Oklahoma, but refining operations in California that use heavy oil. Company A agrees 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, which has West Texas crude oil production, but refining operations in Oklahoma. Company A sells 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.

9. Currently, diversity in practice exists on how oil and gas companies account for purchase and sale transactions pursuant to buy/sell arrangements. Some integrated companies and independent refining companies account for all such transactions at fair value, recording both the revenue for the oil sold and inventory/cost of sales for the oil purchased at fair value. Others account for the transactions based on the recorded amount of the crude oil sold. Still others account for purchases of crude oil for their refineries from buy/sell transactions as nonmonetary exchanges based on the recorded amount of the crude oil sold, but recognize crude oil purchased for resale at fair value.

Accounting Issue and Alternatives

Issue: Whether there are circumstances under which nonmonetary exchanges of inventory within the same line of business should be recognized at fair value.

View A: There are no circumstances under which nonmonetary exchanges on inventory should be recognized at fair value.

10. View A proponents believe that all nonmonetary exchanges of inventory within the scope of this Issue should be accounted for based on recorded amounts because the exchange is within the scope of paragraph 21 of APB 29. However, to the extent there is net monetary consideration, paragraph 12 of this Issue Summary discusses the accounting for any net monetary consideration received. Paragraph 21 of APB 29 states:

> *Exchanges.* If the exchange is not essentially the culmination of an earnings process, accounting for an exchange of a nonmonetary asset between and enterprise and another entity should be based on the recorded amount (after reduction, if appropriate, for an indicated impairment of value of the nonmonetary asset relinquished). The Board believes that the following two types of nonmonetary exchange transactions do not culminate an earnings process:
>
> a. An exchange of a product or property held for sale in the ordinary course of business for a product or property to be sold in the same line of business to facilitate sales to customers other than parties to the exchange, and
>
> b. An exchange of a productive asset not held for sale in the ordinary course of business for a similar productive asset or an equivalent interest in the same or similar productive asset (similar productive asset is defined in paragraph 3 and examples are given in paragraph 7). [Footnote references omitted.]

11. View A proponents believe that all nonmonetary inventory exchanges within the scope of this Issue are within the scope of paragraph 21(a) of APB 29 because they are exchanges of a product held for sale in the ordinary course of business (inventory) for a product to be sold in the same line of business (because the inventory received is from an entity in the same line of business) to facilitate sales to customers other than the parties to the exchange (that is, the inventory received will be either directly sold, as is, to third party customers or will become part of a finished good that will be sold to third party customers). View A proponents note that paragraph 16(a) of APB 29 clarifies that the emphasis in the type of exchange described in paragraph 21(a) is on, "developing economical ways to acquire inventory for resale to customers rather than on marketing inventory to obtain revenue from customers. Therefore, 'swapping' inventories between enterprises…is merely an incidental early stage of an earnings process, and revenues should not be recognized until the time of sale of the exchanged products (in the same or another form) to a customer of the enterprise."

12. View A proponents observe that this conclusion is consistent with the analysis in TPA 5100.46 and TPA 5100.47 regarding nonmonetary exchange of software. TPA 5100.46 addresses nonmonetary exchanges of software when the software received will either be resold or imbedded in the entity's product and resold. TPA 5100.46 concludes that the transaction is within the exception to fair value in paragraph 21(a) of APB 29. TPA 5100.47 further clarifies that the way in which the entity plans to "resell" the software is not relevant in the analysis. Specifically, footnote 2 to TPA 5100.47 states:

> A software vendor that receives any of the following would be receiving inventory:
>
> *a*. a product to resell, sublicense, or sublease,
> *b*. a right to embed the technology received into a product, or
> *c*. a right to further develop the technology received into a product.

13. View A proponents note that nonmonetary exchanges of inventory that would otherwise be based on recorded amounts may include an amount of net monetary consideration (boot). In those circumstances, the pro rata gain recognition guidance in paragraph 22 of APB 29 should be applied by the receiver of the boot.

14. View A opponents believe that determining whether nonmonetary exchanges of inventory are "inventory swaps" within the scope of paragraph 21(a) of APB 29 depends on the specific facts and circumstances of the transaction, as discussed under View B. Some View A opponents also believe that not reporting these transactions at fair value would make an entity's procurement and marketing activities less transparent to users of their financial statements and result in less relevant and representationally faithful financial information.

View B: There are circumstances under which nonmonetary exchanges of inventory should be recognized at fair value.

15. View B proponents believe there are circumstances under which nonmonetary exchanges of inventory are not within the scope of paragraph 21(a) of APB 29—thus, the transactions should be recognized at fair value. View B proponents have identified certain indicators that should be

considered when determining whether nonmonetary exchanges of inventory are within the scope of paragraph 21(a) of APB 29. In developing those indicators, those proponents focused on the specific words in paragraph 21(a) of APB 29 such as: (a) whether the inventory sold is "held for sale in the ordinary course of business,"[3] (b) whether the inventory received will be "sold in the same line of business," and (c) whether the exchange "facilitates sales to customers other than parties to the exchange." However, View B proponents acknowledge the discussion in paragraph 16(a) of APB 29 (discussed in paragraph 10, above) and, therefore, believe that if an exchange has no valid business purpose other than to reduce transportation costs when acquiring inventory for resale (either in the same or in another form), the transactions should be recognized at recorded amounts.

16. The FASB staff will ask the Task Force whether the indicators, taken individually and in the aggregate, appropriately distinguish between transactions that are within the scope of paragraph 21(a) of APB 29 and transactions that are outside the scope of paragraph 21(a) of APB 29. Additionally, the FASB staff will ask the Task Force whether there are other indicators that should be considered and whether any of the indicators should be considered determinative or presumptive.

Indicators that nonmonetary exchanges of inventory are within the scope of paragraph 21(a) of APB 29

- The inventory sold is identical to or substantially the same as the inventory purchased
- The inventory sold in the exchange is identical or similar to inventory that the entity commonly sells, as is, to other third parties
- The inventory sold in the exchange could have been used as a component (raw material or work-in-process) in the production of finished goods inventory of the seller
- The inventory received in the exchange will be directly resold, as is, to third party customers.

Indicators that nonmonetary exchanges of inventory are outside the scope of paragraph 21(a) of APB 29

[3] View B proponents note that APB 29 refers to inventory "held for sale in the ordinary course of business," which uses words identical to those used in ARB 43, Chapter 4, to describe only *finished goods* inventory. Specifically, ARB 43, Chapter 4, describes finished goods inventory as inventory "held for sale in the ordinary course of business," work-in-process inventory as inventory "in process of production for such sale," and raw materials inventory as inventory "to be currently consumed in the production of goods or services to be available for sale."

- The inventory sold is significantly different from the inventory purchased
- The inventory sold in the exchange is significant different from inventory that the entity commonly sells to other third parties
- The inventory sold in the exchange could not have been used as a component (raw material or work-in-process) in the production of finished goods inventory of the seller
- The inventory received in the exchange will be used as a component (raw material or work-in-process) in the production of finished goods inventory of the seller before being sold to third party customers

Interaction with Other Board Agenda Projects

17. The Board has agreed to amend APB 29 in its short-term convergence project; however, the amendment will carry forward without reconsideration the current guidance in paragraph 21(a) of APB 29 related to the exchange of products that are held for sale in the ordinary course of business (inventory exchanges). Therefore, the Board's project will not address or provide additional guidance on those transactions. However, if the Task Force concludes that certain transactions are within the scope of APB 29, but that they are not within the scope of paragraph 21(a), the amendment to APB 29 likely will require an additional evaluation as to whether such transactions have commercial substance.

Transition

18. The FASB staff recommends that any consensus in this Issue should be applied to transactions deemed nonmonetary exchanges of inventory within the scope of this Issue in reporting periods beginning after Board ratification of the consensus 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 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.