

**FASB Emerging Issues Task Force**

**Issue No.** 06-12

**Title:** Application of AICPA Audit and Accounting Guide, *Brokers and Dealers in Securities*, to Entities That Engage in Commodity Trading Activities and Related Issues

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**Date previously discussed:** None

**Previously distributed EITF materials:** None

**References:**

FASB Statement No. 131, *Disclosures about Segments of an Enterprise and Related Information* (FAS 131)

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

FASB Statement No. 157, *Fair Value Measurement* (FAS 157)

Accounting Research Bulletin No. 43, *Restatement and Revision of Accounting Research Bulletins*, Chapter 4, "Inventory Pricing," (ARB 43)

AICPA Audit and Accounting Guide, *Brokers and Dealers in Securities* (Broker-Dealer Guide)

AICPA Audit and Accounting Guide, *Audits of Investment Companies* (Investment Company Guide)

International Accounting Standard No. 2, *Inventories* (IAS 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)

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**\* 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, exposes it for public comment, and it is ratified by the Board.**

## **Background**

1. The landscape for the commodities trading market continues to expand both in volume and in diversity of market participants. While some global investment banks and energy companies have been trading a wide range of energy-related products (and other physical commodities) for many years, other financial intermediaries have become increasingly active over the last several years in the energy trading markets. Traditionally, the product offerings were primarily focused on financial products including those based on crude oil, natural gas, power, coal, and base metals; in addition to market making, speculation, and risk management trading activities. Recently, these other financial intermediaries have expanded their portfolios to incorporate the purchase and sale of commodities by taking physical delivery of the underlying commodity. These entities may or may not be regulated as a broker-dealer.
2. While generally accepted accounting principles apply to broker-dealers in the same manner as they apply to other industries, certain activities of a broker-dealer's operations are unique. For this reason, the Broker-Dealer Guide provides certain interpretations and other guidance specific to broker-dealers. Determining whether an entity is within the scope of the Broker-Dealer Guide is significant because the Broker-Dealer Guide provides a specialized accounting model. One important difference in financial reporting for entities within the scope of the Broker-Dealer Guide is the requirement to carry inventory at fair value.
3. The specific accounting requirements for a broker-dealer make it important to consistently determine whether an entity is within the scope of the Broker-Dealer Guide. The Broker-Dealer Guide states:

This Guide applies to preparation and audit of financial statements of entities that are broker-dealers in securities. The activities of broker-dealers in securities are described in Chapter 1. Operations of such entities are subject to the rules and regulations of the Securities and Exchange Commission and other regulatory bodies.

Broker-dealers in securities are subject to regulation under the Securities Exchange Act of 1934. Some broker-dealers are also futures commission merchants for commodity futures and commodity option contracts subject to

regulation under the Commodity Exchange Act. [Preface: footnote reference omitted.]

4. In practice, diversity exists regarding the interpretation of the type of entity that can apply the Broker-Dealer Guide. Some believe the Broker-Dealer Guide is only applicable to entities that are regulated as broker-dealers under the Securities Exchange Act of 1934 (the 1934 Act), while others believe the Broker-Dealer Guide is applicable based on the activity of the entity, if the activities of the entity are similar to those of a regulated broker-dealer. Entities that qualify as a consolidated supervised entity (CSE<sup>1</sup>) have applied the Broker-Dealer Guide under an activities-based approach to non-regulated subsidiaries (or subsidiaries regulated in other jurisdictions) that conduct activities similar or identical to regulated broker-dealers. The SEC has prohibited certain other entities that are not subject to regulation as a broker-dealer under the 1934 Act from applying the Broker-Dealer Guide under an activities-based approach on the basis that their organizations are predominantly financial institutions (conducting banking activities) that are subject to the banking regulations.

5. In addition to the identification of the type of entity that can apply the Broker-Dealer Guide, diversity exists on whether entities that are within the scope of the Broker-Dealer Guide should be accounting for physical commodity inventory at fair value. Many entities (both those that are and those that are not regulated) that are applying the Broker-Dealer Guide believe that physical commodity positions (such as natural gas, crude oil, and so forth) should be recorded at fair value based on an interpretation of the Broker-Dealer Guide that allows all trading inventory to be measured at fair value.

6. Although inventory is not specifically defined in the Broker-Dealer Guide, industry practice has been to use references linked to the Broker-Dealer Guide to interpret the definition of inventory as all trading positions, including financial instruments and physical commodities, that are held for sale to customers in connection with market making activities, as proprietary positions, or to economically hedge risks inherent in both.

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<sup>1</sup> A broker-dealer's ultimate holding company and affiliates (referred to collectively as a consolidated supervised entity or CSE) must consent to group-wide Securities and Exchange Commission supervision in order to use an alternative method for computing net capital for certain broker-dealers.

7. However, paragraph 17 of Issue 02-3 prohibits fair value accounting for non-derivative contracts.<sup>2</sup> The consensus in Issue 02-3 observes that prior to Issue 02-3, broker-dealers carried physical commodity inventory at fair value. However, Issue 02-3 eliminated "any basis for recognizing physical inventories at fair value, except as provided by other guidance under higher categories of the GAAP hierarchy."<sup>3</sup> Furthermore, ARB 43 has historically been the accounting guidance applied to measure commodity inventory for most non-regulated broker-dealers. ARB 43 describes inventory held for sale in the ordinary course of business and requires that inventory be recognized at cost less impairment; however, ARB 43 allows an exception in Chapter 4, Statement 9, which states, in part:

Only in exceptional cases may inventories properly be stated above cost. For example, precious metals having a fixed monetary value with no substantial cost of marketing may be stated at such monetary value; any other exceptions must be justifiable by inability to determine appropriate approximate costs, immediate marketability at quoted market price, and the characteristic of unit interchangeability.

The SEC has further interpreted ARB 43 to imply that recognition of inventory above cost should be rare.<sup>4</sup> Many times, energy-based financial products are marked-to-market because they meet the definition of a derivative (including physically settled contracts that meet the requirements of FAS 133). However, since the Broker-Dealer Guide provides specialized accounting guidance that may not be specifically addressed by ARB 43, entities that qualified for the Broker-Dealer Guide have applied the provisions of the Broker-Dealer Guide as it relates to inventory.

8. Energy companies that conduct similar commodities trading activities do not fair value their physical commodity inventory since they have historically been considered outside the scope of the Broker-Dealer Guide and do not meet the guidance in Chapter 4, Statement 9, of ARB 43. These entities contend that they are at a competitive disadvantage since their energy trading

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<sup>2</sup> Paragraph 17 of Issue 02-3 indicates that the consensus "prohibiting mark-to-market accounting for nonderivative energy trading contracts is equally applicable to brokers and dealers, as the Guide for brokers and dealers in securities does not afford brokers and dealers special treatment in that regard."

<sup>3</sup> Paragraph 15 of Issue 02-3. The Broker-Dealer Guide is category (b) GAAP; Issue 02-3 is category (c) GAAP.

<sup>4</sup> Speech by R. Scott Blakley, SEC Professional Accounting Fellow, December 2003.

subsidiaries are conducting activities similar to those of a regulated broker-dealer but have no basis to support fair value accounting recognition.

## **Accounting Issues and Alternatives**

### **Issue 1: How to determine whether an entity is included within the scope of the Broker-Dealer Guide.**

*View A: Entities that are registered as a broker-dealer under the 1934 Act or by a comparable foreign regulator should be included in the scope of the Broker-Dealer Guide.*

9. Proponents of View A assert that the scope of the Broker-Dealer Guide is clearly articulated in the Preface section of the Broker-Dealer Guide (included in paragraph 3 above), and, therefore, entities that conduct business activities that are consistent with those of a broker-dealer but that are not subject to the regulations of the SEC or another comparable foreign regulator, should not apply the Broker-Dealer Guide. They believe that the Broker-Dealer Guide provides specialized accounting that should be restrictively applied to those entities that are regulated as a broker-dealer.

10. Proponents of View A also believe that the determination of the application of the Broker-Dealer Guide should be made for each separate legal entity without regard to whether similar activities are conducted elsewhere in the consolidated entity. That is, proponents of View A believe that a consolidated entity can have similar activities, assets, or liabilities that are accounted for differently (that is, using different recognition, measurement, or disclosure requirements) depending on the regulatory status of an individual legal entity; therefore, only subsidiaries of a CSE registered as a broker-dealer under the 1934 Act or by a comparable foreign regulator would be in the scope of the Broker-Dealer Guide.

11. Proponents of View A also point out that entities that are regulated by "comparable" foreign regulators should also be within the scope of the Broker-Dealer Guide. For example, in the U.K., that would include any entity that conducts broker-dealer activities and is regulated by the U.K. Financial Services Authority (FSA).

12. Opponents of View A counter that the scope of the Broker-Dealer Guide is ambiguous since changes in the regulatory landscape have blurred the scope of the Broker-Dealer Guide. They believe that the reference to "other regulatory bodies" in the preface of the Broker-Dealer Guide explicitly allows entities that are subject to regulation by other bodies to be included in the scope (for example, entities regulated by the Board of Governors of the Federal Reserve System (the Fed)).

13. Opponents of View A believe that the characteristics of the operations of an entity are more relevant in determining whether the entity is within the scope of the Broker-Dealer Guide, regardless of whether it is subject to regulation. In addition, opponents of View A believe that View A places undue emphasis on the form of a transaction rather than on its economic substance.

14. Opponents of View A are also concerned about the consistency in application of a method based on regulation, particularly when applied to non-U.S. entities. For example, European entities that have a membership with an exchange are eligible to conduct activities of a broker-dealer regardless of how the entity is regulated. Another entity may be regulated as a financial institution and have the same membership to act as broker-dealer. In this circumstance, under View A one entity would apply the Broker-Dealer Guide and the other entity would not. Those opposing View A believe that a consistent method of application should exist for both U.S. and non-U.S. jurisdictions and that it can only be achieved using the models set forth in either View B or View C described below.

*View B: The Broker-Dealer Guide should be applied to all entities within a consolidated group, except those legal entities that are specifically subject to other industry guidance, if the predominant characteristics of the consolidated entity are those of a broker-dealer.*

15. View B proponents believe that if the predominant characteristics of a consolidated entity are that of a broker-dealer, then the Broker-Dealer Guide must be applied to all entities within the consolidated group, except those entities within the consolidated group that are subject to

other specialized industry guidance (for example, banking and insurance). If the predominant characteristics of the consolidated entity are not those of a broker-dealer, then the Broker-Dealer Guide can only be applied to entities within the consolidated group that are regulated as a broker-dealer under the 1934 Act or that are regulated by comparable foreign regulators (that is, View A above).

16. In determining whether the predominant characteristics of the consolidated entity are those of a broker-dealer (including non-regulated broker-dealer subsidiaries), proponents of View B believe the qualitative and quantitative characteristics to be considered should include, but not be limited to, the following (no one characteristic is considered to be determinative):

- a. The relative amount and significance of total assets and firm inventory owned<sup>5</sup> that are held by entities within the consolidated group for each annual period over an extended period that are: (i) registered as broker-dealers under the 1934 Act or regulated by comparable foreign regulators versus (ii) all other entities.
- b. The activities of the consolidated entity and the extent to which those activities are consistent with the activities of a broker-dealer set forth in the Broker-Dealer Guide.
- c. The extent to which management and organization of business units that conduct broker-dealer activities are integrated across the consolidated entity with or without regard to specific legal entities within the consolidated group (including those entities that are registered broker dealers with the SEC or a comparable foreign regulator).
- d. The extent to which risk management, credit, finance, operations, technology, legal, compliance, internal audit, human resources, and any other business support functions are of business units that are integrated across the consolidated entity with or without regard to specific legal entities within the consolidated group (including those entities that are registered broker dealers with the SEC or a comparable foreign regulator).
- e. Whether the consolidated entity is subject to group-wide supervision by the SEC and whether the ultimate holding company and its affiliates are seeking to be, a CSE or would qualify as a CSE.

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<sup>5</sup> Firm inventory owned would be defined, for this calculation, to include financial instruments and physical commodities.

- f. The consolidated entity's segment reporting structure under FAS 131 and the degree to which some or all of the reported segments engage in broker-dealer activities.

After considering the above quantitative and qualitative characteristics and other relevant factors, the entity shall make a determination about whether the predominant characteristics of the consolidated entity are those of a broker-dealer.

17. Proponents of View B believe this approach is consistent with long-standing and widely accepted industry practice for large, globally-integrated investment banks. They believe that an entity should apply the principles outlined in the Broker-Dealer Guide to all legal entities within a consolidated group in which broker-dealer activities are conducted, regardless of whether such entities are individually regulated. Proponents of View B do not support an approach that would treat, for example, SEC registered broker-dealers differently from foreign regulated broker-dealers.

18. Proponents of View B also believe that the consistent application of fair value accounting to all broker-dealer activities is fundamental to the accurate presentation of the results of such business activities. Proponents of View B believe that if entities that have broker-dealer activities were to account for the same (or similar) activity using different accounting models (depending on the underlying legal entity), the financial information among the entities that comprise a consolidated group and between individual consolidated entities would lack comparability and consistency, two important characteristics of the conceptual framework. Finally, they believe a reporting entity that engages in a wide array of financial services (including, for example, commercial banking, insurance, and investment banking) should not be able to selectively apply the Broker-Dealer Guide to some, but not all, of its broker-dealer activities. For that reason, they believe broader application of the Broker-Dealer Guide should be permitted only if the Broker-Dealer Guide is applied consistently to all legal entities conducting broker-dealer activities within the reporting entity's consolidated group.

19. Opponents of View B believe that this model supports fair value accounting (by inclusion within the Broker-Dealer Guide) for a limited number of large financial institutions that qualify



as a CSE (currently only Lehman Brothers, Goldman Sachs, Bear Stearns, Merrill Lynch, and Morgan Stanley), for which their banking and insurance activity is insignificant when compared with their broker-dealer activity, but not for other institutions that may have other significant lines of business, such as some large financial institutions (which may have significant banking, insurance, and broker-dealer activity) or energy companies that have separate trading subsidiaries. View B opponents contend that the relative size of banking and broker-dealer activities within the different types of financial intermediary competitors in the commodities trading industry is not a meaningful distinction for accounting purposes, especially as relative segment sizes tend to converge as a result of industry consolidation and deregulation. In addition, depending on market movements and changes to the asset mix, an organization's predominant activity or primary regulator may not always be clear or remain the same.

20. Opponents of View B also believe that this approach will not significantly improve comparability and consistency. Because other entities within the consolidated group are subject to another specialized industry guide (for example, banking or insurance), similar transactions or activities will be accounted for differently depending on which entity performs the transaction.

*View C: Application of the Broker-Dealer Guide should be determined based on the activity of an individual legal entity and not on its regulator or the industry it operates in.*

21. View C proponents believe that the Broker-Dealer Guide should be applied to activities of entities that meet the definition, characteristics, and intent of broker, dealer, and trader activities, regardless of the entity's registration status or whether the predominant characteristics of the consolidated entity (or parent company) are those of a broker-dealer. Proponents of View C believe that entities do not need to be specifically regulated by the 1934 Act or comparable foreign regulation to fall within the scope of the Broker-Dealer Guide, provided that the entities conduct business activities that are consistent with those of a broker-dealer as described in Chapter 1 of the Broker-Dealer Guide. Those activities may include facilitating purchases and sales of securities, commodities, and related financial instruments; carrying inventory and making a profit or loss on the spread between bid and ask prices or on markups from dealer prices or market fluctuations; or providing a source of market liquidity (market makers and

specialists) and creating a secondary market for products, among other things. Proponents of View C believe that the requirement that an entity be regulated as a broker-dealer was never mandated for an entity to apply the Broker-Dealer Guide but, instead, was the predominant practice for broker-dealer entities when the Broker-Dealer Guide was first issued.

22. Proponents of View C point out that, in addition to the definitions, characteristics, and intent of broker-dealer activity established by the Broker-Dealer Guide, proponents of View C would expand the definition to incorporate the Basel II<sup>6</sup> capital rules' definition of a "trading book" (positions in financial instruments and commodities held either with trading intent or in order to hedge other elements of the trading book), which is similar in concept to the activities of a broker-dealer and more comprehensive than the definitions included in the Broker-Dealer Guide. View C proponents would suggest the following guidelines when determining an entity's eligibility to apply the Broker-Dealer Guide:

- a. A significant number of positions within the entity must either be free of any restrictive covenants on their ability to trade or provide a complete hedge.
- b. Positions should be assessed frequently for changes in value
- c. A significant number of positions should be actively managed and traded. Positions held with trading intent are those held intentionally for short-term resale and/or with intent of benefiting from actual or expected short-term price movements or to lock in arbitrage profits, and may include, for example, proprietary positions, positions arising from client servicing (for example, matched principal broking), and market making.
- d. Each entity must have clearly defined policies and procedures for determining applicability of the Broker-Dealer Guide.

23. View C proponents believe that an activities-based approach to application of the Broker-Dealer Guide would result in a consistent method of accounting for similar activities with similar economics, within an organization's subsidiaries. View C proponents also note that this broader, substance-based application is consistent with the FASB's long-term objective of requiring fair

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<sup>6</sup> The Basel Committee on Banking Supervision provided an alternative risk-based capital adequacy standard for commercial banks and bank holding companies.

value for all financial instruments. The activities-based approach, with fair values determined and disclosed in accordance with FAS 157, offers the best representation of the trading activities with ample disclosures about the reliability of those fair value methods and results.

24. Opponents maintain that View C is too broad and would allow the application of the Guide to a wide variety of entities. These opponents believe that the Guide represents a narrow exception for a defined population of entities that are subject to additional regulation, which makes it unique. Opponents of View C believe that oversight by other regulatory bodies (for example, the Fed) is not the same as oversight under the 1934 Act or comparable foreign regulation. While proponents of View C acknowledge that a characteristics-based approach would increase the number of companies that would likely apply the Broker-Dealer Guide and its fair value provisions, proponents of View C believe that fair value information would be more useful to investors and other users of an entity's financial statements given the activities in which such entities engage.

25. Opponents of View C also observe that since the application of View C is based on, and is applied to the activities of an individual legal entity (and not to all entities in a consolidated group), there will likely be accounting recognition that differs for certain accounts between entities. In addition, this approach creates an opportunity for companies to intentionally move certain activities from one legal entity to another in order to afford the perceived advantages of applying the Broker-Dealer Guide.

**Issue 2: Whether entities within the scope of the Broker-Dealer Guide should record physical commodity inventory at fair value.**

*View A: Entities within the scope of the Broker-Dealer Guide should record physical commodity inventory pursuant to ARB 43.*

26. Proponents of View A believe that inventory, as discussed in the Broker-Dealer Guide, refers only to investment securities or positions that are held for trading purposes. Proponents of View A believe that, in general, the Broker-Dealer Guide provides for specialized industry

accounting that may represent an exception from the accounting required by a higher level GAAP. As such, if the Broker-Dealer Guide intended for physical inventories to be accounted for at fair value under any circumstance other than under ARB 43, the Broker-Dealer Guide would have explicitly provided for that exception. Proponents of View A point out that throughout the Broker-Dealer Guide, the term "inventory" is used to refer to inventories of securities or a group of security transactions. Since the Guide does not explicitly state that physical inventory should be recorded at fair value, proponents of View A believe that Chapter 4, Statement 9, of ARB 43 should be evaluated to determine if there is a basis to mark the physical commodity inventory to market. ARB 43, Chapter 4, Statement 1, states, in part, that:

The term *inventory* is used herein to designate the aggregate of those items of tangible personal property which (1) are held for sale in the ordinary course of business, (2) are in process of production for such sale, or (3) are to be currently consumed in the production of goods or services to be available for sale.

27. Opponents of View A point out that the term "inventory" is not explicitly limited to inventories of securities or a group of security transactions. Rather, inventory, as it is referred to in the Broker-Dealer Guide, can be interpreted to mean both securities and physical commodities. For example, opponents reference Exhibit 4-8, Note 2, "Significant Accounting Policies," of the Broker-Dealer Guide, in which the discussion of *Securities Transactions* includes physical commodities. It states, in part, that "profit and loss arising from all securities and *commodities* transactions entered into for the account and risk of the Company are recorded on a trade date basis" (emphasis added). Similarly, the discussion in Note 13, "Commitments and Contingent Liabilities," discusses contingent liabilities as "incidental to [the Company's] securities and *commodities* business" (emphasis added). Proponents of View A counter that the references cited do not mention the measurement attribute for inventory, rather, the references only include the terms "commodity" and "securities" in the same sentence. Therefore, proponents of View A believe that those references do not necessarily provide support for a different measurement basis for commodities.

*View B: Inventory, as discussed in the Broker-Dealer Guide, should include trading positions in physical commodity inventory and those positions should be recorded at fair value*

28. Proponents of View B believe that the accounting model as set forth in the Broker-Dealer Guide requires that inventory (including short inventory) and related derivative positions be accounted for at fair value. Proponents of View B interpret inventory, as contemplated in the Broker-Dealer Guide, to include all positions being purchased to sell to a broker-dealer's customer, without regard to the type of asset being sold (including physical commodity inventory).

29. Furthermore, proponents of View B point to the example Statement of Financial Condition in Exhibit 4.3, which reflects "Spot commodities owned, at market value" to support this view. Proponents of View B observe that while the Broker-Dealer Guide does not specify what items may be considered "inventory," it provides references to commodities in the example noted previously. Some believe that since the Broker-Dealer Guide refers to commodities in a significant number of places, physical commodities held as trading positions were intended to qualify as broker-dealer inventory (and therefore be accounted for at fair value).

30. Opponents of View B point out that the Broker-Dealer Guide generally uses the term "inventory" in reference to an inventory of securities. While certain commodity inventory may have economic characteristics that are similar to securities, they are not financial instruments and should not be recorded at market value unless the criteria in Chapter 4, Statement 9, of ARB 43 are met. These opponents believe that the references provided in the Broker-Dealer Guide do not infer that commodity inventory should be measured at fair value (or market value) if it does not meet the requirements to be recognized at fair value under ARB 43. Rather, this inventory could have been reflected at market value in the example in the Broker-Dealer Guide because it met the requirements pursuant to ARB 43.

### **International Convergence**

31. IFRS defines *broker-traders* as those who buy or sell commodities for others or on their own account. The inventories referred to are principally acquired with the purpose of selling in the near future and generating a profit from fluctuations in price or broker-traders' margin. There is no clear distinction under IFRS that this application should exist in registered broker-dealers;

rather, this would be applied on a substance-based approach based on activities and intent of the entity. In addition, IAS 2 requires that broker-dealers measure inventory at fair value less costs to sell.

## **Disclosure**

32. The staff recommends that an entity that is required to apply the provisions of the Broker-Dealer Guide shall disclose the basis for that application.

## **Effective Date and Transition**

33. The staff recommends that a consensus on this Issue should be effective for financial statements issued for fiscal years beginning after September 15, 2007, and interim periods within those fiscal years. Earlier application is encouraged, provided that the reporting entity has not yet issued financial statements for that fiscal year, including any financial statements for an interim period within that fiscal year. The staff recommends that the transition provisions of this Issue be consistent with the transition provisions of the Investment Company Guide. As such, the staff recommends that entities recognize the effects of applying the consensus:

- a. If an entity previously applied the provisions of the Broker-Dealer Guide, but based on the consensus on this Issue is no longer eligible to apply the Broker-Dealer Guide, that entity should report the effect of adopting this Issue as a change in accounting principle prospectively in conformity with applicable GAAP, other than the Broker-Dealer Guide, as of the date of adoption.
- b. If an entity had not previously applied the provisions of the Broker-Dealer Guide, but based on the consensus on this Issue is now required to apply the Broker-Dealer Guide, that entity should report the effects of adopting the consensus on this Issue as a change in accounting principle through a cumulative-effect adjustment to retained earnings or to other components of equity or net assets in the statement of financial position as of the date of adoption. An entity shall disclose the cumulative-effect of the change on retained earnings or other components of equity or net assets in the statement of financial position.

34. Upon transition, the staff recommends that an entity disclose, where significant:
- a. The change on the reported amounts of assets or liabilities
  - b. Any related effects on net income, change in net assets from operations, or change in net assets
  - c. Any related effect on earnings-per-share amounts.