

EITF ABSTRACTS

Issue No. 03-11

Title: 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

Date Discussed: July 31, 2003

References: FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities*
FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*
FASB Statement No. 138, *Accounting for Certain Derivative Instruments and Certain Hedging Activities*
FASB Statement No. 149, *Amendment of Statement 133 on Derivative Instruments and Hedging Activities*
FASB Concepts Statement No. 5, *Recognition and Measurement in Financial Statements of Business Enterprises*
Statement 133 Implementation Issue No. B15, "Separate Accounting for Multiple Derivative Features Embedded in a Single Hybrid Instrument"
Statement 133 Implementation Issue No. C12, "Interpreting the Normal Purchases and Normal Sales Exception as an Election"
Statement 133 Implementation Issue No. G2, "Hedged Transactions That Arise from Gross Settlement of a Derivative ('All in One' Hedges)"
Statement 133 Implementation Issue No. K4, "Income Statement Classification of Hedge Ineffectiveness and the Component of a Derivative's Gain or Loss Excluded from the Assessment of Hedge Effectiveness"
APB Opinion No. 29, *Accounting for Nonmonetary Transactions*
AICPA Accounting Research Bulletin No. 43, *Restatement and Revision of Accounting Research Bulletins*
SEC Staff Accounting Bulletin No. 101, *Revenue Recognition in Financial Statements*

ISSUE

1. At the October 25, 2002 meeting, the Task Force discussed the income statement presentation of gains and losses on contracts held for trading purposes in 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." The Task

Force reached a consensus that gains and losses (realized and unrealized) on *all* derivative instruments within the scope of Statement 133 should be shown net when recognized in the income statement, whether or not settled physically, if the derivative instruments are *held for trading purposes* as defined in Issue 02-3. The FASB staff subsequently clarified that the designation of derivatives as held for trading purposes is not intended to preclude those derivatives from being designated as hedging instruments if all of the applicable criteria in Statement 133 have been met.

2. The following example illustrates net and gross presentation of the realized gains and losses on a derivative instrument that is physically settled based on the specified fact pattern:

Example

On January 1, 20X3, a company enters into a forward contract to purchase one barrel of crude oil at \$30 for delivery on July 1, 20X3. The forward contract is a derivative pursuant to Statement 133, the company does not elect to designate the contract as "normal purchases and normal sales" pursuant to paragraph 10(b) of Statement 133 and related Implementation Issues, and it designates the derivative instrument as "held for trading purposes." Assume the following market forward prices for the July 1, 20X3 delivery of one barrel of crude on the following dates:

March 31, 20X3	\$25
June 30, 20X3	\$35
July 1, 20X3 (delivery date)	\$35

Further assume that the company sells the barrel of crude, purchased by physically settling the forward contract, on July 31, 20X3, for \$37.

Journal Entries for Net Presentation

March 31, 20X3

Trading revenue, net	\$5	
Derivative liability		\$5

June 30, 20X3

Derivative liability	\$5	
Derivative asset	5	
Trading revenue, net		\$10

July 1, 20X3

Inventory	\$35	
Cash (forward contract price)		\$30
Derivative asset		5

July 31, 20X3

Accounts receivable	\$37	
Inventory		\$35
Trading revenue, net		2

Journal Entries for Gross Presentation

A "gross" presentation would yield the same entries as of March 31, June 30, and July 1 (although the account descriptions may differ), but would differ as of July 31, as follows:

July 31, 20X3

Cost of sales	\$35	
Inventory		\$35
Accounts receivable	\$37	
Sales		\$37

Under a "gross" presentation of the gains and losses on a derivative that is physically settled, the income statement, if presenting only the series of transactions presented in this example, would show sales of \$37 and cost of sales of \$35.

3. The above example presents two methods of recognizing the realized gains and losses from a physically settled derivative that is not designated as a hedging instrument. Now, assume that the forward contract presented above is designated as the hedging instrument in a cash flow hedge of the variability of the consideration to be paid in the forecasted purchase that will occur upon physical settlement of the forward contract

itself. That is, the forward contract is designated as the hedging instrument in an "all-in-one" hedge pursuant to Implementation Issue G2.

All-in-One Hedge Example

Assume the same facts as presented in the previous example. Additionally, assume that (a) the contract includes a disincentive for nonperformance that is sufficiently large to make performance probable (that is, the contract meets the definition of a firm commitment under Statement 133), (b) the company designates the forward purchase contract as a hedge of the variability in cash flows attributable to the price risk associated with the forecasted purchase of one barrel of oil under the contract, and (c) the company documents at inception of the hedge that the assessment of hedge effectiveness will be determined based on changes in the entire fair value of the derivative instrument (the forward contract).

Journal Entries for All-in-One Hedge

March 31, 20X3

Other comprehensive income	\$5	
Derivative liability		\$5

June 30, 20X3

Derivative liability	\$5	
Derivative asset	5	
Other comprehensive income		\$10

July 1, 20X3

Inventory	\$35	
Cash (forward contract price)		\$30
Derivative asset		5

July 31, 20X3

Cost of sales*	\$30	
Other comprehensive income	5	
Inventory		\$35
Accounts receivable	\$37	
Sales*		\$37

* Assumes a "gross" presentation. If using a "net" presentation, these entries would be netted in one revenue line item.

- Statement 133 does not provide guidance on the appropriate level of income statement summarization of a derivative's realized gains and losses. Further, in Issue 02-

3, the Task Force did not address the issue of whether gains and losses (realized and unrealized) should be shown gross or net in the income statement for contracts that are not held for trading purposes but are derivatives subject to Statement 133. Currently, practitioners use the guidance in Issue No. 99-19, "Reporting Revenue Gross as a Principal versus Net as an Agent," for determining how to summarize gains and losses realized upon physical settlement of a derivative contract. In that Issue, the Task Force reached a consensus that "whether a company should recognize revenue based on (a) the gross amount billed to a customer because it has earned revenue from the sale of the goods or services or (b) the net amount retained (that is, the amount billed to the customer less the amount paid to a supplier) because it has earned a commission or fee is a matter of judgment that depends on the relevant facts and circumstances. . . ." The consensus provides factors or indicators to consider in making that evaluation.

5. Application of the factors or indicators provided in the consensus to Issue 99-19 usually results in reporting gains and losses on a gross basis when the derivative contract is physically settled. However, the results of applying the factors or indicators in Issue 99-19 may not result in an income statement presentation that, in all cases, is consistent with the underlying economics. Consider the following example of a "barrel back" arrangement:

"Barrel Back" Example

OilCo is an oil and gas producer with operations in California and Oklahoma. OilCo has entered into an agreement, termed a "barrel back," with a California refiner, whereby OilCo agrees to deliver a fixed quantity of its California production to the refiner. In exchange, the refiner agrees to deliver a fixed quantity of oil to OilCo in Cushing, Oklahoma. To maximize pricing, OilCo stores the oil in Cushing until the oil is ultimately sold to a third party. Assume the following facts:

- OilCo has no trading activities and has determined that the related derivative instrument is not held for trading purposes.
- The agreement between OilCo and the refiner meets the definition of a derivative pursuant to Statement 133.
- The normal purchases and normal sales exception in paragraph 10(b) of Statement 133 does not apply or has not been elected.¹
- The factors in Issue 99-19 indicate gross reporting for the "barrel back" and the third-party sale.

6. The derivative in the above example is a compound derivative (combination of two forward contracts) and, based on paragraph 18 of Statement 133 (and Implementation Issue B15), cannot be separated into components that would be accounted for separately.

7. Although the "barrel back" is settled by physical delivery of the underlying asset and the factors in Issue 99-19 indicate "gross" reporting, a question arises as to whether this transaction should instead be reported on a net basis in the income statement. Although the transaction may have been executed for valid business purposes, the arrangement *resembles* a "roundtrip" (the sale of oil to the refinery in California and the purchase of *similar* oil from the refinery in Cushing). Therefore, some believe that the "barrel back" should be recorded as a net adjustment to the carrying amount of the oil inventory (eventually cost of sales) and recorded net in the income statement, while the third-party sale should be recorded gross in the income statement. Reporting the "barrel back" on a gross basis would double the revenues reported by OilCo with no corresponding increase in production. Others believe the "barrel back" should be

¹Pursuant to Implementation Issue C12.

recorded gross in the income statement because they believe the sale to the refiner represents the close out of the existing position in California oil, while the purchase represents the establishment of a different position in Cushing oil for sale at a later date to another third party. Those who prefer a gross presentation also note that OilCo held title to and bore the inventory risks for both barrels of oil.

8. The issue is whether realized gains and losses should be shown gross or net in the income statement for contracts that are *not* held for trading purposes (as defined in Issue 02-3) but are derivatives subject to Statement 133 (whether or not the derivative is designated as a hedging instrument pursuant to Statement 133).

EITF DISCUSSION

9. The Task Force reached a consensus that determining whether realized gains and losses on physically settled derivative contracts not "held for trading purposes" should be reported in the income statement on a gross or net basis is a matter of judgment that depends on the relevant facts and circumstances. Consideration of the facts and circumstances should be made in the context of the various activities of the entity rather than based solely on the terms of the individual contracts. In evaluating the facts and circumstances for purposes of determining whether an arrangement should be reported on a gross or net basis, the Task Force acknowledged that the economic substance of the transaction as well as the guidance set forth in Opinion 29 relative to nonmonetary exchanges and the gross versus net reporting indicators provided in Issue 99-19 may be considered in making this determination.

Board Ratification

10. At its August 13, 2003 meeting, the Board ratified the consensus reached by the Task Force in this Issue.

STATUS

11. No further EITF discussion is planned.