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June 13, 2008

Mr. Russell G. Golden  
Director of Technical Application and Implementation Activities  
Financial Accounting Standards Board  
401 Merritt 7  
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Norwalk, CT 06856-5116



File Reference: Proposed FSP ARB 43-a

LETTER OF COMMENT NO. 5

Dear Mr. Golden:

The American Petroleum Institute (API) is pleased to provide comments on the proposed FASB Staff Position (FSP) ARB No. 43-a, *Amendment of the Inventory Provisions of Chapter 4 of ARB No. 43 (ARB 43)*. The API is a national trade organization representing more than 400 companies engaged in all aspects of the oil and gas industry, including exploration, production, refining, marketing, pipeline operations and marine transportation.

Many of our member companies are involved to varying degrees in the trading of crude oil, natural gas and refined products. As this FSP would require that any inventories associated with an entity's trading activities be initially and subsequently measured at fair value, with changes in fair value recognized in earnings, many of our member companies would be significantly affected by this new accounting standard as currently written.

The impacts of this FSP on our API-member companies could include the following:

- Complete termination of the LIFO-accounting election for U.S. income tax purposes, with estimated income tax payments for some member companies in excess of \$1 billion.

For companies that value inventories at LIFO for U.S. income tax purposes, the U.S. federal income tax law imposes a "conformity requirement" that these inventories also be accounted for under the LIFO method for financial reporting purposes. Companies that currently use the LIFO method for all commodity inventories would have to isolate the "trading" portion and convert to fair-value accounting. Because trading and nontrading transactions are commingled in the accounting and operating systems of many of our member companies, any transfers between LIFO and non-LIFO inventories could taint all LIFO pools, resulting in the complete termination of the LIFO election.

- Partial termination of the LIFO-accounting election for U.S. income tax purposes, with estimated income tax payments for some member companies in the hundreds of millions of dollars.

This estimated impact assumes that companies will be able to isolate trading inventory in a way that does not compromise their respective complete LIFO elections for U.S. income taxes.

- *Major redesign of operating systems, accounting systems and inventory-related work processes, with an estimated aggregate impact for our member companies in the tens of millions of dollars.*

We believe the potential income tax payments and implementation costs would be punitive to our industry and would represent an unintended consequence of an accounting rule meant only to address the very-dated differences between ARB No. 43 (issued in 1953) and the AICPA Auditing and Accounting Guides, *Brokers and Dealers in Securities* (issued in 1997) and *Investment Companies* (issued in 2000).

We note also that the proposed FSP is not aligned with International Accounting Standard (IAS) 2, *Inventories*, which requires that inventory be measured at the lower of cost or net realizable value, aside from a scope exception that requires only commodity broker-traders to measure their trading positions at fair value. Because of the likely move by U.S. companies to International Financial Reporting Standards (IFRS), we believe the Board should reconsider issuing this FSP. The U.S. companies that do not consider themselves to be broker-traders – but would have to fair-value their trading inventories under this FSP – may have to switch back to historical cost under IAS 2 at the time of conversion to IFRS. If that is the case for most companies affected by the FSP, we believe the costs of implementing this FSP would far exceed the benefits.

A decision not to issue this proposed FSP would also be aligned with the report on May 2, 2008, by the Substantive Complexity Subcommittee to the SEC Advisory Committee on Improvements to Financial Reporting (CIFR). In that report, the subcommittee identified issues dealing with the “mixed attribute model,” which was defined as a model “...in which the carrying amounts of some assets and liabilities are measured at historic cost, others at lower of cost or market, and still others at fair value.” One subcommittee recommendation (“Preliminary Hypothesis 4”) was: “The SEC should recommend that the FASB be judicious in issuing new standards and interpretations that expand the use of fair value in areas where it is not already required, until completion of a measurement framework.”

Finally, we understand the LIFO inventory conformity issue has been identified as one of the key technical and economic barriers for the conversion from U.S. GAAP to IFRS and is being studied by the U.S. Internal Revenue Service and Securities and Exchange Commission. We believe any change to LIFO accounting for U.S. companies should be addressed in this context rather than being triggered by the issuance of new U.S. GAAP such as this proposed FSP.

If this FSP does get issued, we recommend the accounting guidance be clarified to allow companies to make a judgment based on facts and circumstances as to whether their business activities are similar to those of a broker-trader. This approach would permit companies to designate whether inventories are trading versus nontrading. By way of background, many of our member companies have supply and trading organizations operating primarily to optimize the efficiency and effectiveness of refining networks and product distribution systems, including the disposition of the companies’ own produced crude oil and natural gas and manufactured refined products. For these companies, inventories for all types of supply, distribution and trading activities are typically commingled, and any trading activity is generally not organizationally distinctive. Rather, trading is conducted within the broader context of network and system optimization. If this FSP does get issued, we recommend the accounting guidance be clarified to allow such companies to consider the predominant activity when exercising judgment in determining which inventory classification is appropriate.

The issues and questions raised in the proposed FSP are listed below, along with our comments:

Excerpt from proposed FSP:

**Issue 1: Commodity Inventories**

The Board considered but rejected an alternative that would limit the scope of this proposed FSP to commodity inventories that are not used in production, wholesale, retail, or distribution activities. This alternative was considered because the primary reason for undertaking this project is to resolve conflicting guidance as to whether traded commodity inventory can be accounted for at fair value. This alternative places an emphasis on the nature of the inventory (that is, commodity inventory versus other ARB 43 inventory) as compared with the proposed approach that places an emphasis on whether an entity is trading any inventory within the scope of ARB 43. This alternative also would differ from the proposed approach in that most commodities have interchangeable/fungible units and, therefore, generally also have readily determinable fair values. (In this context, the phrase *readily determinable fair value* is intended to include fair value estimates that use Level 1 inputs as described in FASB Statement No. 157, *Fair Value Measurements*.)

Would you prefer the alternative approach to limit the scope of the proposed FSP to commodity inventories that are not used in production, wholesale, retail, or distribution activities? Why or why not?

**API Comments:** We have no preference, as the accounting for our industry's commodity inventories would be included in the scope of the proposed FSP under either alternative. However, as indicated above, we strongly recommend another alternative to allow a company to designate commodity inventories as trading versus nontrading based on the company's individual facts and circumstances.

Excerpt from proposed FSP:

**Issue 2: Readily Determinable Fair Value**

The Board considered but rejected an alternative that would limit the scope of this proposed FSP solely to inventories included in an entity's trading activities that have *readily determinable fair values*. The Board decided that such a threshold would be inconsistent with the framework in Statement 157. Similarly, FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*, does not have a minimum reliability threshold for fair value of commodity-based derivative instruments, which often are part of an entity's trading portfolio.

This alternative would limit the scope to inventories included in an entity's trading activities that have readily determinable fair values based on the notion that fair value should only be used when a reliable measurement can be obtained.

Would you prefer the alternative approach to limit the scope of this proposed FSP to inventories included in an entity's trading activities that have readily determinable fair values? Why or why not?

**API Comments:** Similar to our response to Issue 1, we do not prefer this alternative approach but instead recommend an alternative that would allow a company to designate commodity inventories as trading versus nontrading based on the company's individual facts and circumstances.

Excerpt from proposed FSP:

**Issue 3: Trading Items Other Than Physical Inventories**

The Board considered but rejected an alternative that would expand the scope of this proposed FSP to include trading items other than inventories within the scope of ARB 43. This alternative would result

in all of the items that are included in an entity's trading activities being measured at fair value with changes in fair value recognized in earnings, not just ARB 43 inventories. This alternative focuses on the nature of activity (that is, trading) and not just classification of the item as inventory. For example, an entity's natural gas trading operation often will include noninventory executory contracts (many of which are not currently recognized in financial statements), such as storage and transportation contracts along with physical inventory. The executory contracts may not be traded separately but, in many cases, are a necessary component of the trading strategy. Such a broader scope also would include certain assets that are not currently accounted for at fair value.

The Board rejected this alternative because of the limited-scope objective for this project, that is, to address the inconsistency between the guidance in ARB 43 and that in certain AICPA Audit and Accounting Guides with respect to accounting for inventory.

Do you believe that the Board should consider a broader scope project that would include all contracts and assets or liabilities within an entity's trading activities even if it would result in significantly delaying the issuance of final guidance? Why or why not?

**API Comments:** We agree the scope of the proposed FSP should not be broadened. We do not believe the FASB should be seeking to make significant changes to U.S. GAAP in the absence of an absolute need to do so. We believe the focus should be on the critical changes necessary to support an efficient migration to IFRS.

Excerpt from proposed FSP:

#### **Issue 4: Accounting Policy Election**

The Board considered but rejected an alternative that would allow an entity to make an irrevocable, entity-wide accounting policy election for all commodity inventories to be measured at either fair value or the lower of cost or market. Under this alternative, an entity's commodity inventory in its entirety would be measured using the same measurement attribute regardless of whether the inventory is part of its trading, production, distribution, or other type of activity. The Board rejected this alternative because it was not ready to consider the broad effects of such a change, including the effect on revenue recognition for a manufacturer. However, the Board believes that fair value is always the appropriate measurement attribute for inventories included in trading activities.

Do you believe that the measurement attribute for inventories should be subject to an entity-wide accounting policy election? Why or why not?

**API Comments:** We do not believe the measurement attribute should be subject to an entity-wide accounting policy election. Consistent with our comments for Issue 3, we do not believe the FASB should be promulgating new GAAP that is not supportive of the eventual migration to IFRS.

Excerpt from proposed FSP:

#### **Issue 5: Implementation Issues**

The Board also requests comments on the following issues:

- a. What costs would be incurred to implement this proposed FSP?
- b. Are the transition provisions of this proposed FSP appropriate?
- c. Given this proposed FSP's comment period, the Board expects to issue a final FSP in the third quarter of 2008. Does this expected issuance date provide sufficient time for entities to

understand and apply the requirements of this proposed FSP, which could be effective for fiscal years (and interim periods within those fiscal years) beginning after November 15, 2008?

**API Comments:** As discussed in our opening comments, implementing this proposed FSP as currently written would result in severe economic consequences for many of our API-member companies because (1) LIFO elections for U.S. income tax purposes could be partially or completely terminated, resulting in significant immediate cash outlays for income taxes, and (2) information technology systems and work processes would have to undergo major redesign to separately track the LIFO and non-LIFO inventories. (These system changes could not be completed by the effective date indicated in the proposed FSP.) We believe these real costs would be very disproportionate to the possible benefits to users of financial statements who might wish to compare the fair values of trading inventories between broker-dealers and others.

**Other API Comments:** As an alternative to a mandatory requirement to fair-value any inventory that might be considered trading (per the “oil company” examples provided in the draft FSP), we recommend the final FSP be written to allow companies to designate inventories as trading and account for that inventory at fair value based on each company’s evaluation of its facts and circumstances. To that end, we recommend the examples in the proposed FSP be revised as indicated below.

Excerpt from proposed FSP – paragraphs 9 through 11 (suggested new text shown as underlined):

#### **Initial and Subsequent Measurement of Inventory Included in an Entity’s Trading Activities**

**9. Inventories included in an entity’s trading activities shall be initially and subsequently measured at fair value with changes in fair value recognized in earnings. When reclassifying inventory from trading to nontrading activities (or vice versa), the transfer shall be recorded at fair value at the date of reclassification.**

**Example 1** — An integrated oil company’s activities include exploration and production of oil, refining, wholesale and retail distribution of gasoline, and trading of oil. The Company trades crude oil by purchasing and selling it on the open market in order to make a profit on price changes only (that is, the oil is not sold to an end user within an entity’s retail sales operation or to a wholesaler). The Company considers these trading activities to be similar to those of a broker-dealer, and for recordkeeping purposes the Company segregates its crude oil trading inventory from its crude oil held for refining and other nontrading activities and accounts for the inventory at historical cost. Under this FSP, the Company is required to account for its crude oil trading inventory at fair value with changes in fair value recognized in earnings. All other crude oil inventories to be used for production, refining, retail, or wholesale distribution (that is, not used for trading purposes) are accounted for under other applicable GAAP.

**Example 2** — An integrated oil company’s activities include exploration and production of oil, refining, wholesale and retail distribution of gasoline, and trading of oil. The Company’s activities include the trading of crude oil by purchasing and selling it on the open market in order to make a profit on price changes only (that is, the oil is not sold to an end user within an entity’s retail sales operation or to a wholesaler). Part or all of the cargoes or pipeline shipments of crude oil may change as to the intended disposition prior to delivery based on the company’s refining needs and opportunities to optimize costs for the refining network. Because of this, for recordkeeping purposes the Company does not segregate its crude oil trading inventory from its crude oil held for refining and other nontrading inventories. Under this FSP, the company may elect to designate the entire inventory as nontrading and not account for any crude-oil inventory at fair value.

## Disclosures

**10. An entity shall provide disclosures that enable financial statement users to understand management's conclusion that inventory is included in an entity's trading activities, including a description of those activities and the typical holding period. Those disclosures also shall include the effect of inventory transfers between nontrading and trading categories on the entity's financial performance.**

11. For every annual and interim reporting period for which a statement of financial position and statement of financial performance are presented, an entity with ARB 43 inventory included in an entity's trading activities shall disclose:

- a. The basis for concluding that the inventory is part of the entity's trading activity including a description of those activities and the typical holding period
- b. The reasons for inventory transfers between trading and nontrading categories
- c. For inventory transfers from the nontrading to trading category:
  - (1) The carrying amount of the inventory at the pre-transfer accounting policy (for example, average cost, LIFO, or FIFO) and the volume of inventory transferred (for example, barrels of oil, bushels of wheat, and so forth)
  - (2) The amount of gain or loss that is recognized at the transfer date in the statement of financial performance

**Example**—ABC Oil Company is a gasoline refiner as well as an oil trader. The company considers its trading activities to be similar to those of a broker-dealer. It designates a portion of its inventory to be trading and accounts for this inventory at fair value. ABC Oil Company typically requires 2 million barrels of oil for its refining activities. However, as of February 9, 2011, based on its expectation of a reduction in the demand for gasoline over the next year, ABC Oil Company determined that it needed only 1.5 million barrels of oil on hand to meet its production needs. On February 10, 2011, ABC Oil Company transferred 0.5 million barrels of oil from its refining inventory to its trading inventory to speculate on short-term movements in the price of oil. ABC Oil Company will make the following disclosure in its financial statements for the quarter ending March 31, 2011:

*On February 10, 2011, the Company transferred 0.5 million barrels of oil from its refining inventory to its trading inventory to speculate on short-term movements in the price of oil. The transferred barrels of oil were carried in its refining inventory at an average cost of \$40 per barrel. At the date of transfer, the fair value of the oil was \$90 per barrel. Accordingly, the Company has recognized as trading revenue a \$25 million unrealized gain at the transfer date in its statement of financial performance. The transfer is excluded from (and has no effect on) the Company's gasoline sales revenues and the related cost of goods sold for the quarter ending March 31, 2011.*

- d. For inventory transfers from the trading to nontrading category:
  - (1) The fair value of the inventory and volume of inventory transferred (for example, barrels of oil or bushels of wheat)
  - (2) The profit margin that would have resulted had the inventory been in the production category since its inception.

**Example**—ABC Oil Company is a gasoline refiner as well as an oil trader that considers its trading activities to be similar to those of a broker-dealer and designates a portion of its inventory as trading. On November 17, 2010, ABC Oil Company transferred 1 million barrels of oil from its trading inventory to refining inventory to meet an increase in demand for gasoline. During December 2010, ABC Oil Company sold all of the gasoline refined from the barrels of oil transferred to refining inventory on November 17, 2010. ABC Oil Company will make the following disclosure in its financial statements for the quarter ending December 31, 2010:

*On November 17, 2010, the Company transferred 1 million barrels of oil from its trading inventory to its refining inventory to meet an increase in demand for gasoline. On the date of transfer, the barrels of oil were recognized in trading inventory at their fair value of \$90 per barrel. The transferred barrels of oil had an average cost of \$40 per barrel. The actual refining gross margin recognized on the sale of the related gasoline during December 2010 was \$220 million. However, if the transferred barrels of oil were carried at their original average cost as part of the refining inventory since inception, the refining gross margin on the sale of the related gasoline would have been \$270 million.*

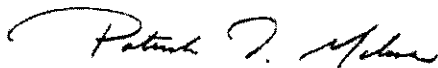
In addition to the suggested changes to paragraphs 9 through 11, we note the disclosures in paragraph 11. d. (2) would be particularly onerous for companies using the LIFO method. To calculate the “profit margin that would have resulted had the inventory been in the production category since its inception” could require the maintenance of a second LIFO accounting system to isolate the different builds and draws that would occur in each LIFO pool over time had trading inventories not been periodically transferred to the production category. Accordingly, we suggest these disclosures not be required.

We note also in the “Summary” section on page 6 of the “Notice for Recipients of This Proposed FASB Staff Position” a reference to an oil refiner in the sentence: “Comparability of financial reporting would be improved because all trading inventories would be accounted for at fair value regardless of the type of reporting entity (for example, a broker dealer vs. an oil refiner).” We recommend deleting the parenthetical example so the reader does not wrongly infer that all oil refiners would account for portions of their respective inventories at fair value under this FSP.

\* \* \* \*

Although we believe the Board should withdraw the proposed FSP, we very much appreciate any consideration that can be given to incorporating our comments into the final FSP if one does get issued. We believe our recommended approach will remove the significant economic impacts to our industry and at the same time permit appropriate judgments to be made in the context of a principles-based accounting standard.

Sincerely,



Patrick T. Mulva  
Chairman, General Committee on Finance  
American Petroleum Institute

Attachment

cc: Desiree Burnley – API  
Don Whittaker – API

## **Attachment**

API Ad Hoc Working Group

Proposed FSP ARB 43-a

### Participating Companies

Anadarko Petroleum

BP

Chevron

ConocoPhillips

Devon Energy

ExxonMobil

Hess

Marathon Oil

Murphy Oil

Occidental Petroleum

Shell Oil