MINUTES

Financial Accounting Standards Board

To:	Board Members		
From:	Valuation of Commodity Inventory and Emission Allowances that are Acquired for Resale—McGrath (ext. 443)		
Subject:	Minutes of the March 14, 2007 Board Meeting (Valuation of Commodity Inventory and Emission Allowances that are Acquired for Resale)	**Date:**	May 30, 2007
cc:	L. Smith, Bielstein, MacDonald, Leisenring, Golden, Polley, Gabriele, Jolla, Wilks, Lott, Jacobs, Klimek, Cosper, McGrath, Wilkins, FASB Intranet		

The Board meeting minutes are provided for the information and convenience of constituents who want to follow the Board's deliberations. All of the conclusions reported are tentative and may be changed at future Board meetings. Decisions become final only after a formal written ballot to issue a final Statement or Interpretation.

Topic:	Agenda Decision: Valuation of Commodity Inventory and Emission Allowances that are Acquired for Resale
Basis for Discussion:	Board Memorandum 1 dated February 23, 2007
Length of Discussion:	9:55 a.m. to 10:30 a.m.
Attendance:	
Board members present:	FASB: Herz (by phone), Batavick, Crooch, Linsmeier, Seidman, Trott, and Young IASB: Leisenring
Board members absent:	None
Staff in charge of topic:	McGrath
Other staff at Board table:	L. Smith, Golden, and Fanzini
Outside participants:	None

<u>Summary of Decisions Reached</u>:

The Board decided to add a project to its agenda to provide guidance on whether ARB No. 43, *Restatement and Revision of Accounting Research Bulletins*, should be amended to require fair value accounting for certain nonfinancial assets with readily determinable fair values that are held in trading inventory, including traded emissions allowances.

<u>Objectives of Meeting:</u>

The objective of this meeting was for the Board to discuss whether to add a short-term project to its agenda to provide guidance on whether ARB 43 should be amended to require certain nonfinancial physical assets with readily determinable fair values that are held in trading inventory to be accounted for at fair value.

<u>Matters Discussed and Decisions Reached:</u>

1. Mr. McGrath stated that the purpose of the meeting was for the Board to consider whether to add a short-term project to its agenda to provide guidance on whether ARB 43 should be amended to require certain nonfinancial physical assets with readily determinable fair values that are held in trading inventory to be accounted for at fair value. He stated that this issue came about at the November 16, 2006, EITF meeting, when the Task Force discussed EITF Issue No. 06-12, "Accounting for Physical Commodity Inventories for Entities within the Scope of the AICPA Audit and Accounting Guide, *Brokers and Dealers in Securities*." The Task Force deferred making a decision on that Issue and recommended that the Board consider addressing the accounting for traded physical commodity inventory through the issuance of an FASB Staff Position. Should the Board issue guidance that requires trading positions in physical commodity inventory to be measured at fair value, the Task Force will determine whether it should revisit Issue 06-12 at a future meeting.

Issue 1: Agenda Decision

2. Mr. McGrath stated that ARB 43 has historically been the accounting guidance applied to measure commodity inventory for most nonregulated broker-dealers. ARB 43 requires

that inventory be recognized at cost less impairment. Inventory can be recognized above cost only in rare circumstances. Entities who are applying the AICPA Audit and Accounting Guides, *Brokers and Dealers in Securities,* or, *Investment Companies,* ("the Guides") account for their inventory and related derivative positions at fair value. Mr. McGrath stated that diversity exists as to whether entities that are within the scope of the Guides should be accounting for physical commodity inventory at fair value or whether they should be accounting for them pursuant to the guidance in ARB 43. He added that some constituents believe that even if one could interpret either Guide to allow physical commodities to be considered broker-dealer or investment company inventory, fair value accounting would not be appropriate since an industry accounting guide is lower in the GAAP hierarchy than ARB 43. In contrast, entities that are not within the scope of the Guides have been precluded from accounting for physical commodity positions at fair value due to the guidance in ARB 43, even though they have been conducting similar commodities trading activities.

3. Mr. McGrath suggested that the Board consider the following three alternatives for providing guidance:

    a. Alternative A—Issue guidance to require, for all entities, that traded physical commodity inventory items with readily determinable fair values be accounted for at fair value. The outcome of this project would most likely be an FSP to amend ARB 43.

    b. Alternative B—Issue limited guidance that applies to broker-dealers/financial intermediaries only.

    c. Alternative C—Do not add a project to the Board's agenda, but instead address this as a part of Phase 2 of the Fair Value Option project.

4. Mr. McGrath stated that the staff recommends Alternative A. He said that the current diversity in the accounting and reporting of traded physical commodity inventory affects the comparability of financial statements for all participants in these markets. Because the trading activity of physical commodities by financial intermediaries has increased and

is expected to increase in the future, there is a need for a standard that will provide guidance and eliminate diversity in practice. Mr. McGrath stated that the need for comprehensive guidance on the accounting for physical commodity inventories has been expressed by several major investment banks, commercial banks, and broker-dealers, as well as corporations in the oil and gas and agricultural industries. He stated that the staff further believes that traded physical commodity inventory should not be included in Phase 2 of the Fair Value Option project since the existence of an option will not have the effect of eliminating diversity in practice. He added that the staff believes that fair value accounting better reflects the economics of these transactions.

5. Messrs. Trott, Linsmeier, Young, Crooch, Herz, and Batavick supported Alternative A. Mr. Trott disagreed with the current state of accounting in which the valuation of commodity inventory is determined by the structure of the entity holding the inventory.

6. Mr. Young asked whether trading activities and production activities are generally distinguishable in entities that have both. Mr. Batavick stated that, in his experience, entities that have both trading activities and production activities generally conduct and track those activities separately. Mr. Trott disagreed, and stated that in many cases it may be difficult to distinguish between trading and production activities within an entity.

7. Mr. Trott stated that the biggest challenge the Board would face in this project would be defining trading activities. Mr. Linsmeier agreed, and stated that one of the difficulties of defining trading activities would be distinguishing between items that are traded and items that are tradable. Furthermore, an entity may place a tradable commodity into a production process, at the end of which the product may or may not also be a tradable commodity. Mr. Linsmeier urged the Board to at least consider a model under Alternative A which would require tradable (even if not traded) commodities to be accounted for at fair value. Mr. Young agreed.

8. Mr. Crooch stated that another difficulty associated with defining trading activities is that the Board may end up creating differences in accounting that do not represent the economics of the transactions. For example, if one half of a tank of oil is going to be

traded and the other half is going to be made into gasoline, why would the two halves of that tank be measured differently?

9. Messrs. Young and Crooch suggested that the project consider requiring fair value accounting for all commodities, regardless of whether they are produced or traded. Mr. Batavick stated that commodities that are being produced and sold should not be accounted for at fair value, since such a requirement would have major implications for revenue recognition. Mr. Crooch stated that, while some critics might argue that there should be a triggering event to allow for the recognition of some of the revenue associated with producing a commodity (rather than recognizing it over time), he thought that the price change of the commodity is the triggering event. Mr. Herz stated that it would still be important to distinguish between margins on production and gains and losses due to price changes of traded commodities.

10. Mr. Herz stated that any definition of trading activities may also need to consider the timeframe for holding traded items. He stated that holding gains would be more relevant when an entity holds an item for two months before trading it than they would be when an entity actively trades an item on a daily basis.

11. Mr. Linsmeier also raised the issue of defining the criteria for items with readily determinable fair values. Mr. Batavick shared that concern and suggested that the Board could consider scoping the project to items that are actively traded on, or indexed to, an exchange.

12. Ms. Seidman supported a modified version of Alternative A. She supported adding a project to the agenda and she stated that she generally believes that traded inventory should be accounted for at fair value; however, she is not supportive of the qualifying criterion that the inventory item must have a readily determinable fair value. Ms. Seidman stated that derivatives must be accounted for at fair under FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*, whether or not their underlying(s) are readily marketable. So, for many entities, they may have derivatives being accounted for at fair value, while Alternative A seems to suggest that the commodity being hedged would have some limitation on it. Ms. Seidman stated that this

would introduce unnecessary complexity. Ms. Seidman also suggested that the staff begin exploring the scope of this project by looking at EITF Issue No. 98-10, "Accounting for Contracts Involved in Energy Trading and Risk Management Activities," and the reasons for its withdrawal.

13. Mr. Leisenring cautioned the Board that defining commodities may prove to be difficult, especially in the field of agriculture. He stated that the IASB had to consider an extremely wide variety of types of contracts when they developed International Accounting Standard 41, *Agriculture*.

Issue 2: Emission Allowances

14. Mr. McGrath stated that at the February 21, 2007 Board meeting, the Board directed the staff to consider addressing the accounting for traded emissions allowances in this project. He stated that the staff has found that diversity exists in practice with regard to the accounting for traded emissions allowances. Given the diversity in practice, Mr. McGrath stated that the staff recommends that the Board address traded emissions allowances within the scope of this project. The staff believes that the market for certain traded physical commodities and emissions allowances is fundamentally similar, so these items should be considered together as part of this project. Mr. McGrath asked that the Board affirm its earlier decision to address the accounting for traded emissions allowances as a part of this project.

15. No Board members objected to initially considering the accounting for emissions allowances as a part of this project.

Issue 3: Nonphysical Commodities

16. Mr. McGrath stated that if Board members decide to include nonphysical commodity contracts within the scope of this project, the staff will conduct additional research to determine the types of nonphysical commodity contracts that would be included in the scope of this project. He stated that the staff recommends addressing physical commodities and emissions allowances only since these are the most pressing practice issues. The staff believes that all energy contracts should eventually be addressed given

the growth in the energy markets but the staff recommends that the accounting for traded nonphysical commodities or nonfinancial contracts (such as electricity, storage contracts, etc.) be addressed in a separate project, either during Phase 2 of the FVO or in a separate FSP. These items would significantly increase the scope of this project. Mr. McGrath added that a project that includes all energy contracts would be a reconsideration of Issue 98-10, which would require additional research and Board deliberation prior to bringing a final FSP to the Board.

17. Mr. Leisenring said that the Board will need to better understand the definition of physical commodities. He stated that it would be hard to exclude nonphysical commodities from the scope of the project without fully understanding what that would mean.

18. Messrs. Trott and Linsmeier stated that the scope of this project should not necessarily be defined by the physicality of the item, although they were not opposed to considering physical commodities as a starting point. They stated that the Board will first need to decide what kinds of items should be required to be measured at fair value, which may or may not be based on the physicality of the item being considered. Then, the Board should consider which items would be more appropriately addressed under Phase 2 of the Fair Value Option project. Mr. Herz agreed.

19. Ms. Seidman stated that nonphysical commodities should be included in the scope of the project. She stated that there is a major practice issue with determining whether or not some energy contracts meet the definition of a derivative (and would, therefore, be accounted for at fair value), sometimes based on whether the underlying is readily convertible to cash. She stated that the Board could greatly simplify the accounting for these types of contracts by including nonphysical commodities in the scope of the project. That way, all of the related parts of an entity’s trading activities would be accounted for consistently.

20. Mr. Young stated that broadening the scope of the project may provide valuable insight. Rather than focusing on the types of activities conducted by financial institutions,

addressing the accounting for nonphysical commodities would provide information about various aspects of industrial and commercial production activities.

21. Mr. Batavick and Ms. Seidman acknowledged that accounting for physical commodities and emission allowances are the two most pressing practice issues. Ms. Seidman stated that although broadening the scope may require more research and will probably take longer to complete, the accounting for nonphysical commodities would ultimately need to be addressed so it should be included in this project.

22. No Board members objected to including nonphysical commodities in the scope of this project. Ms. Seidman suggested reaching out to respondents on the FASB Exposure Draft, "The Fair Value Option for Financial Assets and Financial Liabilities," as a starting point for conducting research on the scope of the project.

<u>Follow-up Items:</u>

None.

<u>General Announcements:</u>

None.