FASB Emerging Issues Task Force

Issue No. 04-13

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

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Dates Previously Discussed: November 17–18, 2004; March 17, 2005; June 15–16, 2005

Previously Distributed EITF Materials: Issue Summary No. 1, dated November 8, 2004; Issue Summary No. 1, Supplement No. 1, dated March 1, 2005; Working Group Report No. 1, dated June 2, 2005 (Supplement No. 2)

References

FASB Statement No. 49, *Accounting for Product Financing Arrangements* (FAS 49)

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

FASB Statement No. 153, *Exchanges of Nonmonetary Assets* (FAS 153)

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

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

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

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

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

EITF Issue No. 99-19, "Reporting Revenue Gross as a Principal 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. 02-2, "When Certain Contracts That Meet the Definition of Financial Instruments Should Be Combined for Accounting Purposes" (Issue 02-2)

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. At the June 15–16, 2005 EITF meeting, the Task Force reached a tentative conclusion on this Issue and directed the staff to post a Draft Abstract to the FASB website for public comment. The Draft Abstract was posted to the website on July 7, 2005, for a 45-day comment period that ended August 20, 2005.

2. The FASB staff has analyzed the comment letters received on the Draft Abstract, which have been distributed to members of the Task Force. At the September 15, 2005 EITF meeting, the Task Force will be asked to consider the comments received as it redeliberates the tentative conclusions reached in the Draft Abstract. After the Task Force redeliberates the issues raised in this Supplement, the Task Force will be asked to reach a final consensus on this Issue.

Summary of Comment Letters

3. Three comment letters were received on the Draft Abstract. Those commenting included a user/preparer of financial statements, a trade association (American Petroleum Institute), and the AICPA Private Companies Practice Section (PCPS) Technical Issues Committee. Two of the comment letters agreed with the proposed model, while one disagreed.

4. The respondent that disagreed with the proposed model used the same arguments presented in its previous comment letter dated November 10, 2004, which had been provided to the Task Force. The Task Force considered the arguments in the November comment letter as it deliberated Issue 04-13. Therefore, the staff believes that the Task Force does not need to discuss further the arguments in the recently issued comment letter.

5. The staff believes the following comments warrant consideration by the Task Force at the September 15, 2005 EITF meeting.

Comment 1:	The scope of Issue 04-13 should be clarified to exclude transactions that are not capable of being held in inventory (e.g., electricity).
Comment 2:	The transition guidance should be applied to new contracts executed in reporting periods beginning after March 15, 2006.
Comment 3:	Issue 04-13 should provide examples on both Issue 1 and Issue 2.

Accounting Issues and Alternatives

Issue 1: Should the scope of the Issue 04-13 be clarified to exclude transactions that are not capable of being held in inventory?

6. One respondent believes that the scope of Issue 04-13 should be clarified to exclude transactions involving products that are not capable of being stored in inventory. The comment letter states that because exchange transactions involving products that are not capable of being stored in inventory have characteristics similar to the buy/sell exchanges within the scope of Issue 04-13, Issue 04-13 could inadvertently be applied to those types of transactions.

FASB Staff Analysis

7. The staff does not believe that additional clarification regarding the scope of Issue 04-13 is necessary. The scope of Issue 04-13 includes inventory transactions affected by paragraph 20(b), as amended by FAS 153, of APB 29. Paragraph 20(b) refers to an exchange of product or property 'held for sale' in the ordinary course of business when describing nonmonetary exchanges of inventory, which is consistent with the characterization of inventory described in Chapter 4 of ARB 43. Therefore, the FASB staff believes that it is clear that Issue 04-13 only relates to exchanges of products that are inventoriable ('held for sale') as described in paragraph 20(b) of APB 29.

View A: The scope of Issue 04-13 should not be clarified.

View B: The scope of Issue 04-13 should be clarified to exclude transactions that are not capable of being stored in inventory.

Issue 2: Should the transition guidance in Issue 04-13 be applied to new contracts executed in reporting periods beginning after March 15, 2006?

8. One respondent recommended that transition be applied to new contracts executed in reporting periods beginning after March 15, 2006. That respondent expresses concern about contracts that included transactions involving both pre and post implementation periods because

most of their member systems manage transactions by contract and therefore it would be very difficult (if not impossible) to bifurcate the pre and post transactions for implementation. The respondent recommends that the Draft Abstract be amended to apply prospectively to "new contracts executed" in reporting periods beginning after March 15, 2006.

FASB Staff Analysis

9. The staff believes that the transition guidance in Issue 04-13 should apply to all contracts entered into after March 15, 2006, to accommodate implementation issues raised by the respondent. However, the staff believes that additional transition criterion is necessary to address the potential lack of comparability for long-term contracts that were entered into prior to March 15, 2006. The staff believes that typical contracts affected by Issue 04-13 are less than one year, and therefore the Draft Abstract should also require all inventory transactions that are completed after December 15, 2006 that are related to contracts entered into prior to March 15, 2006, to be accounted for in accordance with Issue 04-13.

View A: The consensus in Issue 04-13 should be applied to new arrangements entered into in reporting periods beginning after March 15, 2006, and to all inventory transactions that are completed after December 15, 2006, for arrangements entered into prior to March 15, 2006.

View B: The consensus in Issue 04-13 should be applied to all linked transactions for which both deliveries required were executed in reporting periods beginning after March 15, 2006.

Issue 3: Should examples be provided in Issue 04-13 to illustrate the consensuses?

10. One respondent recommends that examples be provided in Issue 04-13 to illustrate the final consensuses.

View A: Examples should be provided in Issue 04-13 to illustrate the final consensuses.

View B: Examples should not be provided.

Other Comments Received on the Draft Abstract

11. The staff received other comments on the Draft Abstract that are not specifically addressed herein such as comments seeking specific application guidance. Suggested changes to the wording or clarifications to a concept in the Draft Abstract that the staff has determined are not significant enough to warrant specific consideration are reflected in the marked Draft Abstract included as Appendix 04-13A.

Appendix 04-13A

***EITF Abstracts* (DRAFT)**

Issue No. 04-13

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

Dates Discussed: November 17–18, 2004; March 17, 2005; June 15–16, 2005; September 15, 2005

References: FASB Statement No. 49, *Accounting for Product Financing Arrangements*

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

FASB Statement No. 153, *Exchanges of Nonmonetary Assets*

AICPA Accounting Research Bulletin No. 43, Chapter 4, "Inventory Pricing"

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

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

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"

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

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

ISSUE

1. An entity may sell inventory to another entity from which it also purchases inventory to be sold in the same line of business. 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 (WIP), or finished goods.

2. The issues are:

Issue 1— The circumstances under which two or more exchange transactions involving inventory with the same counterparty should be viewed as a single exchange transaction for purposes of evaluating the effect of Opinion 29

Issue 2— Whether there are circumstances under which nonmonetary exchanges of inventory within the same line of business should be recognized at fair value.

3. The scope of this Issue excludes inventory purchase and sales arrangements that (a) are accounted for as derivatives under Statement 133 or (b) involve exchanges of software or exchanges of real estate. The FASB staff observes that this Issue does not address whether transactions that are reported at fair value qualify for revenue recognition.

EITF DISCUSSION

Issue 1—The circumstances under which two or more exchange transactions involving inventory with the same counterparty should be viewed as a single exchange transaction for purposes of evaluating the effect of Opinion 29.

4. The Task Force reached a consensus on Issue 1 that two or more exchange transactions involving inventory with the same counterparty that are entered into in contemplation of one another (that is, they are negotiated and agreed to as one arrangement) should be combined for purposes of evaluating the effect of Opinion 29. The Task Force agreed that in situations in which one inventory transaction is legally contingent upon the performance of another inventory transaction with the same counterparty, the two transactions are deemed to have been entered into in contemplation of one another and considered a single exchange transaction subject to Opinion 29. The Task Force also reached a consensus that in situations in which an inventory transaction is not legally contingent upon the performance of another inventory transaction with the same counterparty, the following factors may indicate that a purchase transaction and a sales transaction were entered into in contemplation of one another:

- *There is a specific legal right of offset of obligations between counterparties involved in inventory purchase and sales transactions.*
  The ability to offset the receivable(s) and payable(s) related to the separately documented inventory transactions indicates that there is a link between them and, therefore, it is an indicator that the separately documented inventory transactions were entered into in contemplation of one another. This indicator is more relevant for net settlement provisions relating to specific inventory transactions identified by both counterparties than for inventory transactions that are netted as part of a master netting agreement that include all transactions between the two counterparties.
- *Inventory purchase and sales transactions with the same counterparty are entered into simultaneously.*
  If an inventory purchase transaction is simultaneously entered into with an inventory sales transaction with the same counterparty, that is an indication that the transactions were entered into in contemplation of one another.

A company may sell inventory to a counterparty and simultaneously enter into another arrangement with that same counterparty whereby that counterparty may, but is not contractually required to, deliver an agreed-upon inventory amount. The more certain it is the reciprocal inventory transaction will occur, the stronger the indication that the two inventory transactions were entered into in contemplation of one another.

- *Inventory purchase and sales transactions were entered into at inception at off-market terms.*
  If a company enters into an off-market inventory transaction with a counterparty, that is an indication that the transaction is linked to, and entered into, in contemplation of another inventory transaction with that same counterparty. This indicator may be more relevant for transactions with products that have readily determinable market prices, such as exchange-traded commodities, than for transactions with products that are subject to greater discretionary pricing.

5. The Task Force agreed that none of the factors individually are determinative nor is the list all-inclusive.

6. The Task Force also agreed that the issuance of separate invoices and the exchange of offsetting cash payments are not determinative when considering whether two or more inventory transactions with the same counterparty should be deemed to be a single exchange transaction for purposes of evaluating the effect of Opinion 29.

7. If two or more inventory transactions are combined for the purposes of applying Opinion 29, an entity should apply the guidance in Issue 2.

Issue 2—Whether there are circumstances under which nonmonetary exchanges of inventory within the same line of business should be recognized at fair value.

8. The Task Force reached a consensus on Issue 2 that a nonmonetary exchange whereby an entity transfers finished goods inventory in exchange for the receipt of raw materials or WIP inventory within the same line of business is not an *exchange transaction to facilitate sales to customers* as described in paragraph 20(b) of Opinion 29, as amended by Statement 153, and, therefore, should be recognized by the entity at fair value if (a) fair value is determinable within reasonable limits and (b) the transaction has commercial substance (paragraph 21 of Opinion 29, as amended by Statement 153). All other nonmonetary exchanges of inventory within the same line of business should be recognized at the carrying amount of the inventory transferred. That is, a nonmonetary exchange within the same line of business involving (a) the transfer of raw materials or WIP inventory in exchange for the receipt of raw materials, WIP, or finished goods inventory or (b) the transfer of finished goods inventory for the receipt of finished goods inventory should not be recognized at fair value.

9. The Task Force also reached a consensus that the classification of inventory as raw materials, WIP, and finished goods for purposes of this Issue should be the same classification that an entity uses for external financial reporting purposes. The Task Force also agreed that an

entity should disclose the amount of revenue and costs (or gains and losses) associated with inventory exchanges recognized at fair value.

Transition and Effective Date

10. The Task Force agreed that the consensus in this Issue should be applied to new arrangements entered into in reporting periods beginning after March 15, 2006, and to all inventory transactions that are completed after December 15, 2006, for arrangements entered into prior to March 15, 2006. The carrying amount of the 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 for this consensus. Early application is permitted in periods for which financial statements have not been issued.

Board Ratification

11. At its [September 28, 2005] meeting, the Board ratified the consensus reached by the Task Force in this Issue.

STATUS

12. No further EITF discussion is planned.