

**AICPA
PCPS Technical Issues Committee**

August 24, 2005

Mr. Lawrence Smith, CPA
Director, Technical Application & Implementation Activities--FSP
Financial Accounting Standards Board
401 Merritt 7
P.O. Box 5116
Norwalk, CT 06856-5116

Re: July 7, 2005 Draft Abstract, EITF Issue No. 04-13, *Accounting for Purchases and Sales of Inventory with the Same Counterparty*

Dear Mr. Smith:

One of the objectives that the Council of the American Institute of Certified Public Accountants (AICPA) established for the PCPS Executive Committee is to act as an advocate for all local and regional firms and represent those firms' interests on professional issues, primarily through the Technical Issues Committee (TIC). This communication is in accordance with that objective. These comments, however, do not necessarily reflect the positions of the AICPA.

TIC has reviewed the draft EITF abstract and is providing the following comments for your consideration.

GENERAL COMMENTS

TIC agrees with the consensuses in the EITF abstract. We believe the "in contemplation" model for identifying when to combine two or more inventory transactions with the same counterparty is operational. We also found the indicators for identifying an "in contemplation" transaction to be appropriate and useful.

However, TIC requests that the final EITF include examples to illustrate the provisions of the consensuses. Scenarios that should be addressed include:

Issue 1—The circumstances under which two or more inventory transactions with the same counterparty should be viewed as a single nonmonetary transaction within the scope of Opinion 29, *Accounting for Nonmonetary Transactions*

- Transactions types that meet the "in contemplation" assumption
- Transaction types that do not fit the "in contemplation" assumption

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

- Transactions that would illustrate the fair value exception for nonmonetary exchanges of inventory within the same line of business

SPECIFIC COMMENTS

EITF 04-13 introduces two new concepts that should be explained using illustrative examples to clarify how to apply the consensus in practice:

- The importance of determining whether inventory purchases and sales transactions with the same counterparty have been completed “in contemplation of one another,” as defined; and
- The importance of inventory classification among raw materials, work-in-process and finished goods for purposes of determining whether gains or losses would be recognized on the nonmonetary exchanges.

Need for Examples--Issue 1

TIC would like to offer the following examples based on transactions encountered in one member’s practice:

Example 1a: Car swapping between auto dealers – Simultaneous transaction

Scenario: Honda dealer A in suburb X has too many silver Accords and not enough red Civics. Honda dealer B in suburb Y needs silver Accords and has too many red Civics. Dealer A and Dealer B enter into simultaneous transactions in which they buy from the other dealer the cars needed.

Explanation: Since these transactions were simultaneous, they are considered “in contemplation” and should be recognized at the carrying amount of the inventory transferred. This would be considered a single, nonmonetary inventory transaction within APB Opinion 29 even though the dealerships may exchange invoices and cash payments.

Example 1b: Car swapping between auto dealers – Non-simultaneous transaction

Scenario: Same facts as example 1a, except that Dealership A sells silver Accords to Dealership B in March but doesn’t purchase Red Civics from Dealership B until July.

Explanation: Given the reciprocal nature of dealership operations, there is relative certainty that reciprocal transactions with other dealerships in the area would occur in the future. Therefore, example 1b would also be considered a single, nonmonetary transaction.

Example 2: Auction sales involving counterparties

Scenario: Honda dealers A and B from different cities bring their unwanted used cars to an auction. The two dealers purchase each other's cars through the formal auction process.

Explanation: This transaction would not be considered "in contemplation" because the two dealers did not plan on selling the used cars to each other. The cars were sold through an intermediary (the auction company) where anyone could have had the successful bid. Therefore, any gain or loss would be recognized by the sellers.

Need for Examples—Issue 2

Example 3: Exchange of inventory between manufacturer and subcontractor

Scenario: Manufacturer A buys raw materials for \$500 and sells them to Subcontractor B for \$600. The subcontractor assembles the materials into a subassembly and sells it back to the manufacturer for \$1,000. This is a continuing arrangement between the two parties such that the raw materials and subassemblies are exchanged on an ongoing basis. Because this is a continuing arrangement, the transactions are viewed as "in contemplation" of each other and are therefore viewed as nonmonetary.

Explanation: Manufacturer A would not record the \$100 profit (\$600 - \$500) on the sale of the raw materials to Subcontractor B. However, Subcontractor B would have a \$600 basis in the raw materials. The subcontractor would recognize profit of \$400 (\$1,000 - \$600) on the sale of its finished goods back to Manufacturer A. Manufacturer A would have a cost basis in the completed subassembly of \$900 (\$500 original cost plus \$400 value added in the subassembly process). Recognition of gain by the subcontractor would be based on the guidance in paragraph 7 of the EITF which states:

...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 sale to customers...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....

Editorial Matters—Issue 1

To enhance clarity and the logical flow of the document, TIC recommends that the consensus in issue 1 be re-organized. The four factors that indicate transactions consummated "in contemplation" should be placed immediately after the second line in paragraph 4 that discusses transactions that are legally contingent upon the performance of another inventory transaction with the same counterparty. The discussion of the effect of cash payments and exchange of invoices would then properly conclude the paragraph, since this guidance would apply to either contingent or non-contingent exchanges.

Effective Date

TIC appreciates the lengthy transition period provided. Practitioners will need considerable time to examine the subsidiary receivables and payables ledgers of their clients to determine the existence of exchange transactions among counterparties and to perform other procedures to find similar transactions that do not have a monetary component.

TIC appreciates the opportunity to present these comments on behalf of PCPS member firms. We would be pleased to discuss our comments with you at your convenience.

Sincerely,

Stephen M. McEachern, Chair
PCPS Technical Issues Committee

cc: PCPS Executive and Technical Issues Committees