MINUTES

To:	Board Members
From:	Accounting for Trading Inventory, Potential FSP to Amend ARB 43—Staniszewski (x445)
Subject:	Minutes of the October 31, 2007 Board Meeting (Accounting for Trading Inventory, Potential FSP to Amend ARB 43)
Date:	November 15, 2007
cc:	Bielstein, MacDonald, Fanzini, Leisenring, Stoklosa, Golden, Posta, Gabriele, Barker, Elsbree, Wilks, Lott, Bhave, Klimek, Cosper, Staniszewski, 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:	Accounting for Trading Inventory, Potential FSP to Amend ARB 43
Basis for Discussion:	Board Memorandum 2 dated October 16, 2007
Length of Discussion:	11:00 a.m. to 12:05 a.m.
Attendance:	
Board members present:	Herz, Smith, Crooch, Linsmeier, Seidman, and Young
Board members absent:	Batavick
Staff in charge of topic:	Fanzini
Other staff at Board table:	Golden, Stoklosa, and Staniszewski
Outside participants:	None

Summary of Decisions Reached:

The Board discussed four alternative models to incorporate into a potential FASB Staff Position (FSP) to amend ARB 43. The Board agreed that the proposed FSP would require mark-to-market accounting if the item is bought and sold with the objective of making a profit (that is, meets that staff's definition of trading) and the item has a readily determinable fair value. The Board also agreed that the proposed FSP would include the staff's definition of trading and readily determinable fair value. The Board directed the staff to conduct further research to determine the appropriate transition method for the proposed FSP. The Board agreed that the proposed FSP would be effective for fiscal years beginning after November 15, 2008, and that early adoption would not be permitted.

Objectives of Meeting:

The objective of this meeting was for the Board to discuss four alternative models and to direct the staff as to which model to incorporate within a potential FSP to determine which types of instruments and/or activities are required to be accounted for at fair value through earnings (mark-to-market accounting). The objective of the meeting was met.

Matters Discussed and Decisions Reached:

1. Mr. Fanzini stated that the purpose of meeting was for the Board to consider four alternative accounting models that the staff has created for the purpose of determining which types of instruments and/or activities are required to be accounted for at fair value through earnings. He noted that at the September 12, 2007 Education Session, the staff presented the Board with a proposed working definition of trading for use in identifying the items that could be included in the scope of the project and potential FSP on accounting for commodity assets at fair value with unrealized changes recognized in earnings for the reporting period. During that meeting, the staff was directed to illustrate the working definition of trading in the context of alternative models.

2. Mr. Fanzini observed that each of the four alternatives take into account the staff's working definition of trading, and whether or not the item has a readily determinable fair

value. For this project, Mr. Fanzini noted that the staff has defined readily determinable fair value as including measurement attributes that include prices derived from both actively traded markets and broker-dealer quotes. That is, the staff believes that items that do not have quoted prices that can be derived from active markets or broker-dealer quotes should not be within the scope of this project. Items, such as baseball cards, that do not fall within the scope of this project can be addressed in the second phase of the fair value option project if it is determined that the baseball cards do not have a readily determinable fair value. Similarly, energy capacity contracts, while possibly part of an overall trading activity, might also not have a readily determinable fair value and would not be within the scope of this potential FSP (within certain of the staff's alternative models outlined below).

Alternative Accounting Models

3. Mr. Staniszewski stated that the alternative models that the staff will present address only recognized assets. That is, the models are not intended to provide guidance for an item that is not currently recognized on the balance sheet. The four alternative models include:

   Alternative 1—Mark-to-market accounting is required if the item is bought and sold with the objective of making a profit (that is, meets the definition of trading) and the item has a readily determinable fair value.

   Alternative 2—Mark-to-market accounting is required if the item is bought and sold with the objective of making a profit (that is, meets the definition of trading). Readily determinable fair value is not a criterion.

   Alternative 3—Mark-to-market accounting is required if the item has a readily determinable fair value. This alternative does not consider the entity's activity or intent to trade.

   Alternative 4—Mark-to-market accounting is required for a class of items if an election is made to mark to market any of the inventory that meets the definition of trading and has a readily determinable fair value.

4. Mr. Staniszewski noted that the staff recommends Alternative 1. He observed that under the staff recommendation, only the items meeting the trading definition and positions that have readily determinable fair values should be accounted for at fair value. That is, assets that will be used in production, for example, will be excluded from the fair value requirement within the scope of the proposed FSP. The staff believes that items that are traded are more appropriately accounted for on a marked-to-market basis as that accounting best reflects the economics of that transaction, and for the purposes of this potential FSP, the staff believes that the item needs to have a readily determinable fair value. The staff contemplated whether a readily determinable fair value was necessary at all (Alternative 2). For example, certain contracts accounted for as a derivative under Statement 133 are required to be accounted for on a marked-to-market basis at fair value – even if those contracts do not have readily determinable fair values. However, the staff questions whether certain items that do not meet the definition of a derivative and do not have a readily determinable fair value (for example, baseball cards) should be required to be accounted for on a mark-to-market basis. In addition, Mr. Staniszewski noted that requiring fair value treatment for assets that are to be used in production will have a detrimental impact on an entity's stated policy for revenue recognition. He observed that this potential FSP is not intended to require an entity to recognize gains on assets that are being consumed in an entity's normal business operations or in an entity's product life cycle (that is, WIP).

5. Mr. Staniszewski acknowledged that the staff is aware of the concern regarding the potential that an entity may be carrying an identical asset on its books at different measurements. For example, an integrated oil company may hold oil on its books at the lower of cost or market for the oil being held for use in production while also holding oil that is being held for trading at fair value. Under the staff recommendation, the integrated oil company would continue to hold the oil to be used in production at lower of cost or market while requiring the oil held for trading to be recognized at fair value with unrealized changes recognized in earnings. Mr. Staniszewski noted that the staff believes that items that are being traded are more appropriately recognized on a mark-to-market basis. Further, the staff believes that the recommended approach is more principles-based. Therefore, instead of putting the stress on the accounting standard (by issuing

detailed rules) it puts pressure on internal control processes and the analysis of management and their support for their assertion—which, in the staff's view, is more in line with the objective of principles-based accounting.

6. From an international convergence standpoint, Mr. Staniszewski commented that the staff believes that Alternative 1 presents the most convergent alternative to IFRS literature. IAS 2 bases its scope exception on commodity trading activity and states that measuring inventory for commodity traders is more appropriate on a marked-to-market basis. That is, the staff believes that the requirements of Alternative 1 present the same results as providing an exception to ARB 43 for broker-dealers.

7. Mr. Staniszewski asked the Board if they agreed with the staff's recommendation that the potential FSP incorporate Alternative 1 and move forward with drafting of an FSP. He also asked if the Board would like to include the definition of trading and readily determinable fair value within the potential FSP.

8. Mr. Smith asked how IAS 2 handles commodities that are being traded. Mr. Fanzini stated that IAS 2 provides a specific scope out for commodity broker-traders. Mr. Smith noted that it does not seem that Alternative 1 is the most convergent with IFRS literature. He questioned whether or not the use of the term broker-dealer equates to having a readily determinable fair value. Mr. Golden stated that the definition of a commodity generally includes a readily determinable fair value. Ms. Seidman agreed that it is not appropriate to assume that a commodity always has a readily determinable fair value. Mr. Linsmeier noted that the staff's recommendation may be broader than what is covered in IAS 2. He noted that he would like to understand what the scope of the potential FSP is before making any decisions. Mr. Golden stated that the scope would be limited to recognized assets that are being traded. The scope is not just limited at the current time to those items that would be within the scope of ARB 43. Mr. Crooch clarified that inventory items that are the same could be carried at different measurement attributes. Mr. Golden stated that an entity could indeed be accounting for an item at different measurement attributes.

9. Mr. Crooch asked the staff when an item would be designated as being held for trading or held for use in production. Mr. Golden stated that a transfer from trading to production would be at fair value. He noted that the proposed FSP would have disclosure requirements that would limit the amount of abuse. Mr. Herz noted that the staff has the right principle, and prohibiting an entity from abusing the principle would be more of an audit issue. If an entity tries to manipulate earnings by transferring from one category to the next, the auditors should pick up on this behavior. Mr. Golden agreed and stated that the entity will designate the item based on the entity's intent for that item.

10. Mr. Smith asked why the staff used the term *readily determinable fair value*. He asked how this description fit into the framework within Statement 157. Mr. Fanzini noted that readily determinable fair value is not limited to just level 1, but the staff stopped short of saying that all of level 2 would be included. The staff wanted to broaden the level 1 measurement to also include the items that derive prices from broker-dealer quotes. Mr. Fanzini commented that the staff used readily determinable fair value because the staff wanted to stay away from specifically mentioning level 1 and level 2. Mr. Herz noted that the principle within this FSP would be the robustness of the market. He noted that trading and *readily* tend to go hand-and-hand.

11. Ms. Seidman stated that she was concerned with using a reliability threshold for scoping which items would be within the scope of the potential FSP. She analogized to how Statement 133 required fair value for contracts that are derivatives while the underlying physical position would not have a readily determinable fair value (that is, items with level 3 measurements). Ms. Seidman agreed with the staff that items in a trading activity are most appropriately accounted for on a mark-to-market basis. However, she noted that it seems more appropriate to require fair value for any item that is designated as trading. Mr. Herz noted that he would be willing to accept an alternative with no reliability threshold only if the definition of trading was narrowed. That is, he would want a holding period requirement incorporated into the definition.

12. Messrs. Batavick, Herz, Smith, and Crooch voted in favor of Alternative 1 (the staff recommendation). Mr. Herz stated that he could support Alternative 2, but the definition

of trading would have to be narrowed to include the holding period. Ms. Seidman voted in favor of Alternative 2. Mr. Young supported Alternative 4, and Mr. Linsmeier stated that he needed more information before he could vote.

Disclosures

13. Mr. Smith asked if the staff intended to address disclosure requirements at a future meeting. Mr. Golden stated that the staff does intend to address disclosures, and he stated that Mr. Linsmeier's suggestion to disclose the intended use at the time the item is first possessed in its commodity form will be researched by the staff. Mr. Linsmeier stated that the staff needs to clarify the difference between "acquiring" and "buying" the commodity. If the trading definition incorporates acquiring, it will allow an entity to designate the commodity that it produces. Mr. Stoklosa noted that using the term *acquiring* would change the direction the staff was originally heading towards by using the term *buying*. Mr. Golden acknowledged that the Board members appeared to support changing "buy" to "acquire" in the staff's definition of trading. No Board members objected to changing the working definition of trading to incorporate the notion of acquiring assets. However, Mr. Smith observed that the staff should touch base with Mr. Batavick to make sure he would support the notion of including *acquiring* within the staff's definition.

14. Mr. Smith observed that it would be helpful to add disclosure requirements around transfers. Mr. Herz noted that adding disclosure requirements around transfers from either trading, production, or vice-versa would be needed. Ms. Seidman stated that the staff needed to elaborate on the accounting for transfers from production to trading.

Designation

15. Mr. Herz stated that the date when the financial statements are issued should be when an entity discloses what is to be held for trading or used in production. He made the point that an attempt to try to construct a set of detailed rules would not be appropriate. He stated that he would rather support a principle that provides disclosure requirements.

16. Mr. Golden stated that the staff would explore the potential to require an entity to designate the entity's intended use shortly after the commodity is acquired within appropriate disclosures, and any subsequent transfers would also be disclosed. This is assuming that an entity does not designate on day one. Mr. Herz observed that he does not think a set of rules needs to be established and disclosures will suffice.

17. Mr. Fanzini stated that the staff intends to develop an FSP with the provisions of Alternative 1. He stated that the FSP will incorporate further developments regarding disclosures and transfers. Mr. Golden added that the staff intends to come back to the Board with a completed product that will incorporate any changes made after discussion with oil companies and investors. Mr. Young stated that a major issue surrounds an entity that engages in both activities – trading and production. He stated that the staff should discuss any issues surrounding the current accounting when the entity both trades and produces the commodity with the ITF.

Effective Date and Transition

18. Mr. Staniszewski stated that the staff recommends that the FSP should be effective for financial statements issued for fiscal years beginning after December 15, 2008. Early application would not be permitted. He noted that the staff also recommends retrospective application to all prior periods.

19. Mr. Herz noted that retrospective application may be difficult for an entity to apply. Other Board members concurred with Mr. Herz. Mr. Herz stated that the transition should be applied prospectively with a cumulative catch adjustment. Mr. Golden stated that the staff would like to change the recommended effective date to November 15, 2008. Ms. Seidman stated that using retrospective application would be a classic example of how an entity could use hindsight to manage earnings, and she would object to allowing retrospective application. Other Board members agreed and stated that it may not be possible due to the record keeping that would have needed to be in place to account for the items that would have been with the scope of the potential FSP. Mr. Linsmeier stated that he is interested in hearing the feedback from ITAC regarding the transition method.

Follow-up Items:

20. Mr. Herz stated that the staff should reach out to two groups – the oil companies who have both trading and production activities, and the broker-dealers who had the original problem in EITF Issue 06-12.

General Announcements:

21. None.