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**Proposed Statement of Financial Accounting Standards, *Inventory Costs*,
an amendment of ARB No. 43, Chapter 4
File Reference No. 1200-100**

Ernst & Young appreciates the opportunity to respond to the FASB's Proposed Statement of Financial Accounting Standards, *Inventory Costs, an amendment of ARB No. 43, Chapter 4* (the "Proposed Amendment"). We strongly support the efforts of the FASB and International Accounting Standards Board (IASB) to improve the quality and comparability of financial reporting through convergence to a common set of accounting standards. We note in this instance that the FASB does not expect convergence will substantially change practice. However, we believe that certain proposed changes could result in significant changes to current practice, which clearly was not the Board's intention based on our reading of the basis for conclusions and minutes of Board deliberations. Our specific concerns are discussed further below.

Under the Proposed Amendment, "the allocation of fixed production overheads to the costs of conversion is based on the *normal capacity* of the production facilities rather than actual production levels" (emphasis added). As a result, it appears that many are reading this wording as indicating that the Board believes that all unfavorable volume variances and most favorable volume variances will be reflected as period costs instead of as adjustments to the carrying amounts of inventories. If this is the result intended, we do not believe that this change is an improvement to existing accounting guidance because it would seem to have the effect of stating inventories at amounts that are higher or lower than the actual costs to produce such inventories. As such, we recommend that the Board avoid concepts such as "normal capacity" and instead indicate the basic principle that inventory should be carried at cost of procurement and production and that methods for allocating fixed overhead should not result in capitalizing more costs than were incurred nor in including costs that were not related to current costs of production, such as the cost of idle facilities or extremely low operations.

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If the proposed guidance concerning the treatment of fixed production overheads is retained, we believe that the concept of “normal capacity” must be clarified and expanded. The Proposed Amendment indicates, “Normal capacity is the production expected to be achieved on average over a number of periods or seasons under normal circumstances...” We note that normal capacity represents an estimate of average production levels in future periods and is, therefore, subject to a high degree of judgment. Without additional guidance concerning the determination of normal capacity, we believe inconsistent application in practice will occur.

The Proposed Amendment requires double freight and rehandling expenses to be treated as period costs. We note that the guidance in International Accounting Standard (IAS) 2, *Inventories*, does not address any specific types of costs or the required treatment thereof. Instead, paragraph 16(a) of IAS 2 simply indicates that “abnormal amounts of wasted materials, labour or other production costs” should be excluded from the cost of inventories and recognized as expenses in the period in which they are incurred. We recommend that the guidance contained in the Proposed Amendment be changed to more closely conform to the language in IAS 2, including removal of the specific reference to double freight and rehandling costs.

Finally, the terms “fixed production overheads” and “variable production overheads” in the Proposed Amendment have been adopted from IAS 2. We recommend that the related definitions contained in paragraph 12 of IAS 2 also be incorporated (via footnote or otherwise) in the Proposed Amendment.

We would be pleased to discuss our comments with the Board members or the FASB staff at your convenience.

Sincerely,

