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Letter of Comment No: 10
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MP&T Director
Financial Accounting Standards Board
401 Merritt 7
PO Box 5116
Norwalk, CT 06856-5116

Re: Proposed Statement of Financial Standards - Inventory Costs – an amendment of ARB 43, Chapter 4 (File Reference 1200-100)

I appreciate the opportunity to comment on the above-captioned exposure draft. Specific comments follow the exposure draft changes (which are set forth in bold):

Amendment to Paragraph 5:

Inventories are presumed to be stated at cost.

This paragraph does not need to restate that cost is the presumption when measuring inventories since it is already assumed in ARB 43 Ch 1A, par. 1, Ch 3A, pars. 5 and 9, and in Ch 4 throughout the statements and paragraphs. For example paragraph 4 says in part –

“In accounting for the goods in the inventory at any point of time, the major objective is the matching of appropriate costs against revenues in order that there may be a proper determination of the realized income. Thus, the inventory at any given date is the balance of costs applicable to goods on hand remaining after the matching of absorbed costs with concurrent revenues. (Emphasis added)

Although principles for the determination of inventory costs may be easily stated, their application, particularly to such inventory items as work in process and finished goods, is difficult because of the variety of considerations encountered in the allocation of costs and charges.

I recommend that this admission of difficulty should be deleted. There are more difficult (and complex) accounting standards that accountants are required to follow, (e.g., those dealing with options, derivatives and VIE's – FAS 123, 133, and FIN 46) and those standards do not find it necessary to state how difficult the problems are they are meant to solve. Further, I note that the difficulties stemming from the

allocation of costs are not dealt with in any depth by this revision, nor is the appropriate accounting for these difficulties ever offered in the accounting literature.

I assume the term "allocation of costs" means to inventory and the income statement, and the term "allocation of charges" means to the income statement. The term "charge" being used and defined in paragraphs 4 and 8 of Chapter 4.

For example, variable production overheads are allocated to each unit of production on the basis of the actual use of the production facilities.

I suggest the following changes: "variable production overheads ~~are~~ may be allocated to each unit of production on the basis of the actual use of the production facilities or direct labor hours." However, the allocation of fixed production overheads to the costs of conversion is based on the normal capacity of the production facilities.

Normal capacity is the production expected to be achieved on average over a number of periods or seasons under normal circumstances, taking into account the loss of capacity resulting from planned maintenance.

The concept of "normal capacity" is related to "normal sales" which in turn drives "normal production." I suggest that this causal relationship be part of the definition. In addition, since this definition of "normal capacity" in this revision is not very expansive it will not narrow alternative methods of deriving "normal capacity." Is this a nod by the Board to a more "principles-based" approach.

The actual level of production may be used if it approximates normal capacity. In periods of abnormally high production, the amount of fixed overhead allocated to each unit of production is decreased so that inventories are not measured above cost.

I agree with this long established mathematical truism -- that in periods of production that are higher than normal, say at "theoretical full" capacity -- all fixed overhead will be allocated and the unit cost would always be less than a standard unit cost measured at normal. However, the statement should clarify that if, for example, normal capacity is 70% of the theoretical full (installed) capacity, then the 30% of the fixed overhead must also be expensed.

At the end of this sentence, after the word cost, I would add, "measured at normal capacity."

The amount of fixed overhead allocated to each unit of production is not increased as a consequence of low production or idle plant.

Here, the standard should specifically say that costs associated with low production and idle plant must be recorded as a component of cost of goods sold.

Unallocated overheads are recognized as an expense in the period in which they are incurred. Other items such as double freight, rehandling costs, and abnormal amounts of wasted materials (spoilage) require treatment as current period charges rather than as a portion of the inventory cost.

After the words wasted materials, add the words "and labor."

The final statement should clarify which component of "double freight" should be immediately expensed so as to help accountants easily recognize this charge to the income statement.

Also, general and administrative expenses should be included as period charges, except for the portion of such expenses that may be clearly related to production and thus constitute a part of inventory costs (product charges).

I believe the parenthetical phrase is confusing and unnecessary. See the comments regarding inventory charges above.

Selling expenses constitute no part of inventory costs. The exclusion of all overheads from inventory costs does not constitute an accepted accounting procedure. The exercise of judgment in an individual situation involves a consideration of the adequacy of the procedures of the cost accounting system in use, the soundness of the principles thereof, and their consistent application.

U.S. accounting principles do not use or define the idea of "soundness." It would be better to say "general acceptance."

Appendix

A7. The Board believes the benefit of reducing the possibility for potential misinterpretation of the principles of inventory pricing outweighs the cost of applying the newly worded Statement. 4

Accountants have been applying ARB 43 Chapter 4 for decades. I cannot recall any persistent abuse in its application and find that this standard does not fill any gap in the literature nor does it fulfill any significant need. In addition, it is not clear just how the FASB determined the cost imposed on companies to fulfill this change. I recommend that instead of using the boilerplate found in paragraph A7, the Board explain how they mathematically determined that the benefits exceed the costs.

I will be pleased to discuss these comments or answer any questions that you may have. Please contact me at 212-468-7820.

Sincerely,

Robert N. Waxman, CPA