Letter of Comment No: 24
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financial executives
international

committee on corporate reporting

April 23, 2004

Suzanne Q. Bielstein
Director of Major Projects and Technical Activities
Financial Accounting Standards Board
401 Merritt 7
P.O. Box 5116
Norwalk, CT 06856-5116

Re: File Reference No's 1200-100, 1200-200, 1200-300, 1200-400

Dear Suzanne,

The Committee on Corporate Reporting ("CCR") of Financial Executives International ("FEI") appreciates the opportunity to share its views on the four Exposure Drafts ("ED's") issued December 13, 2003 as part of the Financial Accounting Standards Board's (the "Board") short term international convergence project: *Accounting Changes and Error Corrections, Earnings per Share, Exchanges of Productive Assets,* and *Inventory Costs.* FEI is a leading international organization of 15,000 members, including Chief Financial Officers, Controllers, Treasurers, Tax Executives and other senior financial executives. CCR is a technical committee of FEI, which reviews and responds to research studies, statements, pronouncements, pending legislation, proposals and other documents issued by domestic and international agencies and organizations. This document represents the views of CCR and not necessarily the views of FEI.

CCR continues to support the concept of international convergence of accounting standards. After reviewing the Board's proposed treatment for short-term convergence in the four ED's, we find we are supportive of 2 of the EDs: one without further comment (*Earnings per Share)* and one with views detailed below (*Exchanges of Productive Assets).* With respect to the ED on *Inventory Costs,* CCR has mixed views and thus requests further study. We do not support the ED on *Accounting Changes and Error Corrections,* for the reasons detailed below.

We do not support this ED, based primarily on the two reasons noted below:

- First, we are concerned about the reduction in perceived reliability and credibility of financial statements that would arise from a multitude of accounting changes being applied by "retrospective application" in addition to the correction of errors being presented as "restatements". We are further concerned about the market impact that will be placed on individual companies and the market as a whole, due to the blurring of this distinction.

- Second, although we concur that practicability should be retained as an element of the standard, we are concerned about the cost-benefit of the impracticability exception as currently drafted.

Investor Reaction to Restatements

We object to the proposed requirement that changes in accounting principle be treated by "retrospective application" because that could cause a multitude of changes in prior year reported numbers, in addition to the correction of errors treated by restatement. Under such constant changes to prior period numbers, even multiple changes within the same year, the perceived reliability and credibility of financial statements would suffer. In addition, mandatory retrospective application, on a one-off basis, and as a continual series of changes, could obfuscate, rather than bring clarity to, financial reporting.

Further, in today's real-time media environment, we are concerned that the resultant blurring of accounting changes vs. correction of errors could cause excessive investor confusion, as all changes may be reacted to as if they were "restatements" (i.e., correction of errors). In contrast, allowing companies to present changes in accounting principles with the current cumulative effect approach helps investors to better understand the changes as the impact is isolated and explained.

We believe it is vital that users be able to differentiate between errors and accounting changes, but we do not believe the ED, as currently drafted, would add to clarity in this area. While we appreciate the desire and the appeal to converge with the IASB to a single set of standards, we question whether the proposed change would result in a higher quality standard than already exists in the United States.

Concerns with Impracticability Exception as Currently Drafted

If the final standard retains a requirement for retrospective treatment of changes in accounting principles, we support the retention of the "impracticability" exception in paragraph 11.

We note the ED provides three criteria for the impracticability exception:

a. The effects of retrospective application are not determinable.
b. Retrospective application requires assumptions about management's intent in a prior period.
c. Retrospective application requires significant estimates as of a prior period, and it is not possible to objectively determine whether information used to develop those estimates would have been available at the time the affected transactions or events would have been recognized in the financial statements or whether information arose subsequently.

To the above three criteria, we would add a fourth: where retrospective application would impose undue cost. The undue cost criteria would be similar to that described in SFAS 107, paragraph 15: "In the context of this Statement, *practicable* means that an estimate of fair value can be made without incurring excessive costs. It is a dynamic concept: what is practicable for one entity might not be for another; what is not practicable in one year might be in another."

Exchanges of Productive Assets - File Ref. No. 1200-300

Overall, we support fair value as the appropriate measure to record exchanges of productive assets. As such, we are generally supportive of the ED; however, we are concerned about the nature in which the "principle" of commercial substance becomes a "rules-based" approach based on cash flows in the ED. We are also concerned about the ED's prohibitions relating to certain cash flows pertaining to tax planning strategies.

"Commercial Substance"

We question whether the "commercial substance" criteria in the ED are operational, particularly in terms of meeting the definition of operational provided in the Notice for Recipients, as to whether the results of applying the requirement or criteria are those intended by the Board. Although we agree with the "principle" of commercial substance, we disagree with the "rules-based" approach of determining commercial substance based on cash flows. We would find it unusual for the exchange of similar productive assets to not have commercial substance. We believe the commercial substance test could result in dissimilar assets having similar cash flows, leading to peculiar results. It would be worth considering a proposed conceptual definition of commercial substance, e.g., including whether there is an "arm's-length" transaction, or pursuing another alternative such as a similar assets test.

We are also concerned with the discussion in the revised paragraph 21 of Opinion 29 and A12 in the Basis for Conclusions section of the ED about prohibitions on the use of cash flows in meeting the criteria for commercial substance when there may be related tax transactions involved. We believe the presumption involving interaction between the ED's commercial substance exception and tax jurisdictions business-purpose

doctrine could inappropriately call into question transactions that are associated with legitimate tax planning strategies.

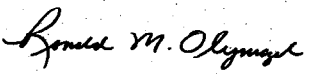
Inventory Costs – File Ref. No. 1200-100

While CCR is supportive of the Board's effort to achieve convergence between ARB 43 and IAS 2, we believe that questions surrounding the effect of the proposed change suggest that further research and consultation is necessary. The expectation of the Board appears to be that this will not precipitate a major change in practice. A number of members of CCR strongly expressed a different view and are concerned that the effects could be both significant and pervasive. Many of the concerns we have heard from members relate to how the definition of "normal capacity" would be applied in a variety of different scenarios that affect the actual level of production and are relatively common in practice. For example, how does the concept of normal capacity apply when the plant capacity is increased to respond to market demand by making engineering changes to the interior of a building and adding production workers, additional shifts and workdays per week. We have seen instances in which the capacity of a given facility has been increased by 500% using such techniques and then returned to a lower, but not the original, production level when the market demand was satisfied. Members for whom this is a concern believe that the application of the ED's concept of normal capacity in these same scenarios will yield different results and they question whether that is appropriate.

Recognizing the importance of the convergence effort between the FASB and IASB, CCR would be pleased to work with the Board to explain these concerns and to identify ways in which they might be satisfactorily addressed.

We appreciate the Board's consideration of our point of view. If you have questions regarding this letter, please feel free to contact Frank Brod at (989) 636-1541 or Ron Olejniczak at (860) 273-7231.

Sincerely,



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