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Certified Management Accountant Program
Certified in Financial Management Program

April 13, 2004

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

Letter of Comment No: 21
File Reference: 1200-300
Date Received: 4/13/04

Dear Ms. Bielstein,

The Financial Reporting Committee (FRC) of the Institute of Management Accountants appreciates the opportunity to provide its views on the four Exposure Drafts related to the Board's short-term convergence project. For the convenience of staff, we have separated our responses to each of the ED's as individual attachments to this letter. The FRC supports the Board's efforts towards convergence with international accounting standards, including circumstances in which US GAAP must change in order to achieve this objective. That said, we also believe that convergence efforts must not simply accomplish conformity – they also must produce high-quality accounting standards. In studying the ED's, the FRC has identified aspects of the proposed statements that we believe the Board needs to address before proceeding further. Some may interpret our objections, which in certain areas are quite strong, as a lack of support for convergence. That is not the case. It is our hope that you will consider the issues raised in each of the responses on their merits and without prejudice as to our support on the broader issue of convergence. A brief summary of our views on each is provided below:

Inventory Costs (File Reference 1200-100)

We interpret the proposed modification to ARB 43 as doing more than conforming wording. In contrast to the Board's expectations, the way that the concept of normal capacity is employed will affect inventory accounting in more circumstances than those in which production is abnormally low. We are therefore concerned that the proposed standard will introduce changes in US practices that have not yet been researched by the Board. Moreover, we believe that in certain cases the accounting result is inappropriate. In the attachment we have provided further information about what we believe are unintended consequences of the change. If the Board decides to proceed with the change, we believe that the project time horizon needs to be extended to examine the effect on inventory accounting in greater depth. However, we also observe that this issue is not a priority in the near term and would therefore recommend that the Board simply suspend work on the ED.

Earnings Per Share (File Reference 1200-200)

We agree with the basic principles of the ED related to determining incremental shares. However, we oppose the requirement that shares to be issued upon conversion of a mandatorily convertible security be included in the computation of basic EPS from the date that conversion becomes mandatory. We believe there are instances where that presentation is not representationally faithful to the underlying economic substance during the period that the mandatorily convertible security is outstanding and not yet converted. In the attachment we have provided an example that illustrates our concern.

Exchanges of Productive Assets (File Reference 1200-300)

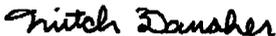
The FRC was unable to adopt a unified view on whether gain recognition was appropriate in all circumstances where the commercial substance test was satisfied. The two views could loosely be described as the "realization and culmination of the earnings process" view on the one hand, and the "accounting for a transaction with economic consequences" view, on the other. Even those who support the latter view, which is relatively consistent with the ED's concept of economic substance, could not reconcile the answers the ED produced across different fact patterns. In the attachment we have provided these examples for your consideration.

Accounting Changes and Error Corrections (File Reference 1200-400)

While we agree that retrospective application of changes in accounting principles enhance the interperiod comparability of financial information, we also believe that restating financial statements of prior periods on a regular basis will dilute public confidence in financial reporting and confuse the users of financial statements. Only time will tell whether the benefits of increased comparability outweigh these consequential effects. We also are concerned about the implications this may have on transition methods in other areas of the standard setting process (e.g., EITF Consensuses and FASB Staff Positions). If the Board proceeds with this proposed ED, we believe that it needs to carefully consider how to define the practicability exception as it relates to cost. Cost benefit judgments made in ordinary course of developing new standards are difficult by their very nature. The cost benefit implications to individual companies of retroactively applying a new standard for all prior periods presented will be highly dependent on the company's circumstances and capabilities and the Board is likely to have difficulty factoring this into its overall assessment. Therefore, the Board needs to include a mechanism, much like materiality, to ensure that the costs of retrospective application incurred by each company are not excessive.

If you have questions regarding this letter or the attached responses, please feel free to contact me at (203) 373-3563.

Sincerely,



Chair, Financial Reporting Committee
Institute of Management Accountants

File Reference 1200-300 “Exchanges of Productive Assets”

The FRC was unable to adopt a unified view on whether gain recognition was appropriate in all circumstances where the commercial substance test was satisfied. The two views could loosely be described as the “realization and culmination of the earnings process” view on the one hand, and the “accounting for a transaction with economic consequences” view, on the other. Even those who support the latter view, which is relatively consistent with the ED’s concept of economic substance, could not reconcile the answers the ED produced across different fact patterns. Overall, we are concerned by the presumption in the ED that commercial substance can only be evidenced by a change in the nature, timing, or risk of the expected cash flows of the entity immediately before and after the exchange. While that may be one method of assessing commercial substance, we believe the notion of commercial substance should be principles-based rather than limited by a rule that looks only at the nature, timing, or risk of expected cash flows. We believe commercial substance may also be substantiated by, for example, determining whether a transaction has a business purpose and is arms-length in nature. We provide the following example to illustrate our point:

Company A exchanges a 600-room hotel in New York City with Company B, which owns a similar hotel in Seattle. Neither hotel meets the definition of a business since they exclude reservation and other operating systems. The principal customers of the hotel in Seattle are from Asia and the western United States, while the principal customers of the hotel in New York City are from Europe and the eastern United States. Company A desires the Seattle property in connection with its plans to expand into the Asian market. The configuration and entity-specific value of the expected cash flows from the hotels do not significantly differ. While this transaction has a business purpose in connection with Company A’s plan to expand into the Asian market and the hotels serve a different class of customers, neither company would be permitted to recognize the transaction at fair value under the guidance of the ED.

The FRC is also concerned with the creation of additional scope exceptions and the addition to paragraph 3(c) of Opinion 29 that limits when a transaction is considered an exchange. Limiting transactions that qualify as exchanges to those where the transferor has no continuing involvement in the transferred asset such that all the risks and rewards of ownership of the asset are transferred introduces a new limitation that goes beyond the restrictions included in other standards that address the accounting for transfers, such as Statement 66 and Statement 140, which allow some level of continuing involvement. The following examples illustrate some of our concerns:

- Assume that two equity method investments that meet the definition of real estate under FIN 43 are exchanged and that the commercial substance test is satisfied. Under the ED, the transferor can have no continuing involvement in the transferred equity method investment. However, under the guidance of either Statement 66 or Statement 140, some continuing involvement would be allowed.
- Assume an equity method investment that meets the definition of real estate is sold for cash. In accordance with paragraph 4 of Statement 140, we believe the transaction would be covered by Statement 66. However, it is not clear whether our belief is correct, as the Notice for Recipients indicates that all transfers of equity method investments would have to meet the conditions of Statement 140 before the transferor could derecognize its interest.

Give the above concerns, the FRC believes it would be prudent for the Board to defer discussion of exchanges of productive assets as part of its Revenue Recognition project. In fact, we note the current description of that project on the FASB Web site indicates that, "The general standard on revenue recognition is expected to supercede certain existing guidance that is general in nature, including APB Opinion No. 29, *Accounting for Nonmonetary Transactions . . .*" If the Board decides to proceed with this amendment of Opinion 29, we recommend amending Statement 66 at the same time to require exchanges of real estate that meet the commercial substance test be accounted for in accordance with Statement 66. In addition to differences highlighted in the previous discussion of the transferor's continuing involvement, if the scope exception in Statement 66 is not reconsidered, even transactions in which the transferor has no continuing involvement will receive different accounting treatment based on which revenue recognition standard (Opinion 29 or Statement 66) applies. Consider the following example:

Company A owns a 600-room hotel in New York City. Company B owns a similar hotel in Miami Beach. Company A and Company B agree to exchange their hotels. The transaction does not involve boot as the fair values are approximately the same. Neither asset meets the definition of a business since they exclude reservation or other operating systems. Assuming the timing, amount or risk of future cash flows is different (the hotel in New York City caters mostly to business persons while the one in Miami caters mostly to vacationers and is therefore more exposed to economic downturns), the transaction meets the commercial substance test and the exchange would be recognized, by both parties, at fair value, even though neither party received any monetary consideration.

In contrast, if Company A exchanged its hotel for a satellite system, Company A would not be able to record the exchange based on fair values because the guidance in Statement 66 applies. Specifically, because the buyer's down payment did not consist of cash, a note from the buyer supported by an irrevocable letter of credit from an independent lending institution, payments by the buyer to third parties to reduce debt assumed, or other amounts paid by the buyer and considered to be part of sales value (paragraph 9 of Statement 66), the use of the full accrual method is not appropriate.

It is not clear to us why the exchange of real estate for other real estate should result in a different accounting treatment. We suspect one reason the FASB did not address the exchange issue at the time it issued Statement 66 is because Opinion 29 required the use of carryover basis for those transactions. Had Opinion 29 reached a different conclusion, the FASB might have decided to scope exchanges transactions into Statement 66 so as to ensure a consistent gain recognition model for transactions that are economically the same.