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Letter of Comment No: 17
File Reference: 1200-400
Date Received: 3/23/04

File Reference 1200-400

March 23, 2004

Ms. Susan Bielstein
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Financial Accounting Standards Board
401 Merritt 7
P.O. Box 5116
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Ms. Bielstein,

I appreciate the chance to comment on the proposed Statement of Financial Accounting Standards, "Accounting Changes and Error Corrections, a replacement of APB Opinion No. 20 and FASB Statement No. 3."

I have discussed the proposal in somewhat more depth on pages six and seven of the enclosed report, "International Convergence: A Game Of Inches," but let me state simply that the proposed standard is an improvement to the accounting literature that can be implemented easily by affected firms as required by the proposed transition provisions. I'd also like to point out that the switch from the cumulative catch-up method of presentation to the retrospective method will be particularly useful to users of financial statements.

I have no suggestions for improvements to the final standard; the exposure draft released to the public is fine as it is. If there is any need to discuss the report or if you have any questions, please do not hesitate to contact me. Best regards.

Sincerely,

Jack Ciesielski

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THE ANALYST'S ACCOUNTING OBSERVER
Jack T. Ciesielski, CPA, CFA

Volume 13, No. 4 *March 16, 2004*

International Convergence: A Game Of Inches

If capital knows no borders, shouldn't financial information about companies be consistent across borders? For years, convergence of accounting standards between the United States and the rest of the world has been bandied about as the logical extension of globalized markets. Standards of the "rest of the world" has gradually come to mean the issuances of the International Accounting Standards Board (IASB). You'll be seeing those standards in plenty more foreign financial statements beginning January 1, 2005. That's when all companies in the European Union will be required to use those standards in their publicly-filed financial statements - something on the order of 6,000 companies. Another boost will come from Australia at the same time, as they institute the same requirement.

Back to convergence: the U.S. accounting standards created by the Financial Accounting Standards Board (FASB) are not the same as the IASB standards, as you'd expect. Getting the two sets of standards synchronized will take years of work, a task begun in the mid-1990's when the FASB collaborated with the IASB's predecessor (the International Accounting Standards Committee) in writing a common standard for earnings per share. The two standard-setters committed themselves more fully to convergence of their standards in September 2002. The first it of that commitment is a series of proposed amendments to FASB standards that will make them more like existing IASB standards. They're small steps - just a few inches in a game measured in yards - but every one of them is superior to the existing practice in U.S. generally accepted accounting principles in subtle, surprising ways.

I. A Cinch By The Inch

Convergence of accounting standards is innately appealing to any users of financial statements who have sweated through making sense of statements prepared on other bases. If mathematics is a universal language of sorts, why shouldn't micro-economics be universally expressed in financial statements? The response of the world's two chief standard-setters: they *shouldn't* be different.

In the mid-1990's, the FASB and the International Accounting Standards Committee (the predecessor of the IASB) combined efforts to produce a new standard on earnings per share, with the resulting 1997 issuance of Statement No. 128 in the United States and International Accounting Standards No. 33 in the IASB literature.

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International Convergence: A Game Of Inches

The two major accounting standard-setters of the world - the Financial Accounting Standards Board and the International Accounting Standards Board - sealed their commitment to converge their standard-setting efforts in late 2002 in their "Norwalk Agreement." Though they had worked together on past projects, their new dedication to convergence included synchronizing the existing catalogs of standards. The FASB has issued four proposals to eliminate some of the differences between the two sets of principles by modifying its own to match the IASB standards. If they become standards, they will all become effective next year.

Earnings Per Share

This amendment to Statement No. 128 does three things to improve EPS calculations:

• It adds dilution from mandatorily redeemable convertible securities into basic EPS

• It eliminates the assumption that certain convertible instruments will be settled in cash instead of stock

• It changes the calculation of year-to-date diluted EPS figures to reflect the average stock price during the YTD period.

Inventory Costs

The proposed standard wouldn't permit capitalization in inventory of things like idle facility expense, excessive spoilage, double freight and re-handling costs. Theoretically, the current U.S. standard permits these to be capitalized as long as they're not "abnormal." Instead of defining what is an abnormal level of these costs, synching with the IASB standard just treats them as period costs.

Exchanges Of Productive Assets

Current accounting permits exchanges of similar productive assets - those used in making products or goods be recorded with no gain or loss. Essentially, the basis of the old asset given is ascribed to the new one received. This proposal would require that the exchange be recorded at the fair value of the assets exchanged unless 1) fair value can't be determined, 2) the exchange is done only to facilitate customer sales (think trade-ins) or 3) there's no commercial substance to the transaction.

Accounting Changes/Error Corrections

This proposal would require companies electing to change accounting principles to present their comparative financial statements on a retrospective basis - a big difference from current practice, where the typical transition method is to present the accounting change as a cumulative catch-up type of adjustment in the year the new principle is adopted. Firms would be required to retrospectively apply the new principles as far back as is practicable in the comparative financials they present. They may be limited by a lack of data; if application of the new principle requires estimates as of a past date that cannot be objectively determined, that will also prevent retrospective presentation.

Cumulative catch-up adjustments may still appear: new standards might well specify their own transition methods, which could include this type of adoption.

The proposal would require that changes in depreciation be accounted for as a change in estimate effected as a change in principle; no retrospective presentation allowed. The standard would leave as is the current reporting for changes in estimate, changes in entity and corrections of previously issued financial statements.

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"It's the old story. I was in the middle of a successful acting career when I was bitten by the accounting bug."

First appeared in the New Yorker. Cartoonbank.com 2004

Since that time, there have been plenty of efforts by the two standard-setters to produce standards that work in the same fashion without being identical. While they did not work together in lockstep to produce twin documents, the two boards took pains to produce standards that were *not* radically different from each other, and would have a decent chance of yielding the same financials if each one was applied in the same circumstances. (You might say each one of the two bodies was looking over the shoulder of the other to make sure they arrived at consistent standards.) A couple of examples include the U.S. standards on segment information and business combinations; the two boards are currently working together closely on another phase of the business combinations accounting standards. Since last year, the pair has been working famously on a homogenous stock compensation accounting standard.

In September 2002, at their joint meeting in Norwalk, Connecticut, the FASB and IASB issued their "Norwalk Agreement" reaffirming their commitment to make their best efforts to produce essentially interchangeable standards in the future and to get their existing catalog of standards in harmony. The first "forward" project since that agreement is the stock compensation standard. The first "backward" project since then is a series of revisions to four existing FASB standards that will make them speak with a European accent.

<u>The "backward" aspect of the Norwalk Agreement is the more challenging of the two aspects of collaboration.</u> Finding the differences between two haystacks of standards produces lots of needles; it's their elimination, with full due process, that takes time. It's a game of inches: lots of gritty stuff to go through, with perhaps only obscure marginal improvements in financial reporting to show for it. Not much press, very few cheers. The "forward" projects, on the other hand, grab lots of attention because they will likely involve big honking problems in financial reporting - like unrecorded stock compensation and perhaps later, pension accounting. Analysts and investors will quite likely be aware of how *those* changes will affect the financial statements they read.

<u>Investing can be a game of inches, too.</u> Yards and yards of sparkly double-digit performance records are wonderful selling devices for investment managers, but if they're only marginally better than the benchmark index, it's just a game of inches. Go down another level from the returns, back to reading the financial statements: it's another a game of inches. Sure, you'll check the big honking scary things that everyone talks about. (Is the pension plan way underfunded? Did they use a ludicrous expected rate of return on assets? How much option compensation did they skip recording?) More subtle details provide inches of insight, however. Finding out how this year's accounting change would have affected previous years might give you some direction about future reported earnings. Knowing the gains or losses on otherwise invisible barter transactions might make you wiser about hidden asset values. And seeing extraneous inventory costs hit the income statement gives you comfort that the recorded inventory values aren't full of water.

In doing its part to fulfill the Norwalk Agreement, the FASB has served up the standards equivalent of Pizza Hut's Four-For-All Pizza™: four brief amendments to existing standards, all tucked away in one standards convergence box.[1] Here's a look at each of these mini-standards.

The author, nor employees or asset management clients of R.G. Associates, have any kind of investment in securities of Yum! Brands, Inc. That said, the Four-For-All Pizza™ is mighty tasty. Can't hold a candle to the P'zone®, however.

1. Earnings Per Share

It's always amazing that so much accounting standard-writing is devoted to the calculation of one number based on two numbers: earnings divided by shares. It just goes to show the imagination and vitality of the investment banking business, which over the years has developed all sorts of clever financing instruments for firms to raise capital without affecting the "shares" part of the EPS ratio.

This amendment to Statement No. 128[2] does three things to sharpen the earnings per share calculations; a couple of them even blunt the investment bankers' scalpels used for face-lifting sagging EPS trends. Briefly, they deal with:

- Getting dilution from mandatorily redeemable convertible securities into basic EPS
- Eliminating favorable assumptions about convertible instruments that can be settled in cash or stock
- Changing the calculation of year-to-date diluted EPS figures

Mandatorily redeemable convertible securities into basic EPS. Statement No. 128 created the concept of "basic"earnings per share, with the earnings numerator adjusted downwards for any preferred stock dividends, and the denominator being simply the weighted average shares outstanding for the period. The trouble is that the basic definition ignores things like mandatorily convertible securities: instruments that will be virtually certain to turn into common shares eventually.

[redacted]

Favorable assumptions about conversion settlements. Convertible bonds sometimes give the issuer the option to choose settle the bonds for cash instead of shares upon conversion. As currently written, SFAS No. 128 permits issuers to presume that the bonds will be settled for cash instead of shares - and that, naturally, will keep incremental shares out of the calculation of diluted earnings per share, keeping EPS higher than they would be if shares were presumed to be the settlement choice of the issuer.

[redacted]

Year-to-date calculations of diluted earnings per share. For dilutive securities in year-to-date calculations of denominator shares, Statement No. 128 required use of the weighted average of the shares added by an assumed conversion of the securities under the treasury stock method from each interim period contained in the year-to-date period - a fairly non-intuitive, sometimes awkward calculation.

[redacted]

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[2]See Volume 6, No. 14, "SFAS No. 128: No More Defining Dilution Down" for a discussion of the current EPS rules, including the treasury stock method; also, "When Convertibles Meet EPS" at the Accounting Observer website: http://www.aaopub.com/Briefs/Convertibles.htm.

2. Inventory Costs

This proposal is the lightest-weight of the four. Put it this way: there shouldn't be too much change in current practice if this proposal goes into effect. It's more of a language clean-up in the existing standard than an outright principle change. Accounting Research Bulletin No. 43, Chapter 4, "Inventory Pricing," gave manufacturers leeway to capitalize some fairly rancid stuff. As it states: "... under some circumstances, items such as idle facility expense, excessive spoilage, double freight and re-handling costs may be so abnormal as to require treatment as current period charges rather than as a portion of the inventory cost."

So - just when does a level of these things become "so abnormal?"For that matter, when should such dreck ever be capitalized as part of inventory? The wording of the existing standard leaves that possibility wide open. By converging to the IASB standard, the answer is "never." Such costs would be treated as period costs in all instances, as they should be.

If any firms are capitalizing these kinds of costs as a matter of routine policy, you can't tell: search your favorite 10-K database for the word "inventory" or "inventories" near say, "idle facility" and you're not likely to turn up anything. (I didn't.) At the same time, it's entirely possible that there may be firms capitalizing the costs without disclosure. If so, it could make for some interesting results in gross profit margins, assuming that this proposal becomes a final standard. The proposed effective date: fiscal years beginning after December 15, 2004.

3. Exchanges Of Productive Assets

There's a curious phenomenon that springs out of an exception in an old standard: some economic events are largely unreported simply because they are exchanges of one vaguely similar property for another. There's disclosure, sure, but the real economics of the transactions never make it into the income statement. ("Real economics" being the answer to the question: what were these things worth to make swapping them desirable?) APB Opinion No. 29, "Accounting for Nonmonetary Transactions" provided an exception to the principle that asset swaps should be recorded at their fair value. If the exchange involved productive assets - things used in making goods or products - or an equivalent interest in the same or similar productive asset, no gain or loss would be recognized on the swap.

That's a little hard to swallow from the start: if there's no economic impact from owning one piece of property (or any other kind of asset) than the other, why would two parties go to the bother of legally exchanging it? The asset being acquired by one party must be worth something more than the one being given up. Believing that a firm is getting something worth *exactly* what it's giving up is silly: it implies that the assets are identical, and if they were, what would be the point of exchanging? For such a trade to be worthwhile, the assets exchanged would have to be more valuable to each party than the one given up.

If this exception didn't exist, analysts and investors might have a better idea of what kind of elevated asset values lurk inside historical cost-based balance sheets. The flip side: it might also force recognition of previously unrecognized losses, too. Disclosures about such transactions can be well and good ("no gain or loss was recognized on this non-monetary exchange..."), but nothing grabs an investor's attention about fair values like a number reported in the income statement. This exception is eliminated by this FASB proposal, bringing it in line with IASB practice.

Well, *that* exception will be gone. Exceptions to the general rule of recording exchanges at fair value will still exist, but they'll be more logical. The only time that exchanges will be based on the recorded amount of the nonmonetary asset given up instead of its fair value is when:

- Fair value can't be determined within reasonable limits for either asset given up or received.
- It's an exchange transaction to facilitate sales to customers. (Accounting-speak for "trade-ins.")
- An exchange transaction has no commercial substance.

<u>That last exception - "no commercial substance" - is an important one.</u> Why report transactions at fair value if there's if there's no commercial substance to them? We've seen that movie before: we'd have been much better off in the late 1990's if a lot of transactions *hadn't* been accounted for at fair value. Figuring commercial substance is a two-step process:

• Figure if the firm's cash flows are expected to change as a result of the deal. This is done by 1) taking into account the cash flows of the asset to be received compared to those of the asset given up, or 2) figuring if the value of the part of the firm's business related to the transaction is affected by the exchange.

• If the cash flows *are* expected to change, and either of the differences in 1) or 2) are significant compared to the fair value of the assets exchanged, then the transaction has commercial substance.

What does <u>not</u> have commercial substance: a vicious circle created by tax motivation. In the U.S., transactions are not allowed for tax purposes if their only purpose is to avoid taxes; transactions must have a legitimate business purpose. "Commercial substance" can't be based solely on tax cash flows arising from achieving a certain financial reporting result; if it was allowed, the two would reporting systems would be at cross-purposes to each other.

<u>If the proposal becomes a final Standard, it will be effective on a prospective basis (new transactions only) in fiscal years beginning after December 15, 2004.</u>

4. Accounting Changes and Error Corrections

Changes in accounting principles most frequently fall into the "cumulative catch-up" category: rather than require firms to recast their past financial reporting in terms of a newly-adopted principle, the existing accounting required by APB Opinion No. 20 calls for the full effect of the accounting change to be reflected in the period of the change. That's not extremely useful for analysts and investors: knowing how a different accounting principle would have affected previous periods is much more informative than a lump sum effect showing up in one period. Analysts and investors tend to place little importance on such reported amounts.

<u>The proposed replacement of APB Opinion No. 20 will do away with the cumulative catch-up approach as the default method of recording changes in accounting principles.</u> Under the proposal, companies will apply changes to most new principles *retrospectively* to comparative financial statements - meaning that they will have to present prior years' amounts on the same basis as the current year. That will make for a much more informative display.

The proposal does leave some leeway for avoiding this treatment: it requires a firm to present the new principle being employed as if the change was made prospectively from the earliest date that is practicable. It's a valid option; there may not be enough historical data available to present results on the same basis three years ago using a new accounting principle adopted in the current year. For instance, a firm switching from FIFO to LIFO accounting in 2004 may not have sufficient records available for restatement any further back than 2000; they'd have to present the inventory on a FIFO basis, and present the income statement as if they started applying in on January 1, 2000. In sum, firms will run with the retrospective treatment of prior periods unless it is "impracticable." "Impracticability" rears its ugly head when:

• The effects of retrospective application can't be determined, or

• Retrospective application requires assumptions about management intent in a prior period, or

• Retrospective application requires estimates as of a prior period, and those estimates can't be objectively developed without the taint of subsequent transactions or events.

<u>One kind of accounting change *won't* get retrospective treatment, and that's a change in accounting estimate.</u> Those kinds of changes will be accounted for in the period of change, or in that period and in the future, if it affects future periods. Why? A change in estimate should be based on fresh information about current conditions; going backwards with it would destroy the information about conditions that existed in the prior periods.

[illegible]

<u>Changes in depreciation, depletion and amortization methods are changes in accounting estimate, even though the methodology may change.</u> (Straight-line to declining balance, for example.) The change in estimate is effected as a change in principle; they're inseparable. Changing the principle should relate to new information about how the asset is used up, and revising the estimates of its usefulness. There's no retrospective statement for these changes, but like any change in principle, they must be justified on the grounds that a change is preferable. For example, a depreciation method change should establish that the new method better allocates an asset's cost to periods of benefit based on the way it's consumed.

<u>Some aspects of accounting changes won't change: corrections of errors in previously issued financials will still be done the same way as always.</u> (Restate financials as far back as presented, and adjust beginning retained earnings.) Likewise, changes in reporting entity will be carried out as always by retrospective restatement for all periods presented. Last of all, when there are changes in principle made in an interim period, they too will be made on a retrospective basis.

One other thing the proposal wouldn't change: standards creating new principles (or revising old ones) may still dictate their own specified methodology for implementation - a frequent occurrence. Think of some recent standards, like ones relating to goodwill and intangibles accounting (SFAS Nos. 141 and 142), asset retirement obligations (SFAS No. 143), asset writedowns (SFAS No. 144) or restructuring/exit costs (SFAS No. 146). The transition methods in them were cumulative catch-up or prospective. Most new principles bar retrospective presentation because of possible implementation "taint" arising from perfect hindsight look-backs; also, more practically, the necessary data may simply not exist. Systems often need to be designed to capture information, and you can't design a system to capture information for reporting requirement not yet in existence.

[illegible]

The transition provisions for the accounting changes proposal are similar to the other three convergence proposals: the standard would become effective for accounting changes and error corrections occurring after December 15, 2004 - in synchronization with the deadline for European Union countries to adopt IASB standards.

* *

There you have it: the FASB Four-For-All™. None of these proposals will rock your world the way, say, a reform in options expense reporting will. Or a change of pension accounting, or a recast of the income statement. But - they *will* have subtle effects. The EPS proposal will likely have the widest-ranging effects of the four, given that nearly all companies have a year-to-date diluted earnings per share measure. (Remember, some companies don't have diluted EPS.) Also, "trick" convertibles containing favorable assumptions about conversion features are not exactly scarce - and this proposal will affect them, too.

The "asset exchanges at fair value" proposal will also likely lead to frequent differences from current practice. Figure it this way: if you're aren't seeing *any* gains or losses on disposal from these kinds of swaps, any at all that are reported under the new rules will be a noticeable change.

As for the other two proposals: profitability pressure could develop from the inventory costing proposal if firms have been capitalizing fluffy stuff as permitted under ARB No. 43, but it certainly doesn't seem likely - unless there's been a lot more being capitalized these days than companies have led us to believe. With regard to the accounting changes proposal, expect to see new standards still being issued with their own transition rules that could differ significantly from what the proposed standard espouses. The accounting changes proposal makes the most change in the area of companies selecting new accounting principles on their own - and that is a decision that's company-driven. You might find twenty companies in six months crossing your radar that change accounting principles on their own - and you might not see it in any companies you cover for years. It's hard to generalize about how commonly this proposal will affect companies.

One interesting note about the standards being modified by the proposals: they're nearly all relics from past standard-setters and later folded into the FASB literature when the FASB was created in 1973. The oldest: ARB No. 43, relating to inventory costing, was issued in 1953. APB Opinion No. 20, the existing standard for accounting changes, came to be in 1971. APB Opinion No. 29, currently governing nonmonetary exchanges of assets, was issued in 1973. The lone exception is SFAS No. 128, covering EPS, was issued in 1997 - but the "year-to-date" issue being corrected by the proposal was carried over from the predecessor EPS standard, dated 1969. The point is that convergence has a side benefit: fossil standards that may not have been rigorously developed in their time or have lost their relevance to current situations can create incrementally worse financial reporting. Convergence efforts will yank those standards out of the musty basement and freshen them up.

It's not a bad start for trying to winnow the needles out of the FASB and IASB haystacks. Expect another round of proposals (probably covering more standards than just four) before the end of the second half of 2004.

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