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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: 18
File Reference: 1200-100
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:

<u>Inventory Costs (File Reference 1200-100)</u>
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.

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

Sincerely,

Mitch Danaher

Chair, Financial Reporting Committee
Institute of Management Accountants

File Reference 1200-100 "Inventory Costs"

We believe that the ED, if adopted, will result in significant changes in US GAAP, contrary to the premise stated in paragraph A4 of the ED. ARB 43 currently provides the following two principles:

- Inventories should be stated at cost; and
- Some acquisition or production costs may be so abnormal as to require a current period charge rather than being handled as a portion of the inventory cost.

The proposed revisions to the second principle would result in inconsistent accounting for inventory-related costs as a result of the asymmetrical treatment of favorable and unfavorable fixed production cost variances proposed in the ED. Specifically, the ED requires that unfavorable variances resulting from production below normal levels would be charged to earnings whereas favorable variances generally are inventoried, except in cases of abnormally high levels of production. Existing practice, which is based on the underlying objectives of a standard cost system, treats all variances consistently and requires the immediate recognition of fixed costs in earnings only in situations involving abnormal production levels, as illustrated in the following example:

> Assume a company with a single plant has fixed production costs of $100 and estimates current period production equal to its "normal" production level of 100 units. Under its standard costing system, it allocates $1 to each unit of production. In one scenario (Low Production Level), the company actually produces 90 units and in a second scenario (High Production Level), produces 110 units. In both cases, it begins with no inventory and has 20 units in inventory at the end of the period. Neither production-level scenario is determined to be abnormal. The table below summarizes the accounting balances for both scenarios:

	High Production Level	**Low Production Level**
Cost of Goods Sold @ standard	90	70
Inventory - @ standard	20	20
Fixed cost volume variance	(10)	10
Current treatment		
Variance held in inventory	(2)	2
Variance charged to cost of sales	(8)	8
Revised cost of sales	82	78
Cost per unit	0.91	1.11
Proposed treatment		
Variance release to cost of sales	(8)	10
Revised Cost of Sales	82	80
Cost/Unit	0.91	1.14

We note that normal capacity for a facility is not a constant in many manufacturing environments. Capacity is a function of a number of factors, including: the number of shifts in a day, the number of workdays in a week, and the effects of manufacturing engineering on the throughput of the manufacturing process. Volume assumptions incorporated in production standards are established in anticipation of a specific level of production that is expected in the coming year. Actual production volume may well be different from standard cost assumptions for a variety of reasons without rising to the level of being considered abnormal in the context of ARB 43.

Under the ED the amount of costs allocated in the high production scenario provided in the example would be adjusted since the level of production it is not abnormally high. This is consistent with how current practice treats normal variances from standard costs related to higher production. However, the ED would require the unallocated costs in the low production scenario to be charged to earnings. We strongly disagree with the asymmetry inherent in this approach. If the Board does not agree with this result, it needs to change the words in the final Statement to clarify the intent. If this is what the Board expected, then (1) we oppose the change, and (2) the project timeline should be extended to more fully consider the effects of this change on inventory accounting and, once completed, the Board should re-expose and clearly communicate to constituents that the ED proposes a significant change in practice.

The inconsistent treatment of production-level variances will also result in significant added complexity. Our experience is that inventory-costing systems are not designed to account for variances differently based on their underlying direction and magnitude. Redesigning those systems to handle directional differences for variances will involve significant resources and lead-time along with increased ongoing tracking requirements. These complexities are exacerbated for large multinational entities due to the need to design and implement and monitor the changes across many different regions, plants, and product lines. Given our belief that the results of the proposed change will not significantly improve the overall quality of financial statements, we do not believe the costs or complexities of implementing the proposal are justified.