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Financial Accounting Series

EXPOSURE DRAFT

Proposed Statement of Financial Accounting Standards

Inventory Costs

an amendment of ARB No. 43, Chapter 4

This Exposure Draft of a proposed Statement of Financial Accounting Standards is issued by the Board for public comment. Written comments should be addressed to:

Director of Projects and Technical Activities
File Reference No. 1200-100

Comment Deadline: April 13, 2004

Financial Accounting Standards Board
of the Financial Accounting Foundation

Responses from interested parties wishing to comment on the Exposure Draft must be *received* in writing by April 13, 2004. Interested parties should submit their comments by email to **director@fasb.org**, File Reference 1200-100. Those without email may send their comments to the "MP&T Director—File Reference 1200-100" at the address at the bottom of this page. Responses should *not* be sent by fax.

Any individual or organization may obtain one copy of this Exposure Draft without charge until April 13, 2004, on written request only. Please ask for our Product Code No. E173. For information on applicable prices for additional copies and copies requested after April 13, 2004, contact:

Order Department
Financial Accounting Standards Board
401 Merritt 7
P.O. Box 5116
Norwalk, CT 06856-5116

Financial Accounting Standards Board
of the Financial Accounting Foundation
401 Merritt 7, P.O. Box 5116, Norwalk, Connecticut 06856-5116

Notice for Recipients of This Exposure Draft

This proposed Statement would adopt wording from the proposed changes to the International Accounting Standards Board's IAS 2, *Inventories*, for portions of ARB No. 43, *Restatement and Revision of Accounting Research Bulletins*, Chapter 4, "Inventory Pricing," relating to inventory costs. The Board believes ARB 43, Chapter 4, and the proposed provisions of IAS 2 have the same intent; however, differences in the wording of the two standards could lead to inconsistent application of their principles.

The Board invites individuals and organizations to send written comments on all matters in this proposed Statement. Comments are requested from those who agree with the provisions of this proposed Statement as well as from those who do not.

Comments are most helpful if they identify the specific paragraph or group of paragraphs to which they relate and clearly explain the problem or question. Those who disagree with the provisions of this proposed Statement are asked to describe their suggested alternatives, supported by specific reasoning.

Summary

This proposed Statement would adopt wording from the International Accounting Standards Board's (IASB) IAS 2, *Inventories*, for portions of ARB No. 43, *Restatement and Revision of Accounting Research Bulletins,* Chapter 4, "Inventory Pricing," relating to inventory pricing. The Board believes ARB 43, Chapter 4, and IAS 2 have the same intent; however, differences in the wording of the two standards could lead to inconsistent application of their principles. Paragraph 5 of ARB 43, Chapter 4, states that ". . . under some circumstances, items such as idle facility expense, excessive spoilage, double freight, and rehandling costs may be so abnormal as to require treatment as current period charges. . . ." By adopting the language of IAS 2, those items would be classified as current-period charges, regardless of whether they met the criterion of "so abnormal."

Reasons for Issuing This Proposed Statement

In October 2002, the FASB and the IASB undertook a joint project to achieve more comparability in cross-border financial reporting through convergence to a single set of high-quality accounting standards. Each Board reviewed its pronouncements for areas of its generally accepted accounting principles (GAAP) that could be improved by converging with the other Board's GAAP. Inventory costs was identified as an area in which the FASB and the IASB could improve accounting by converging their standards. The IASB had more recently examined IAS 2 and proposed changes to that standard in the IASB Exposure Draft, *Improvements to International Accounting Standards.* The FASB decided that the IASB's wording more clearly articulates the principle behind both standards. With that in mind, the FASB decided to converge the wording of portions of ARB 43 related to inventory costs with the proposed changes to IAS 2.

How the Changes in This Proposed Statement Would Improve Financial Reporting

This proposed Statement would improve financial reporting by eliminating the inconsistency associated with application of the "so abnormal" criterion from inventory pricing guidance. Also, by converging with the IASB's wording of the principles for inventory pricing found in IAS 2, this proposed Statement would improve financial reporting by reducing the possibility of inconsistent interpretation of the standards. The Board hopes to reduce the potential for inconsistent application by entities that prepare financial statements using either U.S. GAAP or international financial reporting standards (IFRS) by converging the language of FASB and IASB standards where possible. This is in accordance with the Board's goal of promoting the international convergence of accounting standards concurrent with improving the quality of financial reporting.

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INTRODUCTION

1. ARB No. 43, *Restatement and Revision of Accounting Research Bulletins,* Chapter 4, "Inventory Pricing," discusses the general principles applicable to the pricing of inventory. Paragraph 5 of Chapter 4 provides guidance on allocating certain costs to inventory. This Statement amends paragraph 5 of ARB 43 to adopt language similar to that in IAS 2, *Inventories*.

STANDARDS OF FINANCIAL ACCOUNTING AND REPORTING

Amendment of ARB No. 43, Chapter 4

2. Paragraph 5 and footnote 2 of ARB 43, Chapter 4, are amended as follows: [Added text is underlined and deleted text is struck out.]

> ~~In keeping with the principle that accounting is primarily based on cost, there is a presumption that inventories should be stated at cost.~~ Inventories are presumed to be stated at cost. The definition of cost as applied to inventories is understood to mean acquisition and production cost,[2] and its determination involves many considerations~~problems~~. 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~~problems~~ encountered in the allocation of costs and charges. For example, variable production overheads are allocated to each unit of production on the basis of the actual use of the production facilities. 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 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. The amount of fixed overhead allocated to each unit of production is not increased as a consequence of low production or idle plant. Unallocated overheads are recognized as an expense in the period in which they are incurred.~~under some circumstances,~~ Other items such as ~~idle facility expense, excessive spoilage,~~ double freight, ~~and~~ rehandling costs, ~~may be so~~ and abnormal

amounts of wasted materials (spoilage)~~as to~~ require treatment as current period charges rather than as a portion of the inventory cost. 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). Selling expenses constitute no part of inventory costs. ~~It should also be recognized that t~~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.

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[2]In the case of goods which have been written down below cost at the close of a fiscal period, such reduced amount is to be considered the cost for subsequent accounting purposes.

Other Amendments to Existing Pronouncements

3. In the second sentence of paragraph A3 of FASB Statement No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets,* the phrase *as amended by FASB Statements No. 133, Accounting for Derivative Instruments and Hedging Activities, and No. 15X, Inventory Costs,* is added after *ARB No. 43, Chapter 4, "Inventory Pricing,"*.

Effective Date and Transition

4. The provisions of this Statement shall be effective for fiscal years beginning after December 15, 2004. The provisions of this Statement shall be applied prospectively.

The provisions of this Statement need not be applied to immaterial items.

Appendix

BACKGROUND INFORMATION AND BASIS FOR CONCLUSIONS

Introduction

A1. This appendix summarizes considerations that Board members deemed significant in reaching the conclusions in this Statement. It includes reasons for accepting certain approaches and rejecting others. Individual Board members gave greater weight to some factors than to others.

A2. In September 2002, the FASB and the International Accounting Standards Board (IASB) (collectively the Boards) made a commitment to converge the accounting standards of their respective jurisdictions through a long-term convergence plan. As part of that plan, the Boards jointly undertook a short-term project to eliminate certain differences between the accounting pronouncements of the IASB and the accounting pronouncements in effect in the United States. Both Boards agreed to limit the scope of the short-term project to issues for which (a) the Boards' respective accounting pronouncements were divergent; (b) convergence to a high-quality solution would appear to be achievable in the short-term, usually by selecting between the existing standards of either the FASB or the IASB; and (c) the issue was not within the scope of other projects on the current agendas of either Board. The Boards hope that before the European Commission's 2005 target date for adoption of international financial reporting standards (IFRS) by all European Union listed companies, the short-term convergence project will simplify cross-border financial reporting by reducing the number of items required for reconciliation between U.S. generally accepted accounting principles (GAAP) and IFRS.

Inventory Pricing

A3. Inventory pricing was identified as an area in which the Boards could improve accounting by converging the wording of their standards. While the Board believes ARB 43, Chapter 4, and IAS 2 have the same intent, differences in the wording of those standards had caused concern that they might be interpreted differently. The IASB had more recently examined its standard for inventory costing and the FASB decided that the wording used in the IASB's standard more clearly articulates the principle behind both standards. With that in mind, the FASB decided to adopt the language related to inventory costing of IAS 2.

A4. Paragraph 5 of ARB 43, Chapter 4, states that ". . . under some circumstances, items such as idle facility expense, excessive spoilage, double freight, and rehandling costs may be so abnormal as to require treatment as current period charges. . . ." By adopting the language of IAS 2, double freight, rehandling costs, and abnormal amounts of spoilage would be classified as current-period charges, regardless of whether they met the criterion of "so abnormal." However, the FASB does not expect that convergence, in this instance, will substantially change practice. The FASB believes that accounting is improved by reducing the possibility of inconsistent interpretation of the standards by multinational reporting entities.

Effective Date and Transition

A5. The Board decided that the provisions of this Statement should be effective for fiscal years beginning after December 15, 2004, so that entities based in the European Union that report under U.S. GAAP would have time to implement its provisions prior to the 2005 target date for reporting under IFRS.

A6. As part of its short-term convergence project, the Board is reexamining its provisions for accounting changes. The Board issued a proposed Statement on accounting changes concurrent with issuance of the Exposure Draft for this Statement. That proposed Statement would deem retrospective application impracticable if (a) the effects of retrospective application are not determinable, (b) retrospective application requires assumptions about management's intent in a prior period, or (c) retrospective application requires significant estimates as of a prior period for which it is not possible to objectively distinguish between information that would have been available at the time the affected transactions or events would have been recognized in the financial statements and information that arose subsequent thereto. The Board intends to begin its short-term convergence redeliberations with the proposed Statement on accounting changes. The transition provisions of this Statement are in accordance with that proposed Statement. The Board concluded that prospective application of the provisions of this Statement is appropriate because the effects of retrospective application may not be determinable for many entities or because the cost to accomplish retrospective application would be excessive in relation to the benefits to users of the financial statements.

Benefits and Costs

A7. The mission of the FASB is to establish and improve standards of financial accounting and reporting for the guidance and education of the public, including preparers, auditors, and users of financial information. In fulfilling that mission, the Board endeavors to determine that a proposed standard will fill a significant need and that the costs imposed to meet that standard, as compared with other alternatives, are justified in relation to the overall benefits of the resulting information. Although the costs to implement a new standard may not be borne evenly, investors and creditors—both present and potential—and other users of financial information benefit from improvements in financial reporting, thereby facilitating the functioning of markets for capital and credit and the efficient allocation of resources in the economy. 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.