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Technical Director
Financial Accounting Standards Board
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Members of the Board,

I appreciate the opportunity to submit my comments to the Board with respect to the *Proposed Accounting Standards Update: Inventory (Topic 330) Simplifying the Measurement of Inventory*. I retired from public accounting in 2007 after 27 years at Deloitte & Touche LLP and am currently a full-time faculty member at the University of Notre Dame teaching undergraduate and graduate courses in accounting and auditing.

While I commend the Board for its desire to simplify inventory accounting and to better align with international reporting, I submit that eliminating some steps in an old process may make the accounting simpler, but simpler is not necessarily better. For example, some preparers believe carrying financial instruments at historical cost is simpler; the Board clearly does not believe it is better. My comments are as follows:

Question 1: Should inventory be measured at the lower of cost and net realizable value? If not, what other measurement is more appropriate and why?

The Board knows this definition of lower of cost or market dates back several generations. US Manufacturing companies have a long history of reporting inventory at lower of cost or market and users generally understand that concept. On the other hand, users are likely not familiar with our historical method of arriving at "market". Users are familiar with the concept of net realizable value particularly as it pertains to inventory and should not be confused or otherwise troubled by a change in terminology from "lower of cost or market" to "lower of cost or net realizable value"; they will likely consider those descriptions to be equivalent. On the preparers' side, most entities have long-standing processes in place within their inventory accounting systems to arrive at "market" for their inventories. While this process is a simplification, it may entail some costs to modify existing systems, particularly those that do not strictly follow the current "ceiling/floor" model.

The Board should take time to challenge this process and conclude that this Proposed ASU is really an improvement. For example, the Board considered whether to use the term "fair value" in the context of inventory and concluded that it would not because to do so would require preparers to apply all of ASC 820. This conclusion is appropriate as far as it relates to terminology; the term "fair value" may give users, particularly creditors, certain unrealistic expectations as to the liquidity of items in inventory. The term "net realizable value" implies that some effort – whether to complete or to sell – is still necessary in order for the entity to realize the amounts depicted for inventory on the balance sheet.

However, it may be appropriate to look to ASC 820 for guidance on the determination of net realizable value. The Board should fully consider the applicability of the underlying concepts of its fair value reporting initiatives to ensure that this proposed simplification is more than just tweaking an old, outmoded standard; if the Board makes changes it should not do so without considering the need for substantive improvements. Specifically:

- Net realizable value is an exit value and accordingly has many of the same characteristics as the price specified in ASC 820-10-35-9A. In its deliberations on SFAS No. 157, the Board affirmed that use of an exit price was appropriate as it encompassed the notions of expected cash flows that are inherent in the definitions of assets and liabilities. Users fully expect that entities hold inventory for only one purpose – to generate cash flows.
- Net realizable value is "estimated selling prices in the ordinary course of business less reasonably predictable costs of completion, disposal and transportation". NRV implies sale in an orderly transaction to a willing buyer just as specified for transactions covered by the fair value standard. What is the "estimated selling price" preparers should use in arriving at NRV? Is the process of arriving at that estimated selling price inherently less complex than arriving at an estimate of fair value for an illiquid financial instrument? Does it matter how the preparer arrives at that estimated selling price? Do costs of completion, disposal and transportation necessarily exclude "transaction costs"?
- The complexity in applying lower of cost or market arises when inventory cost is greater than "market". In other words, the only time this process is difficult is when inventory is not generating the cash flows the entity assumed it would when it manufactured or otherwise acquired the product therefore the product is impaired. This often means that markets are thin, product is moving slowly, and obsolescence or other deterioration in quality is present. As the FASB Staff notes, other standards that address impairment first consider whether the asset's carrying value is recoverable – an undiscounted cash flow exercise. The concept of net realizable value encompasses that same exit value concept and the proposed treatment would appear to be consistent with the Board's previous guidance on asset impairment. However, assets that are not recoverable are then valued at fair value – the exit value tied to expected cash flows. Likely, no user or preparer would consider using a discounted cash flow model to value inventory; however, seriously impaired inventory may have no market – no potential customers. At this point, preparers often write off that inventory – assign it a zero carrying value – but continue to hold it for sale. The Board should consider whether that outcome continues to be appropriate in light of its migration away from "conservatism" as a dominant principal.
- The concept of "selling in the ordinary course of business" begs the question of the identity and availability of willing buyers. As noted above, the complexity in this area relates to inventory that is impaired. Do "principal markets" or "advantageous markets" exist for inventory? While these markets may not be relevant for inventory selling below cost, the underlying guidance may still be relevant. An entity that sells products at a 400% markup in high-end retail outlets may eventually sell those items at deep discount stores. In other words, the principal market changes over time; at the very end, the "most advantageous market" may be a market of last resort. For many enterprises, markets are scattered across the country if not the globe and effectively inventory trades in many markets. If a preparer holds commodities that are traded on more than one commodities exchange, which one should it look to and why? Should any of the concepts underlying ASC 820-10-35-5A et seq. apply to inventory?
- Would preparers benefit from application of a hierarchy similar to ASC 820? Commodities (grains for example) trade on active, regulated exchanges and preparers price them based on those markets (Level 1 pricing using an identically traded item). However, those who hold those commodities adjust the exchange prices for differences in quality, location, "basis", and other factors, some of which may be observable inputs some of which may not. Should the fundamental concept of using the best available inputs be specifically included in the Board's guidance on determination of Net Realizable Value?

- Most items of inventory do not trade in active markets but have regular, recurring sales volume and sellers have so much information about those products (e.g., from point of sale systems) that they seem to trade as if they were in an active, public market. In these situations, preparers may have internal information that is as reliable as Level 1 inputs – observable inputs – for their inventory. For new products, preparers do not have an observable sales history with which to compare. Should they look to other, similar products of their own or of competitors to arrive at estimated selling price? Is this the equivalent of a Level 2 input? Preparers have the same problem with impaired inventory as they look to other products in their own inventory or competitors' products to estimate selling prices. These sources may constitute Level 2 inputs, but may also include Level 3 inputs as management adjusts the observable prices to reflect its own information or assumptions using proprietary information. How much information should preparers disclose about their policies and accounting practices related to inventory carried at less than its original, historical cost?
- Preparers may find application of ASC 820 more straightforward for financial instruments since the Board has defined the unit of account as the individual instrument. It does not matter how a preparer manages an available-for-sale financial instrument, it looks to the principal or most advantageous market for the individual instrument. In this Proposed ASU in 330-10-35-8, the Board has retained the long-standing ability of preparers to define the unit of account as the unit that "most clearly reflects periodic income". In its deliberations on SFAS No. 157, the Board noted that brokers rarely sell large blocks of common stock as single blocks. This may or may not be true of inventory. The Board should consider whether the flexibility in defining the unit of account for determining NRV remains appropriate. Is this flexibility inherent in the Proposed ASU consistent with the staff's assertion that it would "increase consistency of measuring inventory among entities"? Should the Board consider defining inventory units of account by reference to applicable markets or plans for disposal?

Question 2: Should the proposed Update be applied prospectively to the measurement of inventory after the date of adoption?

The Board noted that it would not require retrospective application as it may be unduly costly to do so. Determination of such cost is most likely facts and circumstances dependent and for some companies, the cost of retrospective application may not be overly burdensome. The Board should permit companies to choose either retrospective or prospective application.

Question 3: Should the proposed Update be effective in annual periods, and interim periods within those annual periods, beginning after December 15, 2015, with early adoption permitted? Should there be a delay in the effective date for entities other than public business entities and why?

If the Board issues the standard in its current version, it should permit early adoption immediately upon release, as it will require less work by preparers, and the Board need not distinguish between public and private entities. If the Board reconsiders the document, particularly with respect to the interplay with ASC 820, the identification of markets, or disclosures, it may need to allow additional time for private entities, but should still permit early adoption immediately upon release.

I appreciate the opportunity to offer my comments.

Sincerely,

s/ James L. Fuehrmeyer, Jr.

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