

Thomas I. Selling PhD, CPA  
4718 E. Rancho Dr.  
Phoenix, AZ 85018  
[Tom.Selling@GroveSite.com](mailto:Tom.Selling@GroveSite.com)

August 30, 2014

Mr. Russell Golden, Chair  
Financial Accounting Standards Board  
401 Merritt 7  
P.O. Box 5116  
Norwalk, CT 06856-5116

Re: File reference No. 2014-210, Exposure Draft (ED) of Proposed Accounting Standards update (ASU)—*Simplifying the Measurement of Inventory*

Dear Mr. Golden:

I am writing to express my opposition to the ED:

- It would demonstrably *reduce* the usefulness of the information provided to users of financial statements;
- It would do little to simplify the measurement of inventory; and
- It does not adequately explain the Board's reasons for issuing the ED, which negatively affects the ability of financial statement users to express their views under the Board's "due process" policies.

**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 should not alter the current "lower of cost or market" (LOCOM) rules, which have as their objective to report the "utility" (i.e., economic value) of inventory — its most relevant attribute — when it is less than cost. As I will demonstrate below, the ED would reduce the usefulness of the information provided to users of financial statements. Whether or not a change to this uncontroversial standard will appreciably simplify financial reporting is an empirical question, for which no direct evidence has been presented in the ED.

The LOCOM rules are presently set forth in ASC 330-10-35 through 11, but have existed virtually intact, and without controversy since their promulgation in 1947 by the Committee on Accounting Procedure (CAP) in Accounting Research Bulletin (ARB) No. 29. To handle facts and circumstances under which replacement cost would not be the most appropriate measure of economic value, the rules provide two additional measures: net realizable value (NRV); and NRV reduced by an allowance for a normal profit margin. "Market" is defined as the middle value.

Only three orderings of these potential “market” measures are logically possible:

	<u>Scenario</u>		
	<u>A</u>	<u>B</u>	<u>C</u>
<b>“Ceiling”</b>	NRV	Replacement Cost	NRV
<b>“Market”</b>	Replacement Cost	NRV	NRV, less profit
<b>“Floor”</b>	NRV, less profit	NRV, less profit	Replacement Cost

**Scenario A** is not uncommon and it may be seen as typical of products with long life cycles, of which commodities are one example. Since replacing the inventory after sale is a reasonable presumption, the current cost of replacement was correctly regarded by the CAP as the best approach to measuring economic value. *Nothing has come to light in the ensuing decades to seriously challenge this long-established economic reasoning; hence, moving from LOCOM to a lower of cost or NRV rule would result in a shift to an inferior measure of economic value under this scenario.*

This is not an empirical question; it is a matter of logic. It is also a matter of the same logic that the ED would reduce the incidence of inventory write-downs. Moreover, when an inventory write-down does occur, the carrying amount of inventory would *overstate* economic value. (This is because NRV is higher than replacement cost.)

**Scenario B** is frequently encountered by reporting entities that sell goods with short economic life cycles, such as fashion clothing and high-tech consumer goods. Since there may be no economic justification for re-stocking inventory under these circumstances — i.e., replacement cost exceeds NRV — the CAP correctly reasoned that NRV would be the most appropriate measure of utility.

The ED would not change the accounting outcome under this scenario, but it implies that the affected entities would no longer be burdened by having to derive the “ceiling” and “floor” measures. However, I question that reporting entities operating under Scenario A or B calculate of the “floor” and “ceiling” constraints on “market” in practice. For the vast majority of reporting entities the appropriate concept of market will be obvious; and consequently, these entities will comply with GAAP without having to calculate numbers that won’t appear in their financial statements.

**Scenario C** is most unusual. But, it is not hard to imagine events that would cause replacement costs to plummet. (Think the bursting of the housing bubble in 2008.) As in Scenario B, replacement cost would not be appropriate since actual replacement would be unlikely; *and NRV would not be sufficiently conservative under the circumstances.*

In summary, the stated objective of the ED is to simplify GAAP while “maintaining or improving the usefulness of the information provided to users of the financial statements.” With respect to information usefulness, the forgoing analysis

conclusively demonstrates that it would decline in an appreciable number of cases. For those financial statement users who prefer conservative measurements, the ED would reduce conservatism by reducing the incidence of write-downs (Scenario A), and would result in failures to record a sufficient write down (Scenarios A and C).

In addition, the ED provides no compelling evidence that it would appreciably simplify the accounting for inventory. If the Board wishes to ensure that an entity's calculations will be straightforward, *without reducing information usefulness*, it should issue clarifying criteria, which if met by a reporting entity, would expressly relieve it from verifying the appropriate measure of "market" by a floor and ceiling test.

**The ED is not an adequate "due process" document.**

The Board's simplification initiative seems to have a single objective and a single constraint. This makes it self-evident that the most important questions the FASB should have for stakeholders are: (1) whether the simplification objective is met; and (2) whether the information usefulness constraint is violated. Both of these questions are arguably subsumed in "Question 1," but I suggest that in future proposals they should be separated and explicitly addressed.

Moreover, the ED does not disclose how the Board has concluded that its information usefulness constraint is not violated. In my opinion, this is an unconscionable omission.

Sincerely,

A handwritten signature in black ink, appearing to read "Thomas I. Selling". The signature is written in a cursive, slightly slanted style.

Thomas I. Selling PhD, CPA