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Ernst & Young LLP
5 Times Square
New York, NY 10036

Tel: +1 212 773 3000
ey.com

Ms. Susan M. Cosper
Technical Director
Financial Accounting Standards Board
401 Merritt 7
P.O. Box 5116
Norwalk, CT 06856-5116

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Proposed Accounting Standards Update, Inventory — Simplifying the Measurement of Inventory (File Reference No. 2014-210)

Dear Ms. Cosper:

We appreciate the opportunity to comment on the Proposed Accounting Standards Update, *Inventory — Simplifying the Measurement of Inventory* (the Proposed Standard), from the Financial Accounting Standards Board (FASB or Board).

We support the objective of the FASB in its simplification initiative to identify, evaluate and improve areas of US GAAP where cost and complexity can be reduced while maintaining or improving the usefulness of the information provided to users of the financial statements. However, we do not support the proposal to measure inventory at the lower of cost or net realizable value (LCNRV) because we believe it would not meet that objective for all entities. While the Proposed Standard may meet that objective for some, we are concerned it would not do so for entities that use the last-in, first-out (LIFO) accounting method in declining price environments. For such entities, we believe the Proposed Standard could increase the cost and complexity of preparing the financial statements and, in certain circumstances, reduce the usefulness of the information provided to users. We also believe the continuing acceptability of the retail inventory method, discussed in paragraph 330-10-35-7, should be made more clear in the final standard.

LIFO accounting considerations

We have concerns that application of the Proposed Standard could significantly change current accounting results for entities that use the LIFO accounting method in declining price environments (e.g., certain commodities and textiles). It appears that these entities would be required to recognize debit LIFO reserves (i.e., LIFO cost in excess of first-in, first-out or FIFO cost).

Under today's GAAP, entities that use LIFO generally[1] recognize a lower of cost or market (LOCOM) adjustment (i.e., a loss in current earnings) when LIFO inventory cost exceeds market as described in Accounting Standards Codification (ASC) 330[2] (i.e., market — "replacement cost" subject to a "floor"

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1 The recognition of debit LIFO reserves may occur in instances in which a debit LIFO reserve exists at a detailed level (e.g., an individual inventory item or pool) and the LOCOM test is performed at an aggregated level (e.g., for multiple inventory pools) such that no LOCOM adjustment is required.

2 Refer to ASC 330, *Inventory*, paragraphs 330-10-35-4, 330-10-35-5 and the definition of "market" in 330-10-20.

and a "ceiling"). In a declining price environment, inventory is generally carried at replacement cost on the balance sheet. The LOCOM adjustment effectively eliminates the difference between the higher LIFO cost and the lower market. It also eliminates the difference (i.e., a debit LIFO reserve) between the higher LIFO cost and the costing method used by an entity to track inventory (generally FIFO or a form of weighted-average that more closely approximates current cost). Absent the recognition of a LOCOM adjustment, a debit LIFO reserve would be part of the recorded value of inventory on the balance sheet.

We acknowledge that it is possible (as noted previously) to recognize debit LIFO reserves under current accounting guidance. However, we would expect entities to recognize debit LIFO reserves more frequently under the LCNRV approach than they do today because the Proposed Standard would eliminate the replacement cost concept of market in today's LOCOM guidance. We question whether the more frequent recognition of debit LIFO reserves under the Proposed Standard would improve the usefulness of the financial statements for users, especially for entities that use LIFO in declining price environments.

For example, consider a clothing manufacturer (Entity A) that produces a single product (Item X). Entity A tracks the movement of inventory using the FIFO method but has used the LIFO method for financial reporting (and tax accounting) purposes for 25 years. Assume that Entity A has experienced a significant decline in the price of its primary raw material (or labor) during its use of LIFO. Also assume that the following data is used to test the recoverability of inventory Item X at the balance sheet date using today's LOCOM guidance:[3]

- LIFO cost is $110 per unit
- Net realizable value ("ceiling") is $100 per unit
- FIFO cost (i.e., replacement cost) is $90 per unit
- Net realizable value, less an approximately normal profit margin ("floor") is $80 per unit

Entity A determines that the replacement cost (FIFO cost) is the appropriate measure of market to use for the LOCOM test because it falls between the "ceiling" and "floor." Therefore, Entity A performs its LOCOM test for Item X by comparing the LIFO cost of $110 per unit (i.e., cost) to the replacement cost (FIFO cost) of $90 per unit (i.e., the appropriate measure of market). Entity A measures Item X inventory at market (replacement cost, i.e., FIFO cost) on the balance sheet. To reduce the LIFO cost of inventory to market, Entity A records a LOCOM adjustment by recognizing a loss in current earnings in the amount of $20 per unit, in effect eliminating the debit LIFO reserve (i.e., the LIFO cost in excess of the FIFO cost) of $20 per unit.

Now assume the same fact pattern, except that Entity A applies the proposed guidance. Because that guidance would eliminate the replacement cost and "floor" measures of market, Entity A would compare the LIFO cost of $110 per unit to the net realizable value of $100 per unit. Entity A would measure inventory at net realizable value on the balance sheet because that amount is lower than the LIFO

[3] Refer to ASC 330-10-35-1 through ASC 330-10-35-5 and ASC 330-10-20.

cost. The net realizable value ($100 per unit) of Item X exceeds the replacement cost ($90 per unit) that is used as the carrying amount under today's LOCOM guidance. Therefore, the Proposed Standard would change Entity A's accounting results by requiring it to carry a $10 per unit debit LIFO reserve for Item X inventory, perhaps recognizing the cost of Item X as it was carried on the balance sheet as long ago as 25 years. We do not believe that the measurement of inventory on the balance sheet at an amount not recognized under current GAAP (i.e., the "years' ago" amount) maintains or improves the usefulness of information provided to users of Entity A's financial statements (i.e., part of the simplification initiative's objective) and question whether it is consistent with any LOCOM underlying principle.

As drafted, the Proposed Standard would require entities to apply the LCNRV approach prospectively to measure inventory after the date of adoption. For the purpose of this discussion, we assume that the prospective transition described in the Proposed Standard would be effected by recognizing any changes in the measurement of inventory through earnings. We also assume that any LOCOM reserve recorded at the transition date would result in a new cost basis for the related inventory. We believe this assumption is consistent with the guidance in ASC 330-10-35-14.[4]

However, the American Institute of Certified Public Accountants (AICPA) 1984 Issues Paper on LIFO,[5] which has been incorporated into the Codification based on prior views expressed by the Securities and Exchange Commission (SEC) staff,[6] provides guidance for the reversal of recognized LIFO inventory reserves (i.e., both credit reserves and debit reserves). That guidance requires an entity to reverse LIFO reserves as it sells or otherwise disposes of the physical inventory to which the reserve relates.

After adopting the Proposed Standard, it appears that entities that use LIFO in declining price environments would be required to recognize debit LIFO reserves (potentially by reversing previously recorded LOCOM adjustments), with a corresponding credit to income as the related inventory is disposed of (i.e., in the period(s) after adoption). This would be done to ***increase*** the measurement of inventory to net realizable value from its carrying amount immediately prior to transition (i.e., the value that was based on either the replacement cost or the "floor"). We understand that companies in certain industries (e.g., retail, manufacturers) would recognize significant debit LIFO reserves of millions or billions of dollars, and corresponding income, in the period(s) following the transition date if this approach is followed. The recognition of debit LIFO reserves and the related windfall in earnings in

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4 ASC 330-10-35-14 states "In the case of goods which have been written down below cost at the close of a fiscal year, such reduced amount is to be considered the cost for subsequent accounting purposes."

5 See AICPA Issues Paper, *Identification and Discussion of Certain Financial Accounting and Reporting Issues Concerning LIFO Inventories* (30 November 1984), paragraphs 6-31, 6-34 and 6-38.

6 In Staff Accounting Bulletin (SAB) Topic 5.L, *LIFO Inventory Practices*, (codified in ASC 330-10-S99-1) the SEC staff stated "In the absence of existing authoritative literature on LIFO accounting, the staff believes that registrants and their independent accountants should look to the [AICPA 1984 Issues Paper on LIFO] for guidance in determining what constitutes acceptable LIFO accounting practice. In this connection, the staff considers the [AICPA 1984 Issues Paper on LIFO] to be an accumulation of existing acceptable LIFO accounting practices which does not establish any new standards and does not diverge from GAAP." "[T]he Commission strongly encouraged registrants and their independent accountants to examine their financial reporting LIFO practices." "[T]he staff believes that a registrant and its independent accountants should re-examine previously adopted LIFO practices and compare them to the recommendations in the [AICPA 1984 Issues Paper on LIFO]. In the event that the registrant and its independent accountants conclude that the registrant's LIFO practices are preferable in the circumstances, they should be prepared to justify their position in the event that a question is raised by the staff."

the period(s) after adoption would not reflect any real change to the economics of the underlying inventory. While the amounts are not as significant, such accounting would also be applied in periodic LIFO and LCNRV calculations, subsequent to adoption, thus distorting periodic reporting of income. Therefore, we believe such accounting in the period(s) after adoption and thereafter would not provide more useful information to the users of such companies' financial statements.

Possible solutions

We believe there are four ways that the Board could address the complexities of accounting for debit LIFO reserves under the Proposed Standard. These are to:

- Provide guidance for allocating debit LIFO reserves to LIFO layers
- Use an alternative subsequent measurement approach for LIFO inventory
- Use an alternative subsequent measurement approach for inventory
- Initiate a broader project on inventory measurement

Provide guidance for allocating debit LIFO reserves to LIFO layers

If the Board pursues the Proposed Standard as drafted, it could require that the LOCOM adjustment existing at the transition date (i.e., debit LIFO reserves) be recognized as part of the existing LIFO inventory as the new cost basis. In this case, a positive statement should be made that the Advisory Conclusion in the LIFO Issues Paper[7] about the release of LOCOM reserves should be disregarded, especially in light of the SEC staff view in SAB Topic 5.L. As such, we believe it would then be necessary to provide guidance for allocating the debit LIFO reserves recognized at transition (as part of the new cost basis) to the underlying LIFO inventory layers using a rational and systematic basis. For example, the transition date debit LIFO reserves could be allocated to the underlying LIFO inventory layers (i.e., for a specific LIFO item or LIFO pool) based on their proportionate share of the total LIFO inventory measured at net realizable value. We also believe that any rational and systematic approach that is developed should consider existing accounting guidance on LIFO (e.g., SEC staff guidance and the AICPA LIFO Issues Papers[8]).

Alternative subsequent measurement approach for LIFO inventory

The Board could revise the Proposed Standard to exempt LIFO inventories from the LCNRV approach and instead provide for them to be subsequently measured using a different alternative approach. For example, such inventories could be measured at the lower of (1) LIFO cost or (2) the lower of replacement cost or net realizable value. For example, assume the same facts as in the example above.

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[7] See AICPA Issues Paper, *Identification and Discussion of Certain Financial Accounting and Reporting Issues Concerning LIFO Inventories* (30 November 1984), paragraphs 6-31, 6-34 and 6-38.

[8] See AICPA Issues Paper, *Identification and Discussion of Certain Financial Accounting and Reporting Issues Concerning LIFO Inventories* (1984); AICPA Issues Paper, *The Acceptability of "Simplified" LIFO for Financial Reporting Purposes* (1982); and AICPA Practice Bulletin 2, *Elimination of Profits Resulting from Intercompany Transfers of LIFO Inventories*.

Using this alternative, Entity A would measure inventory at the FIFO replacement cost of $90 per unit because (1) replacement cost (FIFO) is lower than net realizable value ($100 per unit), and (2) FIFO replacement cost is lower than the historical LIFO cost ($110 per unit). Because we would expect that Entity A also measures inventory at replacement cost under today's LOCOM guidance (if given the same fact pattern), there would generally not be a debit LIFO reserve to record at transition to the Proposed Standard.

Although such an approach would not simplify the accounting as much as the Proposed Standard because it would retain the concept of replacement cost, we believe it would simplify the subsequent measurement of inventory by eliminating the "floor" measure of market in today's LOCOM guidance. Importantly, it would do so without introducing the added complexities associated with debit LIFO reserves, as described above. In declining price environments, FIFO cost is lower than LIFO cost. In such circumstances, we would expect this possible solution to result in inventory measured at the lower of its replacement cost (FIFO cost) and net realizable value. We believe that the approach we suggest would never state inventory at an amount above its net realizable value.

Alternative subsequent measurement approach for inventory

The Board could revise the Proposed Standard to require the subsequent measurement of inventory at the lower of (1) cost or (2) the lower of *replacement cost* and net realizable value. This approach would be similar to the approach described above, but it would be applied regardless of an entity's inventory costing method. (Note that under such an approach we would recommend that the Board retain the guidance in paragraph 330-10-35-7 of the Proposed Standard, which indicates that the retail inventory method would be acceptable if adequate markdowns are taken.) We acknowledge that this approach would not simplify the accounting as much as the Proposed Standard because it would retain the concept of replacement cost. However, it would simplify the subsequent measurement of inventory by eliminating the "floor" measure of market in today's LOCOM guidance without introducing the complexities associated with debit LIFO reserves. Under this approach, inventory would be measured consistently, regardless of an entity's costing method. Under the alternative subsequent measurement approach for LIFO inventory, above, the approach would not be consistent.

Initiation of a broader project on inventory measurement

The Board could consider initiating a broader project on inventory measurement. In addition to simplifying the subsequent measurement of inventory, such a project could also address complexities like debit LIFO reserves in a more comprehensive manner. We believe one key challenge for the Proposed Standard to overcome is that the Codification contains little guidance about inventory costing methods. With the exception of certain SEC guidance, practice has developed over time based largely on interpretive guidance issued by the AICPA.[9] We believe a broader project on inventory measurement could serve as a basis for the Board to codify certain aspects of guidance that, today, are non-authoritative or are only applied by publicly listed entities.

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[9] See AICPA Issues Paper, *Identification and Discussion of Certain Financial Accounting and Reporting Issues Concerning LIFO Inventories* (1984); AICPA Issues Paper, *The Acceptability of "Simplified" LIFO for Financial Reporting Purposes* (1982); and AICPA Practice Bulletin 2, *Elimination of Profits Resulting from Intercompany Transfers of LIFO Inventories*.

Clarify the continuing acceptability of the retail inventory method of accounting

We understand the Board believes that the retail inventory method (RIM) would continue to be acceptable if adequate markdowns are taken based on paragraph 330-10-35-7. During our analysis of the Proposed Standard, we noted that some reading the proposal have been confused primarily because of the phrase "accomplishes the objectives" in paragraph 330-10-35-7. We recommend that the statement found in 330-10-35-7 be retained and clarified and that a paragraph be added to the basis for conclusions explaining that the Board gave consideration to the continuing acceptability of the RIM during its deliberations and concluded it continues to be acceptable as long as adequate markdowns are taken in a timely manner.

Our responses to the specific questions posed in the Proposed Standard are set forth in Appendix A to this letter, and our comments on the consequential amendments in the Proposed Standard are included in Appendix B.

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We would be pleased to discuss our comments further with the Board or its staff at your convenience.

Very truly yours,

Ernst + Young LLP

Appendix A — Responses to specific questions raised in the Proposed Accounting Standards Update, Inventory — Simplifying the Measurement of Inventory (Proposed Standard)

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?

Response:

We do not support the Proposed Standard's measurement of inventory at LCNRV because we believe it would not meet the simplification initiative's objective of reducing the cost and complexity of GAAP while maintaining or improving the usefulness of the information provided to users of the financial statements. As described in our cover letter, while the Proposed Standard may meet that objective for some entities, we are concerned it would not do so for entities that use the LIFO accounting method in declining price environments. For such entities, we believe the Proposed Standard could increase the cost and complexity of preparing the financial statements and, in certain circumstances, reduce the usefulness of the information provided to users.

For entities that do not use LIFO, we acknowledge that the Proposed Standard would generally reduce the costs preparers incur to subsequently measure inventory by eliminating the multiple measures of "market" that must be considered when applying today's LOCOM guidance. The definition of "net realizable value" has remained substantially the same for more than 67 years (i.e., since ARB 29[10] was issued in July 1947). It is a concept that today's financial statement preparers and users understand to approximate the recoverability of inventory in many cases. We believe that many preparers already calculate the net realizable value of inventory when applying today's LOCOM guidance or have the information needed to do so. As a result, we believe such preparers would not incur significant additional costs to apply the LCNRV guidance in the Proposed Standard. However, we believe that any improvements for non-LIFO entities and their financial statement users wouldn't justify the costs and complexities that would result for LIFO entities in declining price environments and their financial statement users unless the Proposed Standard is revised.

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

Response:

Notwithstanding our views about the complexities related to accounting for LIFO inventories under the Proposed Standard, we support the Board's proposed approach to transition for entities other than those that use the LIFO method.

Although prospective application would likely reduce the amount of effort required to implement the Proposed Standard, we are concerned that it could result in financial statements that are not comparable until all periods are presented on the same basis. In situations where inventory is measured under both existing standards and the Proposed Standard in comparative financial statements,

[10] See Accounting Research Bulletin (ARB) No. 29, *Inventory Pricing*, Statement 6.

comparing financial information between periods would be challenging. For example, if an entity adopted the Proposed Standard during an interim period that was not the first quarter of the entity's fiscal year, the comparability and usefulness of the financial statements would be impaired. In such situations, we are concerned that the transition disclosure requirements[11] might not provide financial statement users with enough information to understand the effects of the change in accounting principle on the financials (e.g., effects upon year-to-date net income) when losses are recorded on inventory both before and after transition (i.e., using different measurement bases).

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?

Response:

Notwithstanding our views about the operational complexities related to accounting for LIFO inventories under the Proposed Standard, we support the Board's proposed transition approach for all entities with an effective date of December 15, 2015, with early adoption permitted.

[11] Paragraph 330-10-65-1(c) of the Proposed Standard would require entities to disclose the nature of and reason for the change in the accounting principle during the first interim and annual period of adoption.

Appendix B — Comments about the Codification Amendments in the Proposed Accounting Standards Update, Inventory — Simplifying the Measurement of Inventory (Proposed Standard)

Agriculture industry guidance

The Proposed Standard would amend certain aspects of guidance specific to the agriculture industry contained in ASC 905-330, *Agriculture — Inventory*, and ASC 905-405, *Agriculture — Liabilities*.

The proposed amendments to paragraph 905-330-35-5 would change the guidance to read:

> The inventories for a pooling cooperative shall be accounted for at either of the following:
>
> a. The lower of cost and net realizable value
>
> b. Net realizable value.
>
> When assigned amounts are used, they should approximate estimated market of unprocessed products delivered by patrons. See Example 1 (paragraph 905-330-55-1) for an illustration.

We suggest that the Board consider whether the term "estimated market," as used in the proposed amendments to paragraph 905-330-35-5 might be aligned with "net realizable value" used elsewhere in the paragraph.

Similarly, the proposed amendments to paragraph 905-405-25-1 state:

> If the boards of directors of agricultural marketing cooperatives operating on a pooling basis with no obligation to pay patrons fixed prices (pooling cooperatives) assign amounts that approximate estimated market to unprocessed products received from patrons, the assigned amounts shall be credited to amounts due patrons. When assigned amounts are used, they should approximate estimated market of unprocessed products delivered by patrons (an example of inventories at lower of cost and net realizable value is provided in Example 1 (see paragraph 905-330-55-1)).

We suggest that the Board consider whether the term "estimated market," as used in the proposed amendments to paragraph 905-405-25-1, might be aligned with "net realizable value" used elsewhere in the paragraph.