The Association of Accountants and Financial Professionals in Business

April 22, 2024

Ms. Marsha Hunt and Mr. Richard Jones
Board Members
Financial Accounting Standards Board
801 Main Ave
PO Box 5116
Norwalk, CT 06856-5116

Re: Stakeholder Outreach – Disaggregation of Income Statement Expenses

Dear Ms. Hunt and Mr. Jones,

The Financial Reporting Committee (FRC or Committee) of the Institute of Management Accountants (IMA) is writing to share its views on the Financial Accounting Standards Board's (FASB or Board) request for feedback from stakeholders on the following issues arising in its redeliberation of Proposed Accounting Standards Update, *Income Statement – Reporting Comprehensive Income – Expense Disaggregation Disclosures (Subtopic 220-40) – Disaggregation of Income Statement Expenses* (Proposed Update):

I. Inventory and Manufacturing Expense as a required expense category and its further disaggregation into the required cost categories
II. The effects of proportionate consolidation, joint ventures, and other cost reimbursement and cost-sharing arrangements
III. Applicability of the disclosure requirements to certain liability-related expenses
IV. The use of estimates or other methods to determine the disaggregation of relevant expense captions and whether additional guidance is needed.

The IMA is a global association representing over 140,000 accountants and finance team professionals. Our members work inside organizations of various sizes, industries and types, including manufacturing and services, public and private enterprises, not-for-profit organizations, academic institutions, government entities, and multinational corporations. The FRC is the financial reporting technical committee of the IMA. The Committee includes preparers of financial statements for some of the largest companies in the world, representatives from the world's largest accounting firms, valuation experts, accounting consultants, academics, and analysts. The FRC reviews and responds to research studies, statements, pronouncements, pending legislation, proposals, and other documents issued by domestic and international agencies and organizations. Additional information on the FRC can be found at www.imanet.org (About IMA, Advocacy, Financial Reporting Committee).

This response supplements the views expressed in our letter dated November 1, 2023, on the Proposed Update. We appreciate the opportunity to continue to participate in stakeholder outreach. We are not commenting on Issue II as it is not applicable to the companies represented on the Committee.

I. Inventory and Manufacturing Expense

Issue 1: *Whether the Inventory and Manufacturing Expense required expense category should be changed to Inventory Expense?*

1. *Would a change from Inventory and Manufacturing Expense to Inventory Expense improve the operability of the proposed guidance?*
    a. *Do you foresee any specific challenges resulting from this potential change?*

In general, we believe a change from Inventory and Manufacturing Expense to Inventory Expense as a required expense category would improve the operability of the proposed guidance because it would eliminate the creation of a new category of expenses to define.

That said, we think the best path forward is not a further refinement of definitions, but rather to remove Inventory and Manufacturing Expense as a required expense category for a more consistent approach to disaggregating cost of sales in line with other relevant expense captions. We think the simplest and most meaningful approach is to make the requirements for the disaggregation of cost of sales similar to that of other relevant expense captions. In other words, cost of sales should be disaggregated into (a) Employee Compensation, (b) Depreciation, (c) Intangible Asset Amortization, and (d) DD&A in accordance with the proposed guidance in paragraph 220-40-50-4 and an amount for "other items" in accordance with the proposed guidance in paragraph 220-40-50-16.

We acknowledge that complications due to the capitalization of amounts in the required expense categories (e.g., Employee Compensation) would still exist and we believe those complications can be mitigated through the potential changes explored herein regarding costs incurred in the period versus expenses incurred in the period (Issue 2 of Issue I) and one level of disaggregation versus two levels of disaggregation (Issue 3 of Issue I) as well as the use of estimates and other methods to determine the disaggregation of relevant expense captions (Issue IV).

Because of the differences in manufacturing processes and how those differences may manifest themselves in the financial statements of each entity, we believe that flexibility and judgment is necessary to produce a meaningful disaggregation of cost of sales. We do not believe a specific method for the sake of consistency should be forced upon preparers. The proposed guidance in paragraph 220-40-50-1 states that the objective of the Proposed Update is to "provide disaggregated information about…expenses to help investors (a) better under the entity's performance, (b) better assess the entity's prospect for future cash flows, (c) compare an entity's performance over time and with that of other entities." We believe the principles underlying the stated objective can be used to enable the level of flexibility needed to allow entities to prepare a disaggregation of cost of sales that would tell investors how their manufacturing process translates into the presentation of cost of sales on the face of the income statement. The required expense categories would allow for comparability with other entities and we would support enhanced qualitative descriptions of the derivation of each required expense category to provide investors with the information needed to better understand the resulting cost of sales. The "other items" category in paragraph 220-40-50-16 would include the remaining costs of manufacturing (including materials) and would require qualitative descriptions. We would be supportive of additional qualitative disclosures to enhance the transparency of the "other items" category.

2. *Is the definition of Inventory Expense, as included in the proposed Update, operable?*
    a. *Is the phrase "consumption in the production of goods or services for such sale" clear that Inventory Expense includes amounts that were consumed and capitalized to inventory during the production of goods or services for sale, or were consumed but not capitalized even though the goods or services were capitalizable in accordance with Topic 330 (for example, costs that were not capitalized by the entity due to a short inventory turnover period)?*

    If Inventory Expense remains a required expense category, we believe the operability of the definition of Inventory Expense in the Proposed Update could be improved with formatting clarifications to explicitly separate each expense type included in the definition and additional language to address the concept of amounts not capitalized to inventory but consumed in production. See suggested <u>underlined</u> edits as follows:

    Inventory Expense: "An expense resulting from <u>(a)</u> the derecognition of inventory due to sale to customers, <u>(b)</u> consumption in the production of goods or services for such sale <u>(whether capitalized to inventory or not)</u>, or <u>(c)</u> remeasurement (for example, an impairment) in accordance with Section 330-10-35 or any other Subsequent Measurement Section within an Industry Subtopic in Topic 330 on inventory."

3. *If the Board retains Inventory and Manufacturing Expense as a required expense category, are there clarifying changes that should be made to its definition?*

    We do not believe the Board should retain Inventory and Manufacturing Expense as a required expense category given the difficulties in separating manufacturing expenses from other costs within cost of sales as described in our comment letter dated November 1, 2023, and the alternative proposal presented in response to Question 1 for Issue 1 under Issue I.

4. *Are entities able to identify and classify variances as inventoriable compared to those that were not inventoriable, including those variances that were inventoriable but were never capitalized due to high turnover in the period?*
    a. *For those variances that are not inventoriable, is the entity able to identify the portion of the variance related to Employee Compensation, the portion related to Purchases (if applicable), and the portion related to all other costs?*
    b. *For those variances that are inventoriable, is the entity able to identify the portion of the variance related to purchases, the portion of the variance related to employee compensation, and the portion of the variance related to all other costs?*

    As noted in our alternative proposal in response to Question 1 for Issue 1 under Issue I, we believe the focus should be on aligning the disaggregation of cost of sales with other relevant expense captions. An entity's ability to identify the composition of inventory costing variances will depend on their manufacturing processes and the architecture of their financial reporting systems. In our simplified proposal, we believe the treatment of inventory costing variances would be captured as part of the enhanced qualitative descriptions of the derivation of each required expense category to tell investors how their process works and how that process translates into the presentation of cost of sales on the face of the income statement.

In our experience, many inventory costing systems characterize costs into three categories: material, labor, and overhead. However, overhead frequently includes indirect labor and indirect materials, which would make it difficult to separate the portion of the overhead variance that pertains to the required expense categories (e.g., Employee Compensation) from other costs. Also, as inventory goes through multiple production steps, the labor and overhead components of the preceding steps become the material component of the next step such that part of the material cost variances in later steps would relate to labor and overhead that had previously been incurred. Additionally, many companies value inventory using cost systems that do not distinguish costs into the categories above, which would make it difficult for those entities to attribute a particular variance to a natural cost element. Others may analyze variances by calculating volume or product mix variances that combine material, labor, and overhead cost components.

Issue 2: *Whether entities should be allowed to further disaggregate Inventory and Manufacturing Expense based on either costs incurred in the period or costs expensed in the period?*

1. *Would the proposal be more operable if entities could elect to further disaggregate Inventory and Manufacturing Expense using either a costs incurred approach or expenses incurred approach?*
    a. *Generally, if an entity elects an expenses incurred approach, would the entity be able to disaggregate the required expense category into the proposed cost categories (that is, Purchases of Inventory, Employee Compensation, Intangible Asset Amortization, Depreciation, and DD&A)?*

Generally, flexibility makes compliance more operable. We are supportive of allowing approaches that will facilitate the ability to comply with the Proposed Update. None of the companies on the FRC with significant manufacturing operations would be able to disaggregate using the expenses incurred approach. They would expect to report using the costs incurred approach, as we believe would most entities that have significant inventory and manufacturing expenses.

2. *Generally, what types of entities or industries would be able to perform the disaggregation using a costs expensed approach?*
    a. *Should the choice between an expense incurred approach or cost incurred approach be an open-ended option for entities or should the Board consider clarifying when each method is applicable or when a method may be precluded?*

We are not aware of specific types of entities or industries that would be able to perform the costs expensed approach. However, we are supportive of allowing entities to do so if they believe they can and that such an approach would be more informative for users. We would support allowing an option to report using either approach. We do not believe there are situations where the Board should preclude such an option.

Issue 3: *If entities are allowed and elect to disaggregate expenses on an expenses incurred basis, how should the disaggregation be performed and disclosed?*

1. ***Alternative #1 One Level of Disaggregation:*** *The expense caption is disaggregated based on the following expenses incurred categories: (1) Purchases; (2) Employee Compensation; (3) Intangible Asset Amortization; (4) Depreciation; and (5) DD&A.*

2. ***Alternative #2 Two Levels of Disaggregation:*** *The expense caption is disaggregated based on the following expenses incurred categories: (1) Inventory and Manufacturing Expense; (2) Employee Compensation; (3) Intangible Asset Amortization; (4) Depreciation; and (5) DD&A. Inventory and Manufacturing Expense would then be further disaggregated based on expenses incurred in the following categories: (1) Purchases of Inventory, (2) Employee Compensation; (3) Intangible Asset Amortization; (4) Depreciation; and (5) DD&A.*

1. *Would either of the above alternatives be more operable than the other? If so, why?*

   If entities are allowed and elect to disaggregate expenses on an expenses incurred basis, Alternative #1 would be more operable and we would support that option.

   We also note that one level of disaggregation is more consistent with the alternative proposal presented in response to Question 1 for Issue 1 under Issue I and should be applicable to all entities to enable the simplified approach to cost of sales disaggregation.

2. *Are there industries that more commonly recognize purchases on the face of the income statement? If so, are those purchases generally comprised of purchases related to inventory under Topic 330?*

   We are not aware of specific industries that have such a practice.

Issue 4: *Whether the cost categories for the further disaggregation of Inventory and Manufacturing Expense should be updated to Purchases of Inventory, Employee Compensation and Other Costs?*

1. *If the further disaggregation of Inventory and Manufacturing Expense is updated such that the costs categories are Purchases, Employee Compensation and Other, would this improve the operability of the proposed guidance and reduce the costs of providing the disclosure?*

   We are supportive of alternatives that simplify the operability of the Proposed Update and we recognize that fewer required expense categories would achieve that goal and be more consistent with the alternative proposal presented in response to Question 1 for Issue 1 under Issue I.

   That said, the potential revision would aggregate Depreciation, Intangible Asset Amortization, and DD&A into the Other category and we believe those categories are generally identifiable through existing cash flow reporting processes and more easily mapped to relevant expense captions. In other words, this potential change would simplify the disaggregation of required expense categories that present the smallest challenge to operability. We see limited benefit to such a change and we note that it would make the amounts reported in Other more aggregated, which seems counter to the overall objective of the Proposed Update.

III. Applicability of the Disclosure Requirements to Certain Liability-related Expenses

1. *Are there any other commonly presented expense captions or amounts within those captions that are recorded as an offset to a liability (based on estimates) that should be exempt from the*

proposed disclosure requirements on the same basis as product warranties, benefits and claims expense, and onerous losses on contracts with customers?

We note that the Board decided to provide guidance about when certain liability-related expenses would be excluded from the disaggregation requirements at its March 27, 2024 meeting. We agree that the components of expenses that are accrued based on an estimated liability in accordance with Topic 450 should not be required to be disaggregated. We believe the best approach would be to state the concept behind the reason for the exception and give examples. We believe that the number of examples should be expanded to more than just product warranties. However, we would limit the number of examples so as not to give the impression that the list was comprehensive. We agree with adding benefits and claims expense and onerous losses as additional examples.

IV. The Use of Estimates or Other Methods to Apply the Proposed Disclosure Requirements

1. *Would you have expected to be able to use accounting estimates or other methods (i.e., a method other than tracing expense detail down to the transaction level) to apply the proposed guidance?*

   Yes, it is commonplace to utilize estimates, conventions, and judgments in combination with materiality assessments when complying with U.S. GAAP in both the recording of financial statement transactions and the presentation of financial statements and we would expect the application of the proposed requirements in the Proposed Update to be similar.

   However, the Proposed Update would require disclosure of amounts that are summarized in expense categories that may be different than how the underlying transactions were recorded or captured in internal financial reporting systems and the proposed requirements to disclose rollforwards and/or reconciliations to the face of the income statement imply a level of precision that may not be possible given those differences. The operability of the Proposed Update is entirely dependent on the architecture of internal financial reporting systems and what level of information those systems were designed to capture. In order to produce the required expense categories mapped to each relevant expense caption, it may be necessary to rely on estimates, conventions, and judgments.

   We believe it would be helpful to indicate that it is acceptable and appropriate to utilize estimates, conventions, and judgments in complying with the proposed disclosure requirements in the Proposed Update without giving the impression that it permits a lesser degree of precision than other disclosures.

2. *How may entities use accounting estimates or other methods to determine the disaggregation of relevant expense captions?*

   As there is some flexibility in the financial statement captions an entity presents, we believe many prepare their financial statements by compiling those line items from amounts contained in their trial balance and the chart of accounts underlying the trial balance would be designed with the preparation of financial statements and related disclosures in mind. Although there may be judgments or estimates in what is recorded at an account level, we believe, for the most part, how expense captions are derived is mechanical. To comply with the Proposed Update, we expect many companies will need to gather information from additional sources beyond trial balances or accumulate data from underlying accounting records. We expect significantly less standardization than exists at the chart of accounts or trial balance level and we expect estimates or other judgments may be required.

3. *What guidance or other information about this issue might be helpful to include in a final ASU?*

   In addition to the acknowledgement of the expectation that preparers can use estimates, conventions, judgments, or methods other than tracing expense details to the transaction level, we recommend that the Proposed Update include illustrative examples.

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

Sincerely,

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cc: Hillary Salo, FASB Technical Director
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