

Basis for Conclusions on AASB 2007-5

This Basis for Conclusions accompanies, but is not part of, AASB 102. The Basis for Conclusions was originally published with AASB 2007-5 Amendments to Australian Accounting Standard – Inventories Held for Distribution by Not-for-Profit Entities.

Background relating to standards on inventories

- BC1 For reporting periods beginning prior to 1 January 2005, under AASB 1019 *Inventories* (now superseded by AASB 102 *Inventories*), inventories were defined only in terms of items held for sale or in the process of sale. The treatment of items in the nature of inventories that were not held for sale needed to be determined by analogy because they were not explicitly covered by AASB 1019.
- BC2 Inventories held for distribution by not-for-profit entities were scoped into AASB 102, issued in July 2004, and were required to be measured at the lower of cost and current replacement cost.
- BC3 This is the same as the requirement in the International Public Sector Accounting Standards Board's IPSAS 12 *Inventories* issued in July 2001. (IPSAS 12 has since been revised in December 2006 for application from 1 January 2008.)
- BC4 The Board notes that inventories held for distribution do not include major spare parts and stand-by equipment that qualify as property, plant and equipment, which are discussed in AASB 116 *Property, Plant and Equipment* at paragraphs 8 and 12.

Background relating to key issue

- BC5 A number of constituents raised issues with the Board relating to the conceptual soundness of applying the lower of cost and current replacement cost treatment to inventories held for distribution as well as the practicality of its application to certain types of inventories held for distribution.
- BC6 The Board considered the view that writing down inventory held for distribution when its current replacement cost falls below cost may result in the recognition of impairments when the service potential to the entity of those inventories remains unchanged. In addition, the Board noted that the service potential to the entity of inventories held for distribution may fall, but that current replacement cost to the entity may remain higher than the original cost. The Board concluded that this is in part because the lower of cost and current replacement cost requirement focuses on financial values, whereas the service potential of inventories held for distribution by many not-for-profit entities is considered in physical terms.
- BC7 The Board also considered the practical problem that current replacement costs are sometimes not readily available for many of the inventories held for distribution that have long lives because they have not been replenished for long periods. In some cases, such inventories may have maintained their service potential, but may no longer be available in the form held by the entity.
- BC8 The Board noted that a for-profit entity will readily know its costs and its net realisable values, because most businesses buy and sell inventories regularly. In a not-for-profit entity that holds inventories for distribution and buys and distributes them regularly, the lower of cost and current replacement cost requirement has been viewed as the nearest available equivalent requirement.
- BC9 The Board noted that the practical problems emerge when the inventories held for distribution are retained over the long term and replacement costs are not readily available. A major part of the burden is the possible need to maintain records of three prices for each type of inventory: (1) the cost; (2) the up-to-date replacement cost in case there is a need for write down; and (3) in the event that the replacement cost has previously fallen below cost, that replacement cost [carrying amount]. The Board also noted that the records of the three prices might also need to be maintained to facilitate the reversal of write downs in the event that the circumstances that previously caused inventories to be written down below cost no longer exist or when there is clear evidence of an increase in current replacement cost because of changed economic circumstances.

Alternative solutions

- BC10 The Board considered developing a proposed solution only in respect of long-lived inventories held for distribution by not-for-profit entities in order to address the practical problems raised by constituents.

However, the Board concluded that it would be more appropriate to develop a solution for all types of inventories held for distribution by not-for-profit entities that addresses the issues at both the principle and practical levels. This is because the Board prefers a solution based on a high-level principle that can be applied consistently by all not-for-profit entities in a manner that best suits the character of their inventories held for distribution.

- BC11 Among the possible solutions considered by the Board was applying an AASB 136 *Impairment of Assets*-style impairment test, however, it was noted that this would have many of the problems already associated with the existing requirements.

Cost adjusted when applicable for any loss of service potential

- BC12 The Board noted that the lower of cost and net realisable value requirement in AASB 102 in respect of inventories other than those held for distribution can be viewed as being based on a notion of recognising a loss of service potential in a for-profit environment. That is, an entity that seeks to sell inventories for more than they cost generally considers the service potential of those inventories in financial terms. If net realisable value falls below cost, the entity can be viewed as suffering a loss of service potential.

- BC13 The Board observed that the lower of cost and current replacement cost requirement for measuring inventories held for distribution by not-for-profit entities can be viewed as seeking to emulate the approach taken for other inventories and its focus is also on a loss of value in financial terms. However, the Board considered that this financial measure of the loss of service potential may not always be the most relevant measure in respect of inventories held for distribution by not-for-profit entities for the reasons outlined in paragraph BC6.

- BC14 The Board considered that the measurement of inventories held for distribution by not-for-profit entities at cost, adjusted when applicable for any loss of service potential, is consistent with the *Framework for the Preparation and Presentation of Financial Statements*, which notes at paragraph Aus49.1:

In respect of not-for-profit entities in the public or private sector, in pursuing their objectives, goods and services are provided that have the capacity to satisfy human wants and needs. Assets provide a means for entities to achieve their objectives. Future economic benefits or service potential is the essence of assets. Future economic benefits is synonymous with the notion of service potential, and is used in this Framework as a reference also to service potential. Future economic benefits can be described as the scarce capacity to provide benefits to the entities that use them, and is common to all assets irrespective of their physical or other form.

- BC15 The Board noted that a fall in the current replacement cost of inventories held for distribution may at times indicate a loss of service potential, but that this is not necessarily always the case, and that a loss of service potential may at times be identified on other, more relevant, bases. For example, obsolescence, which may occur with or without there being a fall in current replacement cost, may be the main factor leading to a loss of service potential for many not-for-profit entities. The term 'obsolescence' covers both 'technical obsolescence' and 'functional obsolescence'. Technical obsolescence occurs when an item still functions for some or all of the tasks it was originally acquired to do, but no longer matches existing technologies. Functional obsolescence occurs when an item no longer functions the way it did when it was first acquired. In either case, a loss of service potential may need to be recognised.

- BC16 The Board also considered that a problem with a purely physical service potential approach is identifying ways in which physical service potential would be measured. However, the Board concluded that many not-for-profit entities will often be more likely to monitor the service potential of their inventories held for distribution than they are to monitor the current replacement costs of those inventories. The Board considered that this is especially likely to be the case when those inventories are important to maintaining its functions or operating capability and, therefore, often in cases when it is most likely to be material to the financial statements.

- BC17 The Board considers that there is a need for the circumstances of a not-for-profit entity to be the determining factor behind its manner of assessing any loss of service potential for inventories held for distribution. The measurement requirement for inventories held for distribution would require each not-for-profit entity to identify the basis (or bases) for determining any loss of service potential that best suits the circumstances relating to the entity. Different bases may apply to different inventories held for distribution within the same entity.

- BC18 There was considerable support for the approach of requiring inventories held for distribution to be measured at cost, adjusted for any loss of service potential, in the submissions on Exposure Draft ED 154 *Proposed Amendments to AASB 102 – Inventories Held for Distribution by Not-for-Profit Entities*. However, some submissions expressed concerns that the lower of cost and current replacement cost

requirement is being applied without difficulty by many entities and argued that it might be unnecessarily disruptive to introduce the change proposed in ED 154.

- BC19 The Board noted that a current replacement cost that is lower than cost might be a common way of identifying and measuring a loss of service potential for inventories held for distribution. Accordingly, many entities are likely to continue their existing practices under a revised AASB 102, and the Board concluded few entities would be disrupted by the change.
- BC20 The Board concluded that the requirement to measure inventories held for distribution at cost, adjusted when applicable for any loss of service potential, would give rise to more relevant information that better reflects the various accountabilities of not-for-profit entities. In addition, the Board concluded that the requirement is likely to be more appropriate in practical terms than the former requirement in some circumstances.

Transition

- BC21 The Board considered that, in some cases, measuring at the lower of cost and current replacement cost versus measuring at cost, adjusted when applicable for any loss of service potential, would give rise to different carrying amounts for inventories held for distribution. The Board concluded that, on transition to the changed requirement, it is appropriate to require not-for-profit entities to adjust any difference prospectively against opening retained earnings and not amend comparative information on the basis that:
- (a) there are likely to be practical problems associated with trying to retrospectively determine whether there have been further losses of service potential and precisely when they occurred, which may not be overcome by the impracticability override in AASB 108 *Accounting Policies, Changes in Accounting Estimates and Errors*;
 - (b) the relatively short period of development involved in amending AASB 102 and, therefore, the absence of a long period during which constituents would be made aware of the changes; and
 - (c) requiring rather than permitting the prospective transitional approach is desirable from a comparability viewpoint.