Technical Advisory Group Issue Paper

AGENDA ITEM: TAGED12-01
18 May 2023 – Video Conference

Section 13 - Inventories

Summary	This paper provides TAG members with a review of the Consultation Paper responses to issue 6 *Inventory held for use or distribution* and a first draft of Section 13 *Inventories* for comment.
Purpose/Objective of the paper	To seek the TAG's views on the responses to the Consultation Paper and the first draft of Section 13 *Inventories*, in particular the measurement of inventories held for distribution, including inventories that have not been donated.
Other supporting items	None
Prepared by	Paul Mason
Actions for this meeting	<u>Advise on</u> • the way forward for finalising the Exposure Draft and associated Guidance • the proposed measurement approach, in particular the use of service potential in the valuation of inventory held for own use or distribution • the proposal for a new cost formula.

INTERNATIONAL FINANCIAL REPORTING
FOR NON PROFIT ORGANISATIONS

Technical Advisory Group

Section 13 - Inventories

1. Introduction

1.1 The measurement of inventories held for use in providing services or for distribution to service recipients has been identified as a specific issue for non-profit organisations. In some cases the inventories will have been donated, and there is a link to Section 23 *Revenue*.

1.2 This paper covers the recognition and measurement of inventories. The proposals in this paper reflect the feedback to the Consultation Paper, and the proposals for the recognition and measurement of revenue in respect of donated items in Section 23.

1.3 The Consultation Paper identified a number of challenges for NPOs when accounting for inventories. These can be summarised as follows:

- **Measurement on recognition**. This was identified as an issue in respect of donated inventories. The proposals in Section 23 *Revenue* permit an NPO to not recognise donated items for resale, distribution or use in providing services until the items are either sold, distributed or used. These proposals will need to be reflected in the text of Section 13 *Inventories.* The Secretariat expects that these proposals will address many of the challenges facing NPOs regarding these items.
- **Measurement of work in progress of services in-kind,** where the service is to be provided at no or nominal cost to service recipients, for example, where an NPO prepares legal cases supporting refugees.
- **Subsequent measurement** of items to be used in providing services or to be distributed at no or nominal cost.

1.4 The Consultation Paper proposed three alternative financial reporting treatments for inventories:

- **Alternative 1:** Measure all inventory at the lower of cost or net realisable value (selling price) with additional NPO-specific guidance. This alternative is based on the *IFRS for SMEs* Accounting Standard.

- **Alternative 2:** Require inventory held for use or distribution to be measured at the lower of cost or current replacement cost. Other inventory would be measured at the lower of cost or selling price, as with Alternative 1. This alternative is based on the treatment under IPSAS.
- **Alternative 3:** Require inventory held for use or distribution to be measured at cost, adjusted when applicable for any loss of service potential, with disclosure of the accounting policy and impact on service delivery. Other inventory would be measured at the lower of cost or selling price, as with Alternative 1. This alternative is based on the treatment under some national standards.

2. Consultation Paper - review of responses to issue 6 *Inventories held for use or distribution*

2.1 A detailed analysis of the responses to the Consultation Paper can be found in Annex A. Respondents generally supported the evaluation of the issues in the Consultation Paper.

2.2 Only two respondents disagreed with the description of the topic in the Consultation Paper. These respondents considered that additional issues to be addressed were:

(a) Some inventory may be donated for own use before being distributed. The Secretariat consider that where inventory is donated to be used in developing items for distribution, this should be treated in the same way as items donated for distribution.

(b) Additional guidance will be required on the circumstances in which work in progress for services to be provided for no or nominal cost should be recognised as an asset. Alternatives 2 and 3 both proposed permitting NPOs to expense the costs as incurred rather than recognising inventory. The Secretariat proposes adopting this permission in INPAG.

2.3 Five respondents (23% of those who commented on the question) disagreed that the list of alternatives was exhaustive. The additional alternatives identified are as follows:

(a) Inventory donated for onward distribution should be measured at zero, with no revenue or expense recognised. Specific reference was made to circumstances where NPOs receive and distribute large volumes of inventory in response to emergencies, and it may not be practical to record and value the inventory received and issued.

(b) Inventory donated for onward distribution or use on a specific project should be expensed on receipt (with one respondent specifically recommending the inventory be reported to the donor as fully expensed), while inventory donated for general use should be recognised as inventory.

(c) One respondent suggested that donated inventory for own use be measured at zero, with no revenue or expense recognised. This was based on inventory being recognised at cost under the *IFRS for SMEs* Accounting Standard., Donated inventory for onward distribution should be recognised at the cost to the donor where known. This may be intended to distinguish between items donated for general use and specific use, with an expense being reported to the donor when items donated for specific use are distributed or used.

(d) Where items of inventory are not measured individually and cost formulas are used, an additional option of 'first expired, first out' should be permitted for perishable items such as food or medical supplies, as NPOs often receive donated items close to their expiry date.

2.4 Only one respondent disagreed with the advantages and disadvantages articulated in the Consultation Paper for each alternative, and no reason was provided.

2.5 Respondents who agreed with the advantages and disadvantages highlighted the fact some NPOs may not have inventory recording systems; noted the need for appropriate disclosures; and supported the option to expense work in progress on services to be provided at no or nominal cost.

2.6 Of those respondents who indicated a preferred alternative:

(a) 56% supported Alternative 1 (recognise inventory at lower of cost or selling price), with additional NPO-specific guidance;

(b) 17% supported Alternative 2 (inventory held for use or distribution to be measured at the lower of cost or current replacement cost); and

(c) 28% supported Alternative 3 (inventory held for use or distribution to be measured at cost, adjusted when applicable for any loss of service potential).

2.7 While a majority of respondents who commented supported Alternative 1, a number of these respondents indicated that guidance would need to address donated items and items held for onward distribution at no or nominal cost. One respondent supported replacement cost in this context (as proposed in Alternative 2) and another respondent commented that both Alternative 2 and Alternative 3 would be acceptable. In addition, a number of respondents supported the proposal in both Alternative 2 and Alternative 3 to permit work in progress on services to be provided for no or nominal consideration to be expensed.

2.8 Respondents who supported Alternative 2 and Alternative 3 considered that their favoured alternative provided appropriate measurement of items held for distribution or use in providing services. Some respondents who supported Alternative 3 did so because of concerns that replacement cost may not always be available, particularly for items that are not regularly sold in the market. This concern may be mitigated by the permitted exceptions proposed in Section 23 *Revenue* that allow an NPO not to recognise inventory for many donated items. If these permissions are applied, replacement values would only be needed for self-produced or purchased inventory, and is therefore likely to be available in most cases.

3. Development of first draft of Section 13 *Inventories*

3.1 The Secretariat has developed a first draft of Section 13 *Inventories* of INPAG (see Annex B), taking into account the proposals in Section 23 *Revenue* and the feedback to the Consultation Paper. The Secretariat is seeking TAG member's comments on a number of issues as set out below.

Scope

3.2 The scope of Section 13 in the *IFRS for SMEs* Accounting Standard has been amended in two ways:

(a) The definition of inventories in paragraph G13.1 has been expanded to include assets held for onward distribution to service recipients in the ordinary course of operations.

(b) The list of exclusions in paragraph G13.2 has been expanded to include inventories to which an NPO elects to apply a permitted exception to the general recognition requirements. The permitted exceptions are set out in paragraph G13.5, These include donated items, which the proposals in

Section 23 *Revenue* would permit an NPO not to recognise as inventories; along with work-in-progress of services to be provided for no or nominal consideration , where an NPO elects to expense the costs as they are incurred. A disclosure requirement has been added to require that an NPO applying one of the permitted exceptions discloses that fact (paragraph G13.27)

Question 1:	Do TAG members agree with the proposed amendments to the scope of Section 13?

Reliable measurement

3.3 Respondents identified practical concerns with recognising and measuring inventories in specific circumstances (see paragraph 2.3(a)). The Secretariat acknowledge that it may not be possible to measure the inventories in some circumstances, for example, where an NPO responding to an emergency receives and distributes large volumes of items in a short period of time.

3.4 In many cases an NPO is likely to apply the permitted exceptions not to recognise donated inventories, thus avoiding the need to recognise and measure these items as inventory. However, the permitted exception in Section 23 *Revenue* would require an NPO to recognise a revenue and an expense as the items are used or distributed.

3.5 In addition, other NPOs may elect to recognise donated inventories but be unable to do so in particular circumstances.

3.6 The Secretariat considers that this can be addressed by providing Application Guidance on reliable measurement (paragraphs AG13.1 and AG13.2) that covers these circumstances, along with a disclosure requirement (paragraph G13.26 e)) for where inventories cannot be measured reliably.

Question 2:	Do TAG members support the approach to reliable measurement proposed by the Secretariat?
Question 3:	Should similar guidance on the reliable measurement of donated items that are distributed be included in Section 23?

Measurement

3.7 Additional paragraphs have been added to the measurement requirements in Section 13 of the *IFRS for SMEs* Accounting Standard.

3.8 Inventories acquired through a donation are measured at fair value, in accordance with the requirements in Section 23 *Revenue* (see paragraph G13.7).

3.9 Guidance on measuring inventories held for distribution to service recipients or for the NPO's own use in delivering its objectives has been included. As discussed above (paragraph 1.4), two alternative approaches were proposed in the Consultation Paper – measuring the inventories at replacement cost or at cost, adjusted when applicable for any loss of service potential.

3.10 The proposed guidance (see paragraph G13.8) incorporates both of the alternatives. The wording is based on the text in a national standard.

3.11 Application Guidance has been included on measuring donated inventories at fair value (paragraphs AG13.3–AG13.5). This guidance is limited, as the Draft Third edition of the *IFRS for SMEs* Accounting Standard has introduced a new Section 12 *Fair value measurement*, which provides further guidance. This Section will be included in ED3 of INPAG. The Application Guidance permits NPOs to refer to the cost to the donor in determining fair value where there is no observable market.

3.12 Application Guidance has also been included on assessing the service potential of inventories when considering whether to recognise an impairment (paragraphs AG13.5–AG13.8). Illustrative examples have also been included to assist NPOs.

Question 4:	Do TAG members support the approach to measurement proposed by the Secretariat?

Cost formulas

3.13 As noted in paragraph 2.3(d) of this paper, one respondent proposed an additional cost formula (first expired, first out) as an option for perishable inventory (particularly where this is donated and may be near its expiry date).

3.14 The Secretariat considers that this approach might provide more representative information, as the fair value of donated inventories near their expiry date may be less than similar items with a longer life.

3.15 Conversely, the use of this method would require sophisticated inventory management systems that NPOs may not have available. In addition, NPOs may elect not to recognise the donated inventory, but to recognise revenue and an expense when the donated items are distributed or used.

3.16 There are therefore valid reasons for both including or excluding the additional cost formula. The TAG is asked for its views. To assist the TAG in its deliberations, Section 13 includes the text that the Secretariat propose to include if the TAG favours the inclusion of the first expired, first out cost formula (see paragraphs G13.22 and AG13.9–AG13.11).

Question 5:	Do TAG members support the inclusion of the first expired, first out cost formula?

Impairment

3.17 The impairment requirements (paragraph G13.23) have been amended to reflect the additional measurement requirements (discussed above in paragraphs 3.7–3.12 of this paper). In addition, proposals for the related proposed amendments to Section 27, *Impairment of assets* are included in Annex C.

Question 6:	Do the TAG members support the approach to impairment proposed by the Secretariat?

4. Next steps

4.1 Section 13 will be updated to reflect the comments of the TAG and be presented at the next meeting.

4.2 With the delay of ED2 until September there is an opportunity to now include Section 13 into ED2. The subject of inventories might more easily be considered at the same time as the topic on revenue given it addresses some of the same transactions. The implications of making this change are considered in TAGED12-05 on the non-priority topics.

May 2023

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Annex A: Detailed Responses to Specific Matters for Comment

Question	Response	Number	%	% Responded
SMC 6(a) Do you agree with the description of issue 6: Inventory held for use or distribution? If not, why not?	Agree	19	28%	90%
	Disagree	2	3%	10%
	Neither Agree Or Disagree	0	0%	0%
	Non Response	*48*	*70%*	
TOTAL		**69**	**100%**	**100%**
SMC 6(b) Do you agree that the list of alternative treatments that should be considered for issue 6 is exhaustive? If not, please describe your additional proposed alternatives, and explain why they should be considered.	Agree	17	25%	77%
	Disagree	5	7%	23%
	Neither Agree Or Disagree	0	0%	0%
	Non Response	*47*	*68%*	
TOTAL		**69**	**100%**	**100%**
SMC 6(c) Do you agree with the advantages and disadvantages articulated for each alternative accounting treatment for issue 6? If you do not agree, please set out the changes you propose, and why these should be made.	Agree	18	26%	95%
	Disagree	1	1%	5%
	Neither Agree Or Disagree	0	0%	0%
	Non Response	*50*	*72%*	
TOTAL		**69**	**100%**	**100%**

Question	Response	Number	%	% Responded
SMC 6(a) Please identify the alternative treatment that you favour for issue 6, and the reasons for your view.	Alternative 1	10	14%	56%
	Alternative 2	3	4%	17%
	Alternative 3	5	7%	28%
	Non Response	*51*	*74%*	
TOTAL		**69**	**100%**	**100%**

Annex B: First draft of Section 13 *Inventories*

Notice

Section 13 – Inventories Updated

Scope of this Section

G13.1 This section sets out the principles for recognising and measuring inventories. Inventories are assets:

a) held for sale in the ordinary course of ~~business~~ operations;

b) held for distribution to service recipients in the ordinary course of operations;

c) in the process of production for such sale or distribution; or

d) in the form of materials or supplies to be consumed in the production process or in the rendering of services.

G13.2 This section applies to all inventories, except:

a) financial instruments (see Section 11 *Financial Instruments*);~~ and~~

b) biological assets related to agricultural activity and agricultural produce at the point of harvest (see Section 34 *Specialised Activities* *[ED3]*)~~.~~; and

c) inventories to which an NPO elects to apply a permitted exception to the general recognition requirements (see paragraph G13.5).

G13.3 This section applies to the presentation and disclosure of refund assets held in inventory representing expected product returns. An NPO shall recognise and measure refund assets in accordance with paragraphs ~~23.51–23.57~~ G23.211–G23.217.

G13.4 This section does not apply to the measurement of inventories held by:

a) producers of agricultural and forest products, agricultural produce after harvest, and minerals and mineral products, to the extent that they are measured at fair value less costs to sell through surplus or deficit; or

b) commodity brokers and dealers that measure their inventories at fair value less costs to sell through surplus or deficit.

Recognition of inventories

G13.5 An NPO shall not recognise inventories where it has elected to apply one of the following permitted exceptions in respect of those inventories:

a) low value items donated to the NPO for resale, recognised as an asset and revenue when the items are sold in accordance with paragraph G23.46 b);

b) items donated to the NPO for distribution to service recipients or for the NPO's own use, recognised as revenue and an expense when the items are distributed or used in accordance with paragraph G23.47 b);

c) work-in-progress that comprises services in-kind donated to the NPO that are not recognised as revenue, an asset or an expense in accordance with paragraph G23.51 b); and

d) work-in-progress that comprises services to be provided for no or nominal consideration and the NPO elects to expense the costs as they are incurred.

Measurement of inventories

G13.6 An NPO shall measure inventories at the lower of cost and estimated selling price less costs to complete and sell, except where paragraph G13.7 and / or paragraph G13.8 applies.

G13.7 Where inventories are acquired through a donation, their cost shall be measured at fair value in accordance with paragraph G23.43.

G13.8 Inventories held for distribution at no or nominal consideration or for use by the NPO in delivering its objectives shall be measured at the lower of cost adjusted, for any loss of service potential and replacement cost.

Cost of inventories

G13.9 An NPO shall include in the cost of inventories all costs of purchase, costs of conversion and other costs incurred in bringing the inventories to their present location and condition.

Costs of purchase

G13.10 The costs of purchase of inventories comprise the purchase price, import duties and other taxes (other than those subsequently recoverable by the NPO from the taxing authorities) and transport, handling and other costs directly attributable to the acquisition of finished goods, materials and services. Trade discounts, rebates and other similar items are deducted in determining the costs of purchase.

G13.11 An NPO may purchase inventories on deferred settlement terms. In some cases, the arrangement effectively contains an unstated financing element, for example, a difference between the purchase price for normal credit terms and the deferred settlement amount. In these cases, the difference is recognised as interest expense over the period of the financing and is not added to the cost of the inventories.

Costs of conversion

G13.12 The costs of conversion of inventories include costs directly related to the units of production, such as direct labour. They also include a systematic allocation of fixed and variable production overheads that are incurred in converting materials into finished goods. Fixed production overheads are those indirect costs of production that remain relatively constant regardless of the volume of production, such as depreciation and maintenance of factory buildings and equipment, and the cost of factory management and administration. Variable production overheads are those indirect costs of production that vary directly, or nearly directly, with the volume of production, such as indirect materials and indirect labour.

Allocation of production overheads

G13.13 An NPO shall allocate fixed production overheads to the costs of conversion on the basis of the normal capacity of the production facilities. Normal capacity is the production expected to be achieved on average over a number of periods or seasons under normal circumstances, taking into account the loss of capacity resulting from planned maintenance. The actual level of production may be used if it approximates normal capacity. The amount of fixed overhead allocated to each unit of production is not increased as a consequence of low production or idle plant. Unallocated overheads are recognised as an expense in the period in which they are incurred. In periods of abnormally high production, the amount of fixed overhead allocated to each unit of production is decreased so that inventories are not measured above cost. Variable production overheads are allocated to each unit of production on the basis of the actual use of the production facilities.

Joint products and by-products

G13.14 A production process may result in more than one product being produced simultaneously. This is the case, for example, when joint products are produced or when there is a main product and a by-product. When the costs of raw materials or conversion of each product are not separately identifiable, an NPO shall allocate them between the products on a rational and consistent basis. The allocation may be based, for example, on the relative sales value of each product either at the stage in the production process when the products become separately identifiable or at the completion of production. Most by-products, by their nature, are immaterial. When this is the case, the NPO shall measure them at selling price less costs to complete and sell and deduct this amount from the cost of the main product. As a result, the carrying amount of the main product is not materially different from its cost.

Other costs included in inventories

G13.15 An NPO shall include other costs in the cost of inventories only to the extent that they are incurred in bringing the inventories to their present location and condition.

G13.16 Paragraph ~~11.67(b)~~ G11.76 b) requires that, in some circumstances, the change in the fair value of the hedging instrument in a hedge of fixed interest rate risk or commodity price risk of a commodity held adjusts the carrying amount of the commodity.

Costs excluded from inventories

G13.17 Examples of costs excluded from the cost of inventories and recognised as expenses in the period in which they are incurred are:

a) abnormal amounts of wasted materials, labour or other production costs;

b) storage costs, unless those costs are necessary during the production process before a further production stage;

c) administrative overheads that do not contribute to bringing inventories to their present location and condition; and

d) selling costs.

Cost of inventories of a service provider

G13.18 To the extent that service providers have inventories, they measure them at the costs of their production. These costs consist primarily of the labour and other costs of personnel directly engaged in providing the service, including supervisory personnel and attributable overheads. Labour and other costs relating to sales and general administrative personnel are not included but are recognised as expenses in the period in which they are incurred. The cost of inventories of a service provider does not include profit margins or non-attributable overheads that are often factored into prices charged by service providers.

Cost of agricultural produce harvested from biological assets

G13.19 Section 34 requires that inventories comprising agricultural produce that an NPO has harvested from its biological assets shall be measured on initial recognition at their fair value less estimated costs to sell at the point of harvest. This becomes the cost of the inventories at that date for application of this section.

Techniques for measuring cost, such as standard costing, retail method and most recent purchase price of purchased or produced inventory

G13.20 An NPO may use techniques such as the standard cost method, the retail method or most recent purchase price for measuring the cost of inventories if the result approximates cost. Standard costs take into account normal levels of materials and supplies, labour, efficiency and capacity utilisation. They are regularly reviewed and, if necessary, revised in the light of current conditions. The retail method measures cost by reducing the sales value of the inventory by the appropriate percentage gross margin.

Cost formulas

G13.21 An NPO shall measure the cost of inventories of items that are not ordinarily interchangeable and goods or services produced and segregated for specific projects by using specific identification of their individual costs.

G13.22 An NPO shall measure the value of inventories, other than those dealt with in paragraph ~~13.17~~ G13.21, by using the first-in, first-out (FIFO), ~~or~~ weighted average or first expired, first out (FEFO) cost formula. The FEFO cost formula may only be used for perishable inventories. An NPO shall use the same cost formula for all inventories having a similar nature and use to the NPO. For inventories with a different nature or use, different cost formulas may be justified. The last-in, first-out method (LIFO) is not permitted by INPAG.

Impairment of inventories

G13.23 Paragraphs G27.2–G27.4 require an NPO to assess at the end of each reporting period whether any inventories are impaired, ie the carrying amount is not fully recoverable (for example, because of damage, obsolescence or declining selling prices). If an item (or group of items) of inventory is impaired, those paragraphs require the NPO to measure the inventory at its selling price less costs to complete and sell (or, for inventories held for distribution at no or nominal consideration or for use by the NPO in delivering its objectives, the cost adjusted for any loss of service potential or replacement cost) and to recognise an impairment loss. Those paragraphs also require a reversal of a prior impairment in some circumstances.

Recognition as an expense

G13.24 When inventories are sold, distributed to service recipients or used by the NPO, the NPO shall recognise the carrying amount of those inventories as an expense in the period in which the related revenue is recognised.

G13.25 Some inventories may be allocated to other asset accounts, for example, inventory used as a component of self-constructed property, plant or equipment.

Inventories allocated to another asset in this way are accounted for subsequently in accordance with the section of INPAG relevant to that type of asset.

Disclosures

G13.26 An NPO shall disclose the following:

a) the accounting policies adopted in measuring inventories, including the cost formula used;
b) the total carrying amount of inventories and the carrying amount in classifications appropriate to the NPO;
c) the amount of inventories recognised as an expense during the period;
d) impairment losses recognised or reversed in surplus or deficit in accordance with Section 27 *Impairment of assets*;
e) a description of any inventories not recognised because they do not meet the recognition criteria due to the NPO being unable to reliably measure the inventories; and
f) the total carrying amount of inventories pledged as security for liabilities.

G13.27 If an NPO elects to use the permitted exceptions in paragraph G13.5, the NPO shall disclose which permitted exception or exceptions have been used and provide an explanation of why the NPO has elected to use the permitted exception(s).

Application Guidance: Section 13 – Inventories

Reliable measurement

AG13.1 Paragraph G2.86 states that for an asset to be recognised, it must be measured. Where an asset cannot be reliably measured, it is not recognised.

AG13.2 There may be some circumstances where an NPO is unable to reliably measure inventories For example, where an NPO responding to an emergency receives large volumes of donated items and distributes them almost immediately. In these circumstances it will not be possible for the NPO to apply a permitted exception (see paragraph G13.5) to those inventories as it will not be possible to reliably measure the revenue and expense that are required to be recognised when the items are used or distributed (see paragraph G23.47 b)). In these circumstances the NPO shall not recognise inventories in respect of these donated items, but shall make the disclosure required by paragraph G13.26 e).

Measurement

Fair value

AG13.3 Guidance in determining fair value is found in Section 12 *Fair Value Measurement [ED3]*.

AG13.4 Where there is a market for the items received as donated inventories, the NPO shall determine fair value by reference to the price in the market.

AG13.5 Where there is no market for the items received as donated inventories, the NPO will need to determine the fair value using another valuation technique. In addition to the valuation techniques set out in paragraph 12.15, the NPO may determine fair value by reference to the cost to the donor where this is known.

Loss of service potential

AG13.6 Where recognised, after initial recognition, the measurement of inventories held for distribution at no or nominal consideration or for use by the NPO in delivering its objectives takes into account any loss of service potential.

AG13.7 The service potential of the inventories takes into account the current age, functionality, and condition of the inventories held by the NPO.

AG13.8 In order to reflect the current age, functionality, and condition, the following factors are considered:

a) Physical obsolescence - this relates to any loss of service potential due to the physical deterioration of the inventories resulting from physical damage or age.
b) Functional obsolescence - this relates to any loss of service potential resulting from inefficiencies in the inventories that is being valued compared with its modern equivalent.
c) Economic obsolescence – this relates to any loss of utility caused by economic or other factors outside the control of the NPO.

Perishable inventories

AG13.9 Paragraph G13.22 permits the use of the first expired, first out cost formula for perishable inventories such as food or medical supplies.

AG13.10 In applying the FEFO cost formula, an NPO shall:

a) Recognise purchased inventories at cost; and

b) recognise donated inventories at fair value in accordance with paragraph G13.7. Where inventories are recognised at fair value, that fair value shall reflect the expiration date(s) of those inventories.

c) When inventories are issued, reduce the carrying amount of the inventories in order of the expiration dates of the inventories.

AG13.11 In assessing perishable inventories for impairment, the selling price less costs to complete and sell, the cost adjusted, for any loss of service potential or the replacement cost used shall reflect the expiration date of the inventories.

Illustrative Examples: Section 13 – Inventories

Assessing loss of service potential

Example 1 – loss of service potential due to physical obsolescence

An NPO operates a food bank. The NPO purchases items of food to be included in food parcels, and also receives donations of food from supermarkets and individuals. Both purchased and donated items are recognised as inventory. Because the donations it receives are unpredictable, it may have a surplus of certain items of food.

These items of food may become limited in their use and so suffer a loss of service potential due to their age as they approach their expiry date. If the NPO has more items than are required for the food parcels, the NPO may have to either sell the items at a discount or dispose of them once the expiry date has passed.

At the reporting date, the NPO will assess whether any inventories have suffered a loss of service potential. The NPO estimates the amount of the inventories that it will not be able to use in the food parcels, and adjusts the carrying amount of the inventories by this amount, taking account of any expected sales proceeds, and recognises a corresponding expense.

Example 2 – loss of service potential due to functional obsolescence

An NPO operates a medical clinic. Its inventories include a stock of a drug that is used to treat a respiratory disease. A number of doses of the drug are required to successfully treat the disease.

A new drug is developed that will successfully treat the disease with a single dose. The inventories of the drug held by the NPO may suffer a loss of service potential due to functional obsolescence. This will be the case if the cost of treating patients with the new drug is less than the cost of treating patients with the existing drug.

At the reporting date, the NPO will assess whether any inventories have suffered a loss of service potential. The NPO estimates the amount it would cost to replace its inventories of the existing drug with the amount of the new drug required to treat the same number of patients. If this is less than the carrying amount of the inventories of the existing drug, the NPO adjusts the carrying amount of the inventories downward to the estimated cost of the amount of the new drug required to treat the same number of patients, and recognises a corresponding expense.

Example 3 – loss of service potential due to economic obsolescence

An NPO that has the objective of helping long-term unemployed people find work runs courses on interview preparation. The NPO has prepared course materials that are provided to all participants, and has sufficient stock for the expected life of the current course.

The courses are subsidised by the government, and as a result the NPO is able to offer the courses for no charge.

As a result of a change of government policy, the courses are no longer subsidised by the government. The NPO has insufficient resources to cover all the costs itself, and introduces a small charge for the courses to cover the cost of hiring the venue and providing lunch.

Because of the introduction of the small charge, the number of participants reduces, and the NPO runs the courses less frequently. As a result, it is likely that the NPO may not be able to use all of the course materials.

At the reporting date, the NPO will assess whether any inventories have suffered a loss of service potential. The NPO estimates the amount of the course materials that it will not be able to use before the course needs to be redeveloped. The NPO adjusts the carrying amount of the inventories of course materials in proportion to the amount it estimates will be unused, and recognises a corresponding expense.

Basis for Conclusions: Section 13 – Inventories

Consultation Paper – issues identified and approaches

BC13.1 The recognition and initial measurement of purchased or self-produced inventories does not give rise to any NPO-specific issues, and no changes to the *IFRS for SMEs* Accounting Standard requirements were proposed in the Consultation Paper.

BC13.2 The Consultation Paper did identify specific issues in respect of:

- The recognition and initial measurement of donated inventories, particularly those donated for resale or for distribution to service recipients;
- The recognition and initial measurement of work-in-progress of services to be provided for no or nominal consideration to service recipients; and
- The subsequent measurement of inventories held for distribution to service recipients or for use by the NPO in meeting it objectives.

BC13.3 The Consultation Paper also identified issues regarding the recognition of revenue in respect of donated inventories, and proposed exceptions permitting NPOs not to recognise revenue and inventories on receipt of the donated items, but to recognise revenue and either an asset or an expense when the items are sold, distributed to service recipients or used by the NPO.

BC13.4 Respondents to the Consultation Paper supported the proposed permitted exceptions to the recognition and measurement of revenue from donated items, including donated inventories. Detailed proposals were included in Sections 23 *Revenue*. Section 13 reflects the adjustments to the requirements of the *IFRS for SMEs* Accounting Standard required to ensure the accounting for inventories and revenue is consistent. Changes to Section 13 may be required if the proposals in Section 23 are modified as a result of stakeholders' comments.

BC13.5 Respondents were supportive of the description of the issue. They provided some additional considerations that needed to be considered in developing the guidance. These included:

- Specific issues regarding donated inventory; these have mainly been addressed by Section 23 *Revenue*; and
- The subsequent measurement of perishable inventories, particularly where these are donated.

Reliable measurement

BC13.6 Some respondents to the Consultation Paper commented that NPOs may face practical issues in measuring inventories in some circumstances. An example provided was an NPO responding to an emergency that receives large volumes of donated inventories and distributes them almost immediately. The Secretariat agreed to include Application Guidance on reliable measurement that addresses this issue, and to require an NPO to provide a narrative description of such inventory.

BC13.7 The Secretariat noted that NPOs in these circumstances could elect to apply the permitted exception to not recognise inventories. However, this exception would require that a revenue and an expense is recognised when the inventory is distributed. The Secretariat agreed that in this scenario the inability to reliably measure the donations would mean that as well as not recognising inventory, a revenue and expense would also not be recognised. This is addressed by similar guidance in Section 23. The inclusion of a narrative description is intended to provide transparency of such circumstances.

Recognition and initial measurement

BC13.8 The proposals in Section 23 to allow NPOs to not recognise inventories for many donated items will address most of the concerns about the initial recognition and measurement of donated items. Section 13 states that an NPO taking advantage of these permitted exceptions should not recognise inventories in respect of the donated items.

BC13.9 Respondents to the Consultation Paper also supported permitting NPOs to expense work-in-progress on services, such as legal casework, to be provided at no or nominal cost. There was concern that some NPOs would not have the systems in place to reliably measure the work-in-progress. Section 13 provides a permitted exception that allows NPOs to expense the work-in-progress as the costs are incurred, rather than to recognise inventories. A requirement for all NPOs to expense work-in-progress on services would support greater comparability. A permitted exception rather than a requirement to expense the work-in-progress is proposed as such work-in-progress may be material to some NPOs.

BC13.10 Some respondents emphasised the importance of disclosures if items of inventory were not to be recognised. The Secretariat agreed with these comments, and NPOs that elect to apply any of the permitted exceptions are required to disclose that fact. This will provide users with useful information that will help them understand the NPO's financial statements.

BC13.11 Some respondents noted that additional guidance on determining fair value where an NPO does recognise donated items of inventory would be needed. The draft

Third edition of the *IFRS for SMEs* Accounting Standard includes a new Section 12 *Fair value measurement* covering this topic. Additional Application Guidance has been provided in Section 13 that where there is no market, the cost to the donor can be used in estimating fair value.

Subsequent measurement of inventories held for distribution to service recipients or for use by the NPO in delivering it is objectives

BC13.12 The *IFRS for SMEs* Accounting Standard requires inventories to be subsequently measured at the lower of cost and estimated selling price less costs to complete and sell,

BC13.13 Measuring inventories by reference to their selling price may not be appropriate for inventories that will not generate future cash flows. The Consultation Paper proposed two alternatives to this treatment in the *IFRS for SMEs* Accounting Standard:

- such inventory would be measured at the lower of cost or current replacement cost; or
- such inventory would be measured at cost, adjusted for any loss of service potential.

BC13.14 There was support for both approaches, although a number of respondents expressed concern that it may not always be possible to identify as replacement cost, particularly for some donated items. Other respondents noted that assessing any loss of service potential could be subjective.

BC13.15 Section 13 requires an NPO to measure inventories held for use or distribution to be measured at the lower of cost adjusted for any loss of service potential and replacement cost. This will allow NPOs to reliably measure inventories that may be impaired even if a replacement cost is not available. Additional Application Guidance on assessing a loss of service potential has been provided.

Cost Formulas

BC13.16 The *IFRS for SMEs* Accounting Standard permits the use of two cost formulas, the first in, first out (FIFO) formula or the weighted average cost formula. One respondent to the Consultation Paper suggested that a third formula, first expired, first out (FEFO) would be more appropriate for NPOs who received donations of perishable items such as food or medical supplies.

BC13.17 The Secretariat agreed that for practical purposes, inventories would need to be managed in this manner to maximise the benefits obtained from the donations. The

Secretariat also agreed that this could affect the valuation of the inventories, as the expiry date could be a factor in determining the fair value of the inventory.

BC13.18 Consequently, the Secretariat agreed to include the FEFO formula as an option for perishable stock, as this would be relevant for a number of NPOs. In coming to this decision, the Secretariat acknowledged that NPOs may elect not to recognise such inventories, but considered that for those NPOs that did recognise such inventories, the inclusion of the additional formula would be helpful.

Impairment

BC13.19 Section 27 *Impairment* requires inventories to be impaired when the carrying amount will not be fully recoverable. The *IFRS for SMEs* Accounting Standard requires a comparison between the carrying amount and the selling price less costs to complete and sell when determining whether inventories are impaired.

BC13.20 As discussed in paragraphs BC13.12–BC13.15, Section 13 has introduced an alternative measurement for inventories that will not be sold. Consequently, the impairment requirements in both Section 13 and Section 27 have been amended; impairment of inventories held for distribution or use by the NPO in delivering its objectives are assessed by reference to the cost adjusted for any loss of service potential or replacement cost.

Annex C: Consequential Amendments to Section 27 *Impairment of assets*

Impairment of inventories

Selling price less costs to complete and sell, cost adjusted for any loss of service potential or replacement cost

G27.2 An NPO shall assess at each reporting date whether any inventories are impaired. The NPO shall make the assessment by comparing the carrying amount of each item of inventory (or group of similar items—see paragraph ~~27.3~~ G27.3) with its selling price less costs to complete and sell (or, for inventories held for distribution at no or nominal consideration, its cost adjusted for any loss of service potential, or its replacement cost). If an item of inventory (or group of similar items) is impaired, the NPO shall reduce the carrying amount of the inventory (or the group) to its selling price less costs to complete and sell (or its cost adjusted, when applicable, for any loss of service potential, or its replacement cost). That reduction is an impairment loss and it is recognised immediately in surplus or deficit.

G27.3 If it is impracticable to determine the selling price less costs to complete and sell (or, for inventories held for distribution at no or nominal consideration, the cost adjusted, when applicable, for any loss of service potential, or the replacement cost) for inventories item by item, the NPO may group items of inventory relating to the same product line that have similar purposes or end uses and are produced and, where relevant, marketed in the same geographical area for the purpose of assessing impairment.

Reversal of impairment

G27.4 An NPO shall make a new assessment of selling price less costs to complete and sell (or, for inventories held for distribution at no or nominal consideration, cost adjusted for any loss of service potential, or replacement cost) at each subsequent reporting date. When the circumstances that previously caused inventories to be impaired no longer exist or when there is clear evidence of an increase in selling price less costs to complete and sell (or cost adjusted for any loss of service potential, or replacement cost) because of changed economic circumstances, the NPO shall reverse the amount of the impairment (ie the reversal is limited to the amount of the original impairment loss) so that the new carrying amount is the lower of the cost and the revised selling price less costs to complete and sell (or cost adjusted for any loss of service potential, or replacement cost).