Guidance on Likely Impacts of COVID-19 for Inventories

1. Purpose

This guidance has been developed by NSW Treasury to provide some insight on the key accounting implications for *inventories held for distribution* in light of the recent COVID-19 outbreak. It aims to assist agencies in assessing the impact of COVID-19 on estimates and disclosures for inventories when preparing financial statements for the year ended 30 June 2020.

This guidance identifies considerations arising from COVID-19. The guidance therefore only provides a brief summary of the requirements in AASB 102 *Inventories* (AASB 102), and agencies should refer to AASB 102 when determining impairment of inventories.

2. Accounting Principles - AASB 102 Inventories key extracts

Measurement of Inventories - General

AASB 102 requires inventories (other than those held for distribution) to be measured at the lower of cost and net realisable value [AASB 102 para 9]. Net realisable value (NRV) is the estimated selling price in the ordinary course of business, less the estimated costs of completion and the estimated costs necessary to make the sale [AASB 102 para 6].

Measurement of Inventories – Held for Distribution

However, not-for-profit entities often hold inventories whose future economic benefits or service potential are not directly related to their ability to generate net cash inflows. These types of inventories may arise when an entity has determined to distribute certain goods at no charge or for a nominal amount. Therefore, AASB 102 has different measurement requirements for inventories held for distribution.

Under AASB 102, not-for-profit entities measure *inventories held for distribution* at cost, adjusted when applicable for any loss of service potential [AASB 102 para Aus9.1]. Different bases may apply in determining whether there has been a loss of service potential and the measurement of that loss, for different types of inventories held for distribution [AASB 102 para Aus9.2].

Paragraph Aus6.1 defines *inventories held for distribution* as assets:

(a) held for distribution at no or nominal consideration in the ordinary course of operations;
(b) in the process of production for distribution at no or nominal consideration in the ordinary course of operations; or
(c) in the form of materials or supplies to be consumed in the production process or in the rendering of services at no or nominal consideration.

The impairment principle in AASB 102 can be summarised as:

- inventories held for distribution: where there is a loss of service potential, adjust for the loss of service potential.
- inventories other than those hold for distribution: where NRV is below cost, write down to NRV.

Identifying whether there has been a loss of service potential requires judgement, in the circumstances. The amount of an adjustment for a loss of service potential will also depend on the particular inventories. However, this would typically be by reference to either the current replacement cost at balance date, or measuring a loss in service capacity due to obsolescence [AASB 102 para Aus9.2]. Current replacement cost is the cost the entity would incur to acquire the asset at the end of the reporting period [AASB 102 para Aus6.1].

3. Guidance on Applying AASB 102 to Inventories Held for Distribution

3.1. Why is more attention needed now?

Governments' responses to COVID-19 and the changed economic environment, as well as recent natural disasters will require agencies to carefully consider the carrying value of inventories held for distribution in certain circumstances, potentially including:

- Inventories purchased during periods of high demand, at costs higher than those applicable at the reporting date.
- Inventories purchased for a specific policy response, that are surplus at the reporting date.
- Inventories that are no longer technologically the most advanced and have been superseded.

3.2. What are inventories held for distribution?

A not-for-profit agency may hold inventories whose future economic benefits or service potential are not directly related to their ability to generate net cash inflows.

For example, a State's Health Department may hold stores of medicines or surgical supplies that are distributed to local health districts, either free of charge or for a fraction of their cost (subsidised cost). These types of stores would be classified as inventories held for distribution.

Agencies should use professional judgement in determining which inventories should be classified as held for distribution. However, the following factors might indicate that inventories are held for distribution:

- Inventories the agency does not plan to sell for greater than cost;
- Inventories used in the delivery of services at no or nominal cost.

3.3. Potential impairment of inventories held for distribution

Inventories held for distribution should be measured at cost, adjusted when applicable for any loss of service potential [AASB 102 para Aus9.1]. A loss of service potential can be identified and measured based on the following :

(a) current replacement cost, where lower than the original acquisition cost or subsequent carrying amount; or

(b) any loss of operating capacity due to obsolescence (the obsolescence covers both 'technical obsolescence'[1] and 'functional obsolescence'[2]).

[1] 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 [AASB 102 BC15].

[2] Functional obsolescence occurs when an item no longer functions the way it did when it was first acquired [AASB 102 BC15].

Current replacement cost (CRC) focuses on financial values and is generally defined as the cost to replace the asset with its modern equivalent. Using CRC to measure inventories held for distribution is emulating the use of NRV for other inventories. Comparing CRC to the carrying value of inventories, can be an indicator of a loss of service potential.

Obsolescence relates to the functional and technical capacity of the inventories. Functional obsolescence can occur when the inventories no longer function as intended. e.g. damaged or expired etc. Technical obsolescence occurs in inventories that still operate as intended, but have been superseded by new technology.

Therefore, CRC and loss of service potential are not always aligned. For instance:

- Inventories may have impaired service potential, because they no longer operate as intended, but the CRC of a modern equivalent asset would not reflect that impairment; or
- CRC at the reporting date may be lower than the original cost of inventories, but there has been no loss of service potential, because those assets will still provide the services as intended.

Tip

Agencies should carefully consider the appropriate basis for measuring the service potential of inventories held for distribution. The concepts of current replacement cost and obsolescence through loss of operating capacity are closely linked. In most instances, agencies will need to consider whether CRC reflects a decline in service potential, before assessing a potential loss of operating capacity due to obsolescence.

For instance, in the following example, if the CRC at 30 June 2020 has fallen as far as $0.50 and the agency holds 9,000 units, management should consider whether this is evidence of a loss of service potential. Factors to consider could include whether:

- The amount of those items in stock will not be consumed for an extended period;
- The item is likely to be superseded or expire before it is consumed; or
- A more efficient or effective alternative exists in the market.

Example 1: CRC not aligned with service potential

In response to the outbreak of COVID-19, a State's health department purchased 10,000 units of surgical supplies in April at $10 each. By 30 June 2020, the current replacement cost of the same type of product has dropped to $7 each and the department held 3,000 units.

Management first considered whether the change in current replacement cost to $7 each, reflected a loss of service potential for that particular item. This included considering:

- The extent the current replacement cost reflects changes in demand, that correspond to a decline in the rate at which these units will be consumed;
- The likelihood the item will be superseded or expire before stocks are consumed; and
- Whether a more efficient or effective item could now be purchased to replace the service potential.

Management determined the department plans to use the remaining 3,000 units in a relatively short time period, well before expiry, and there is no available alternative that is more efficient or effective nor a likelihood of an alternative being on the market in the foreseeable future.

Based on the above, management next considered whether there is any obsolescence due to a loss of operating capacity. Management determined that the surgical supplies remain functional, are the most modern products available, and there is expected demand for the quantity of supplies held. Therefore, there is no loss of service potential, due to a loss in operating capacity.

The inventories carrying amount at 30 June is its original cost of $10 each.

4. Potential Impairment of Other Inventories

Agencies are required measure inventories other than those held for distribution, at the lower of cost or NRV.

Due to COVID-19, agencies may experience reduced demand for certain inventories. Agencies should consider whether the value of their existing inventory has deteriorated and assess if any additional provision for obsolescence is required. Perishables, products with short shelf lives or expiration dates, or specific seasonal inventories are at the most risk of an impairment.

Where agencies produce their own inventories and declines in demand or lockdown measures have reduced production volumes, agencies should review the allocation of fixed overheads to inventory costs. AASB 102 para 13 requires fixed production overheads to be included in the cost of inventory based on normal production capacity. The amount of fixed overhead allocated to inventory is not increased as a result of low production volumes. Consequently, reduced production will result in unabsorbed fixed overheads which will be charged to the income statement in the period in which they are incurred.

5. Impairment disclosures

Agencies should refer to AASB 102 for the full disclosure requirements. However, the following requirements relate to inventory write-downs:

- the amount of any write-down of inventories recognised as an expense in the period [AASB 102 para 36];
- the amount of any write-down of inventories held for distribution recognised as an expense in the period [AASB 102 para Aus36.1]; and
- the basis on which any loss of service potential of inventories held for distribution is assessed, or the bases when more than one basis is used [AASB 102 para Aus36.1].

Determining the appropriate measurement for inventories requires professional judgement and the use of estimation techniques. In the current environment, management should consider providing additional disclosures about key assumptions and critical estimates, including sources of estimation uncertainty. Refer to AASB 101 *Presentation of Financial Statements*, in particular paras. 122 and 125.