# FASB Simplifies Inventory Guidance

On July 22, 2015, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) 2015-11, *Inventory* (Topic 330): *Simplifying the Measurement of Inventory*. The standard simplifies the current "lower of cost or market" test by eliminating the multiple measures of "market." Inventory would be measured as the lower of cost or net realizable value (NRV). NRV retains its current definition, "estimated selling price in the ordinary course of business, less reasonably predictable costs of completion, disposal, and transportation." This change more closely aligns U.S. generally accepted accounting principles (GAAP) and International Financial Reporting Standards.

The ASU excludes inventory measured using the last-in, first-out and retail inventory methods; entities using those methods would continue applying their existing impairment models.

For public business entities, the guidance is effective for interim and annual periods beginning after December 15, 2016. For all other entities, the guidance is effective for annual periods beginning after December 15, 2016, and for interim periods within fiscal years beginning after December 15, 2017. The guidance would be applied prospectively. Early adoption is permitted as of the ASU's issuance date, so entities can take advantage of the simplifications as soon as possible. Entities must disclose the nature of and reason for the change in accounting principle in the first interim and annual period of adoption.

Current GAAP requires entities to measure inventory at the lower of cost or market, where market could be NRV (ceiling), replacement cost or NRV less a normal profit margin (floor). The ASU eliminates existing requirements to consider the replacement cost of inventory and the NRV less a normal profit margin, as noted in the table below:

| **Inventory Measurement – Lower of Cost or Market** | |
|---|---|
| Current U.S. GAAP | New Model |
| ▪ NRV<br>▪ Replacement cost<br>▪ NRV less normal margin | ▪ NRV |

The standard does not change any other aspects of the accounting for inventory; it addresses only the measurement of inventory if its value declines or is impaired. Entities would continue to apply average cost, first-in, first-out, etc., to determine the cost of inventory; they then would compare that to NRV to determine if an inventory write-down is necessary. Entities would recognize the difference as a loss in earnings in the period in which it occurs. Entities would apply the ASU at the inventory level, *e.g.*, individual item, category or total, most clearly reflective of periodic income, based on the inventory's character and composition, consistent with current U.S. GAAP.

***Example***

*A distributor of home appliances purchases 100 ovens for $200 per unit in November 2014, all of which are held in inventory as of December 31, 2014. Prior to year-end, the manufacturer issues a permanent price reduction to $175 per unit. Originally, the distributor listed the ovens at a selling price of $250, but the manufacturer's price reduction led the distributors to match competitor pricing and reduced the price to $220. Assume no cost of completion, disposal or transportation. The table below demonstrates the change in accounting.*

| **Example – Inventory Cost $200** | |
|---|---|
| Current U.S. GAAP | New Model |
| Market:<br>▪ NRV - $220 (new expected selling price)<br>▪ Replacement cost - $175<br>▪ NRV less normal margin - $175<br>$220 - $175 = $45 normal profit<br>$45/$220 = 20.5% normal profit %<br>20.5% * $220 = $45<br>$220 - $45= $175 | Market:<br>▪ NRV - $220 |
| **Conclusion** – Since the replacement cost of $175 is between the upper limit of $220 and the lower limit of $175, it is used as the market value of the inventory; a lower of cost or market adjustment of $25 per unit is recorded | **Conclusion** – Inventory will be valued at $200, which is the lower of cost or NRV; no adjustment is recorded to the inventory |

To learn more, contact your BKD advisor.

## Contributor

Anne Coughlan
Director
317.383.4000
acoughlan@bkd.com