
Interpretation of Federal Financial Accounting Standards 7: Items Held for Remanufacture

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Introduction

Purpose

1. Current standards do not provide specific guidance to assist preparers and auditors in the classification, valuation and reporting of items that are in the process of major overhaul or remanufacture for sale or for internal use. This Interpretation identifies acceptable options for classification, valuation and reporting by applying existing standards, in particular Statement of Federal Financial Accounting Standards (SFFAS) 3, *Accounting for Inventory and Related Property*.

Scope

2. This Interpretation applies to reparable parts and subassemblies that are in the process of (or awaiting) inspection, disassembly, evaluation, cleaning, rebuilding, refurbishing and/or restoration to serviceable or technologically updated/upgraded condition. This Interpretation addresses remanufacturing activity for items intended for sale or for internal use. Items held for remanufacture may consist of direct materials (including repairable parts and subassemblies, also referred to as “carcasses” at the Department of Defense (DoD)), and work-in-process where products are restored to serviceable condition and/or improved/upgraded condition for sale or internal use.
3. Long-lasting spare parts were not specifically addressed in SFFAS 3. It is not the intent of this Interpretation to imply that long-term spare parts for issuance without reimbursement should or should not be classified as Operating Materials and Supplies.

Exclusion

4. This Interpretation does not apply to stand-alone items such as entire airplanes, ships, tanks, intercontinental ballistic missiles (ICBMs) or other higher assemblies that function independently.

Materiality

5. The provisions of this Interpretation need not be applied to immaterial items.

Effective Date

6. This Interpretation is effective upon issuance.

Interpretation

Definitions

7. Items "**held for remanufacture**"¹ are in the process of (or awaiting) inspection,² disassembly, evaluation, cleaning, rebuilding, refurbishing and/or restoration to serviceable or technologically updated/upgraded condition. Items held for remanufacture may consist of:
- Direct materials, (including repairable parts or subassemblies, also referred to as "carcasses" at the DoD) and
 - Work-in-process (including labor costs) related to the process of major overhaul, where products are restored to "good-as-new" condition and/or improved/upgraded condition.
8. "Items held for remanufacture" share characteristics with "items held for repair" and items in the process of production and may be aggregated with either class. Management should use judgment to determine a reasonable, consistent and cost-effective manner to classify processes as "repair" or "remanufacture."
9. Items held for remanufacture may be intended for sale (placed in **inventory** held for sale upon completion of remanufacture) or for internal use (issued to a user within the same reporting entity upon completion of remanufacture).

¹Terms appearing for the first time in **bold** are defined in the Glossary, Appendix D of this document.

²The process of inspection may include holding an item until an inspection can be done.

Recognition and Measurement

Items Intended for Sale (Inventory)

10. Inventory items intended for sale that are held for remanufacture may be valued in accordance with either paragraphs 20-22 or paragraphs 32-33 of SFFAS 3.³ For example, paragraph 21 states that “Historical cost shall include all appropriate purchase, transportation and production costs incurred to bring the items to their current condition and location.” Applied to reparable parts and subassemblies returned for credit in the purchase of a serviceable item, historical cost would be the credit, if any, issued to the customer who returned the item to be repaired and any identifiable and chargeable transportation and handling costs. Regardless of the method used, reparable items returned by customers should be initially valued at less than the value of new or fully remanufactured items with similar features and useful lives. As the inspection and remanufacture process takes place, appropriate “production costs” would include normal costs to bring the item to serviceable or upgraded condition.
11. “Abnormal costs” to be excluded would include any costs that are in excess of the cost to purchase and place in service a new item with similar features and useful life. For items that are no longer available on the open market, or which are being upgraded, management should use judgment in determining normal and reasonable costs to be capitalized.
12. Inventory items held for remanufacture share characteristics with inventory held for repair and items in production for sale (direct materials and work-in process) and may be aggregated with either class of items for reporting purposes.

Items Not Intended for Sale (Operating Materials and Supplies)

13. Items held for remanufacture that meet the definition of **Operating Materials and Supplies**, if significant, may be recognized as a category of operating materials and supplies and valued in accordance with paragraphs 32-33 or paragraphs 42-44 of SFFAS 3.
14. Items held for remanufacture that meet the definition of Operating Materials and Supplies should be initially valued at less than the value of new or fully remanufactured items. As the inspection and remanufacture process takes place, appropriate “production costs” would

³ The paragraphs of SFFAS 3 that are cited in this document are displayed in Appendix C.

include normal costs to bring the item to serviceable or upgraded condition. Abnormal costs to be excluded would include any costs in excess of the cost to obtain and place in service a new item with similar features and useful life. The allowance or direct methods may also reasonably be applied to operating materials and supplies.

Disclosure Requirements

Component Entity Report Disclosures

15. The disclosures for inventory items held for remanufacture should conform with paragraph 35 of SFFAS 3.
16. The disclosures for items held for remanufacture that meet the definition of Operating Materials and Supplies should be in accordance with the requirements of paragraph 50 of SFFAS 3. If significant, Operating Materials and Supplies held for remanufacture may be disclosed as a separate category.

Financial Report of the U.S. Government Disclosures

17. For the Financial Report of the U.S. Government, there is no provision for valuation or recognition that is different from requirements for the component level.

The provisions of this Interpretation need not be applied to immaterial items.
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Appendix A: Basis for Conclusions

This appendix discusses some factors considered significant by members in reaching the conclusions in this Interpretation. It includes reasons for accepting certain approaches and rejecting others. Individual members gave greater weight to some factors than to others.

Project History

- A1. Accounting for the federal government's physical assets that are held as inventory or as operating materials and supplies is complex and has been addressed in numerous FASAB Standards.⁴ The Board continues to address issues as they arise. In March of 2006, the Department of Defense (DoD) Deputy Chief Financial Officer sent a letter to the Board (see Appendix D) requesting specific guidance for items held for remanufacture.
- A2. The DoD requested that SFFAS 3 be amended to provide standards for inventory held for remanufacture. The DoD noted that the category of inventory "held for repair" is not defined in the standards, and that the valuation methods for "held for repair" in paragraphs 32-33 of SFFAS 3 are not cost effective to apply to items held for remanufacture within the moving average cost method, since the moving average cost of a serviceable item changes continually.

Outreach Activities

- A3. FASAB published the ED on August 1, 2006. Upon release of the ED, notices and/or press releases were provided to: the Federal Register, the FASAB News, the *Journal of Accountancy*, *AGA Today*, the *CPA Journal*, *Government Executive*, the *CPA Letter*, *Government Accounting and Auditing Update*, the CFO Council, the Financial Statement Audit Network, the Federal Financial Managers Council, and committees of professional associations generally commenting on exposure drafts in the past. During the comment period, FASAB staff also contacted agencies that were likely to have remanufacturing activity to ensure that they were aware of the ED's scope and comment period. FASAB staff also met with representatives of agencies with significant remanufacture activities.

⁴ Inventory: see SFFAS 3; Property Plant & Equipment: see SFFAS 6, amended by SFFAS 10, 14, 16 and 23.

A4. Six written comments were received from the following sources:

Source of comments	Federal (Internal)	Non-Federal (External)
Users, academics, others		1
Auditors	1	
Preparers and financial managers	4	

A5. Among the issues identified by respondents were: items meeting the definition of Property, Plant and Equipment; inconsistent use of numerous acceptable methodologies within an agency; and the difficulty of distinguishing between routine maintenance and minor repair versus remanufacture.

Property, Plant and Equipment

- A6. Paragraph 12 of the Exposure Draft stated that “Parts and subassemblies held for remanufacture that are intended for use, rather than sale, and which meet the definition of Property, Plant and Equipment, should be recognized as a category in Property, Plant and Equipment and should be valued in accordance with SFFAS 6, as amended.”
- A7. More than one respondent objected to this paragraph, stating that it implied that such items should be classified and depreciated as Property, Plant and Equipment and that it would be costly to change the accounting for such items. The respondents noted that the request for guidance focused on (a) the issue that existing FASAB standards do not recognize the existence of Operating Materials and Supplies held for repair or remanufacture, and (b) existing standards imply that only the direct or allowance methods, and not historical cost, are acceptable valuation methods. Accordingly, the scope of the Interpretation has been reduced to address only Inventory and Operating Materials and Supplies that are in the process of repair or remanufacture.

Inconsistent Practice within Agencies

- A8. One respondent noted that there are inconsistent accounting practices within an agency, and that the proposed Interpretation, which points out numerous acceptable options, might exacerbate this problem.

A9. Selecting among acceptable valuation methods and establishing uniformity throughout a reporting entity is a management responsibility. The purpose of the Interpretation is to point out acceptable methods, rather than to make selections on behalf of agencies.

Definition and Exclusions

A10. This Interpretation is limited to reparable parts and subassemblies, which are not specifically addressed in current standards, and for which guidance has been requested by the DoD. This Interpretation does not apply to stand-alone items that function independently; such as entire airplanes, ships, tanks, ICBMs and other stand-alone items. Such items are already addressed in SFFAS 3 and SFFAS 6, as amended.

“Repair” versus “Remanufacture”

A11. There is no “bright line” that distinguishes items held for remanufacture from items held for repair. A clear example of a repair might be a minor or routine servicing that is performed in the field (or “on the shelf” for an item that is for sale). A clear example of remanufacture might be an item that is sent to a central depot for a total overhaul, or for an upgrade that results in the item being assigned a new National Stock Number to indicate the change in the nature of the item. For processes that involve more than the “repair” example above, but less than the “remanufacture” examples, management should use judgment to determine a reasonable, consistent and cost-effective manner to classify processes as “repair” or “remanufacture.”

Inventory Valuation

A12. SFFAS 3 provides basic principles of inventory valuation applicable to both inventory in the process of production for sale and held for repair:

- Historical cost valuation is to be applied to inventory (SFFAS 3, paragraphs 20, 32, 33 and 42),
- Historical cost includes all appropriate purchase, transportation and production costs incurred to bring the items to their current condition and location, (SFFAS 3, paragraphs 21 and 43) and
- Abnormal costs should be expensed when incurred (SFFAS 3, paragraphs 21 and 43).

A13. Given the common objectives described above for the two categories and the absence of clear distinctions between the two categories, the Board does not believe that an amendment is needed. The Board believes that in some circumstances the only thing that distinguishes the remanufacturing process from the production process is that the raw materials include items previously in service.

A14. The Board believes that the intent of paragraphs 17-34 of SFFAS 3 is that an item held for remanufacture should be initially valued at less than the value of a new or serviceable item, and that as the work on the item progresses, the value of the item should be increased accordingly. The Board believes that any of the three methods (the allowance method or the direct method, described in paragraphs 32-33 of SFFAS 3 or the historical production cost method described in paragraphs 21 and 43 of SFFAS 3) would provide results that would meet this objective.

Operating Materials and Supplies Held for Repair or Remanufacture

A15. SFFAS 3 did not anticipate the existence of a significant category of Operating Materials and Supplies held for repair or remanufacture. For example, reparable parts and subassemblies related to tactical munitions may meet the definition of Operating Materials and Supplies. The Board believes that any of the three valuation methods described for inventory in paragraphs A12-A14 above may be reasonably applied to operating materials and supplies.

Effective Date

A16. Interpretations do not have an effective date, as they carry the effective dates of the standard(s) being interpreted.

Board Approval

A17. This interpretation was approved for issuance by all members of the Board.

Appendix B: Glossary

[See consolidated Glossary in Appendix E of this document.]

Appendix C: Relevant Citations of Current Standards

SFFAS 3, *Accounting for Inventory and Related Property*

[20] **Valuation.** Inventory shall be valued at either (1) historical cost or (2) latest acquisition cost.

[21] (1) Historical cost shall include all appropriate purchase, transportation and production costs incurred to bring the items to their current condition and location. Any abnormal costs, such as excessive handling or rework costs, shall be charged to operations of the period. Donated inventory shall be valued at its fair value at the time of donation. Inventory acquired through exchange of nonmonetary assets (e.g., barter) shall be valued at the fair value of the asset received at the time of the exchange. Any difference between the recorded amount of the asset surrendered and the fair value of the asset received shall be recognized as a gain or a loss.

[22] The first-in, first-out (FIFO); weighted average; or moving average cost flow assumptions may be applied in arriving at the historical cost of ending inventory and cost of goods sold. In addition, any other valuation method may be used if the results reasonably approximate those of one of the above historical cost methods (e.g., a standard cost system).

[32] **Inventory Held for Repair.** Inventory held for repair may be treated in one of two ways: (1) the allowance method or (2) the direct method.

(1) Under the allowance method, inventory held for repair shall be valued at the same value as a serviceable item. However, an allowance for repairs contra-asset account (i.e., repair allowance) shall be established. The annual (or other period) credit(s) required to bring the repair allowance to the current estimated cost of repairs shall be recognized as current period operating expenses. As the repairs are made the cost of repairs shall be charged (debited) to the allowance for repairs account.

[33] (2) Under the direct method, inventory held for repair shall be valued at the same value as a serviceable item less the estimated repair costs. When the repair is actually made, the cost of the repair shall be capitalized in the inventory account up to the value of a serviceable item. Any difference between the initial estimated repair cost and the actual repair cost shall be either debited or credited to the repair expense account.

[35] **Disclosure Requirements.**

- General composition of inventory.
- Basis for determining inventory values; including the valuation method and any cost flow assumptions.
- Changes from prior year's accounting methods; if any.

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- Balances for each of the following categories of inventory: inventory held for current sale, inventory held in reserve for future sale, excess, obsolete and unserviceable inventory, and inventory held for repair unless otherwise presented on the financial statements.
 - Restrictions on the sale of material.
 - The decision criteria for identifying the category to which inventory is assigned.
 - Changes in the criteria for identifying the category to which inventory is assigned.

Operating Materials and Supplies

[36] **Definition.** "Operating materials and supplies" consist of tangible personal property to be consumed in normal operations. Excluded are (1) goods that have been acquired for use in constructing real property or in assembling equipment to be used by the entity, (2) stockpile materials, (3) goods held under price stabilization programs, (4) foreclosed property, (5) seized and forfeited property, and (6) inventory.

[37] Operating materials and supplies shall be categorized as (1) operating materials and supplies held for use, (2) operating materials and supplies held in reserve for future use, or (3) excess, obsolete and unserviceable operating materials and supplies. These categories are defined in paragraphs 36, 45, and 47 respectively.

[38] **Recognition.** The consumption method of accounting for the recognition of expenses shall be applied for operating materials and supplies. Operating materials and supplies shall be recognized and reported as assets when produced or purchased. "Purchased" is defined as when title passes to the purchasing entity. If the contract between the buyer and the seller is silent regarding passage of title, title is assumed to pass upon delivery of the goods. Delivery or constructive delivery shall be based on the terms of the contract regarding shipping and/or delivery.

[39] The cost of goods shall be removed from operating materials and supplies (i.e., the asset account) and reported as an operating expense in the period they are issued to an end user for consumption in normal operations.

[40] If (1) operating materials and supplies are not significant amounts, (2) they are in the hands of the end user for use in normal operations, or (3) it is not cost-beneficial to apply the consumption method of accounting, then the purchases method may be applied to operating materials and supplies. The purchases method provides that operating materials and supplies be expensed when purchased.

[41] An end user is any component of a reporting entity that obtains goods for direct use in the component's normal operations. Any component of a reporting entity, including contractors, that

maintains or stocks operating materials and supplies for future issuance shall **not** be considered an end user.

[42] **Valuation Under the Consumption Method.** Operating materials and supplies shall be valued on the basis of historical cost.

[43] Historical cost shall include all appropriate purchase and production costs incurred to bring the items to their current condition and location. Any abnormal costs, such as excessive handling or rework costs, shall be charged to operations of the period. Donated operating materials and supplies shall be valued at their fair value at the time of donation. Operating materials and supplies acquired through exchange of nonmonetary assets (e.g., barter) shall be valued at the fair value of the asset received at the time of the exchange. Any difference between the recorded amount of the asset surrendered and the fair value of the asset received shall be recognized as a gain or a loss.

[44] The first-in, first-out (FIFO); weighted average; or moving average cost flow assumptions shall be applied in arriving at the historical cost of ending operating materials and supplies and cost of goods consumed. In addition, any other valuation method may be used if the results reasonably approximate those of one of the above historical cost methods (e.g., a standard cost or latest acquisition cost system).

[50] **Disclosure Requirements.**

- General composition of operating materials and supplies.
- Basis for determining operating materials and supplies values; including the valuation method and any cost flow assumptions.
- Changes from prior year's accounting methods; if any.
- Balances for each of the categories of operating materials and supplies described above.
- Restrictions on the use of material.
- The decision criteria for identifying the category to which operating materials and supplies are assigned.
- Changes in the criteria for identifying the category to which operating materials and supplies are assigned.

**Appendix D: Letter from Department of Defense Deputy Chief
Financial Officer**

OFFICE OF THE UNDER SECRETARY OF DEFENSE
1100 DEFENSE PENTAGON
WASHINGTON, DC 20301-1100

MAR 16 2006

Ms. Wendolyn Comes
Executive Director
Federal Accounting Standards Advisory Board 441 G. Street, N.W.
Washington, DC 20548

Dear Ms. Comes:

The Department of Defense (DoD) is continuing to take steps to implement its financial management improvement plans and accounting processes. In the course of this process, we have taken a critical look at the Department's business process for the repair of inventories, and the applicability of the Statement of Federal Financial Accounting Standard (SFFAS) No. 3 as it relates to inventory repair. In line with this review, we have also researched comparable commercial processes through available web-based literature as well as through direct contact with commercial firms. Subsequent to consideration of all our findings, we have concluded that the Department's repair process is directly comparable to the private sector process typically referred to as "remanufacturing," and that our reparable carcasses (referred to as "cores" in the private sector) acquired in exchange sales for reparable items are similar, if not the same, as "raw materials" or components used in the remanufacturing process. More importantly, we have come to believe that "inventory repair" suggests a misleading process when viewed in the context of rebuilding worn and used carcasses/cores for the primary purpose of providing rebuilt items for new sales. The following paragraphs elaborate on our findings and conclusions.

Based on commercial sourced information noted above, we found that the remanufacturing process had specific characteristics that were virtually parallel regardless of product or entity (i.e., commercial or DoD). Both remanufacturing companies and the DoD acquire worn carcasses/cores through exchange sales of remanufactured items or newly procured items with financial incentives or credit given for the exchanged cores. Both inspect, disassemble, evaluate, clean, rebuild, refurbish, and restore products to "good-as-new" condition for inclusion as finished goods inventory and for sale to new customers. More importantly, both often enhance products with upgrades which incorporate new technologies, reduce obsolescence, extend useful life, increase safety, and improve reliability.

Regardless of the technical processes, or the definition attached to the process, we believe that certain, fundamental attributes must be considered in the accounting solution when inventory items are repaired:

- First, inventory, by definition, is "held for sale." Since inventory held for sale is typically found on "warehouse shelves," the repair of damaged items in current storage, and the return of those items to the warehouse is a rare or immaterial event.
- Second, since it is rare for on-the-shelf, held-for-sale items to be repaired, we can generally conclude that any large-scale inventory item repair process, whether undertaken by commercial firms or the DoD, will always be a "source-of-supply" process which provides rebuilt or remanufactured items for new sales.
- Third, it can also be concluded that rebuild processes for resale will always involve some form of market-based or incentive-based business process which provide for the return of worn or used carcasses/cores for rebuild. Carcasses/cores then become similar to raw material and, more importantly, should reflect the cost to obtain them.
- Finally, regardless of the name attached to the refurbishment process, i.e., "repair," "rebuild," "remanufacture," or other, a fundamental rule of accounting states that "all costs incurred to place assets into use, or to get inventory items ready for sale, should be capitalized into the cost of the asset."

Despite these attributes, paragraphs 32 and 33 (Inventory Held for Repair) of SFFAS No. 3 provide that entities should charge or credit the difference between actual and estimated repair costs to current period expense. However, when the process is correctly viewed as a process undertaken with the intent of rebuilding returned worn and used cores for subsequent resale, we believe that limiting the application of capitalized repair to estimated repair is not only inappropriate but, in fact, distorts the matching of cost of sales and revenue at time of sale.

Reconciliation of the historical cost requirements in Statement No. 3 with the requirements set forth in paragraphs 32 and 33 are problematic. The SFFAS No. 3 provides that entities value Inventory Held for Sale at historical cost. Paragraph 21 defines historical cost to "include all appropriate purchase, transportation and production costs incurred to bring items to their current condition and location." In addition, commercial accounting principles for inventory cost have always been guided by a fundamental rule of capitalization as stated in Accounting Research Bulletin 43, Chapter 4, Paragraph 5, as follows: "The primary basis of accounting for inventories is cost, which has been defined generally as the price paid or consideration given to acquire an asset." When applied to inventories, cost means, in principle, the "sum of all applicable expenditures and charges directly or indirectly incurred in bringing an article to its existing condition and location." Paragraphs 32 and 33 of Statement 3, however, impose restrictions on both cost capitalization and the value of carcasses. Paragraphs 32 and 33 require that regardless of the level of effort or cost incurred to rebuild items for resale, rebuild costs must be expensed as period costs if they exceed estimated repair. Secondly, paragraphs 32 and 33 dictate that carcass costs are not independent, but rather are a function of the cost of related

serviceable items less estimated repair. This principle ties the value of carcasses to the procurement cost of serviceable items and thus, subjects carcasses to a continuing revaluation unrelated to their cost.

Each year, the Department, through incentive exchange sales from our revolving funds or through directed returns, processes thousands of reparable item returns (i.e., carcasses) for subsequent repair/rebuild. Similarly, thousands of commercial firms obtain cores through exchange sales or through available market purchases for remanufacturing. The objectives of this business process in both instances are to: (1) establish an alternative source of supply that utilizes the main component of the items being rebuilt, and (2) repair/rebuild/remanufacture the carcasses or cores for subsequent resale. From an accounting perspective, we have to believe that commercial firms can only be capitalizing such costs into the cost of the products sold in lieu of period repair expense. It appears clear that reporting repair expenses for large-scale remanufacturing and resale operations would be in conflict with accepted accounting principles, would understate their inventory and cost of goods sold, and would mismatch costs and revenue at the time of sale. Based on these conclusions, and those attributes we summarized previously, the following and remaining paragraphs state our proposals for SFFAS No. 3 inventory repair principles.

We propose that Inventory Held for Repair be revisited in terms of the prevailing business process. As stated in our first and second attributes above, we believe that "inventory repair" per se is a rare event that, if viewed in terms of overall principles, will reveal source-of-supply and resale objectives.

We propose that "repair expense" be subjected to a critical and theoretical review in terms of "inventory repair." Textbook examples of repair expense versus repair capitalization typically make reference to real property and fixed assets. Capitalized repair is matched to revenue through depreciation charges. Since inventory is not depreciated, capitalized repair can, therefore, only match revenue as a part of cost of goods sold. We believe this is the correct answer; however, there is little, if any, accounting guidance in this area.

If it is concluded that large-scale inventory repair is undertaken primarily for the purpose of selling rebuilt/remanufactured items, we then propose that the question of cost capitalization be subjected to the general requirement to capitalize all costs to bring inventory items to the point of sale. We believe this issue should also be subjected to the question of "asset value or life added" versus the objective of "resale." That is, it can be argued that if repair does not add substantial value or life to an inventory item, then it should be expensed. We believe that the sale objective and the matching of cost of goods sold should be the prevailing factor.

If it is concluded that inventory repair is a rebuild/resell process, we then propose that the valuation of carcasses/cores be independent of the cost of items held for sale. We believe that carcasses should be valued at "cost."

These proposals, depending on your consideration or conclusions, could bring to bear additional changes or findings. For example, recording carcasses at cost and rebuilt items at full cost could negate the need for the allowance method or direct method and potentially revise the implementation adjustments currently stated in Paragraph 34 (i.e., reporting entities which accrued amounts for repair expense under previous standards based on estimated repair costs may be required to make subsequent adjustments for carcasses held at cost without an allowance). Paragraph 17(3) could be revised to include remanufactured components. In addition, it should be kept in mind that this letter addresses only inventory for sale (or repaired for ultimate resale). There are variations of repair and spare parts management in some industries (airlines for example) that repair or rebuild items for internal recycling only. These items, we believe, are accounted for as depreciable assets.

My staff will be pleased to work with you or anyone you deem to be appropriate on the FASAB staff on this issue and will provide any assistance or information that you determine to be necessary. Questions or requirements for additional information can be directed to my point of contact, Mr. Wayne Hudson. Mr. Hudson can be reached by phone at (703) 697-8281 or by e-mail at wayne.hudson@osd.mil.

Sincerely,

Teresa McKay
Deputy Chief Financial Officer