



April 10, 2015

Memorandum

To: Members of the Board

From: Melissa Loughan, Assistant Director
Wendy M. Payne

Through: Wendy M. Payne, Executive Director

Subj: DoD Implementation Guidance Request - **Tab F**¹

MEETING OBJECTIVES

The objective of this session is to review a draft exposure draft regarding use of alternative methods in establishing opening balances for inventory, operating materials and supplies, and stockpile materials under SFFAS 3.

Staff is also updating the Board on the Deployed Assets and Research and Development issue areas, which were closed out.

BRIEFING MATERIAL

The staff analysis is attached along with a question for the Board on page 4. You may electronically access all of the briefing material at <http://www.fasab.gov/board-activities/meeting/briefing-materials/>.

Attachment A- Staff Analysis

Attachment B- Draft Exposure Draft, *Opening Balances for Inventory, Operating Materials and Supplies, and Stockpile Materials*

Appendix A- Letter sent to DoD Deputy CFO

Appendix B- History of Project and Board Decisions

¹ The staff prepares Board meeting materials to facilitate discussion of issues at the Board meeting. This material is presented for discussion purposes only; it is not intended to reflect authoritative views of the FASAB or its staff. Official positions of the FASAB are determined only after extensive due process and deliberations.

BACKGROUND

As you may recall, at the February meeting staff obtained Board member views regarding acceptable valuation methodologies for Inventory and Operating Materials & Supplies at transition to systems capable of accounting in accordance with SFFAS 3. It was agreed staff would consider the Board member comments and develop a draft proposal for the Board's consideration at the April meeting. The Board agreed that the notion of deemed cost as used in the International Public Sector Accounting Standards No. 33, *First Time Adoption of Accrual Basis International Public Sector Accounting Standards*, should be explored but written broadly so that it could be adapted to DoD.

NEXT STEPS

Staff will consider the Board member comments on the draft exposure draft and work towards distributing a pre-ballot between meetings or if the Board comments determine more substantial work with members is required, a revised document will be provided at the June 2015 Board meeting.

QUESTIONS FOR THE BOARD

Please contact me as soon as possible to convey your questions or suggestions. Communication before the meeting will help make the meeting more productive. You can contact me by telephone at 202-512-5976 or by e-mail at loughanm@fasab.gov with a cc to paynew@fasab.gov

Attachment A- Staff Analysis

1. Deployed Assets and Research and Development

The Board may recall the DoD requested FASAB's assistance in these two areas, but after FASAB staff met with representatives from all Military Departments and appropriate Defense Agencies to discuss the request, it was determined that there was no need for FASAB guidance. Therefore, Ms. Payne sent a letter to the Deputy CFO to officially close out these items. See **Appendix A** for a copy of the letter.

Question for the Board:

Does the Board have any questions relating to the close out of Deployed Assets and Research and Development portion of the DoD Implementation Guidance Request Project?

2. Draft Exposure Draft- (Attachment B- *Opening Balances for Inventory, Operating Materials and Supplies, and Stockpile Materials*)

After considering Board member views regarding acceptable valuation methodologies for Inventory and Operating Materials & Supplies at transition to systems capable of accounting in accordance with SFFAS 3, staff worked with the contractor to develop the draft exposure draft. Staff provided a copy of the draft proposal to key DoD points of contact within the Office of the Undersecretary of Defense – Comptroller.

We considered their comments and provided responses. We also expanded the basis for conclusions to provide additional explanation and clarification in certain areas. However, some of DoD's concerns related to supporting documentation and that was considered beyond the scope of this project.

Question for the Board:

Does the Board have any questions or comments regarding the draft exposure draft, *Opening Balances for Inventory, Operating Materials and Supplies, and Stockpile Materials*?

Board Member Questions

- 1. Does the Board have any questions relating to the close out of Deployed Assets and Research and Development portion of the DoD Implementation Guidance Request Project?**
- 2. Does the Board have any questions or comments regarding the draft exposure draft, Opening Balances for Inventory, Operating Materials and Supplies, and Stockpile Materials?**

Opening Balances for Inventory, Operating Materials and Supplies (OM&S) and Stockpile Materials

Introduction

Purpose

1. This Statement permits a reporting entity to apply an alternative valuation method in establishing opening balances for inventory, operating materials and supplies (OM&S), and stockpile materials. These assets are addressed in Statement of Federal Financial Accounting Standards (SFFAS) 3, *Accounting for Inventory and Related Property*.
2. While SFFAS 3 addresses six types of tangible property only these three assets are required to be valued using the "initial amount" measurement approach.¹ An opening balance consistent with this requirement may not be available when a reporting entity is presenting financial statements or elements of financial statements following generally accepted accounting principles promulgated by the Federal Accounting Standards Advisory Board. This Statement is intended to provide a cost-effective approach to adoption of generally accepted accounting principles (GAAP) when historical records and systems do not provide a basis for valuation of opening balances in accordance with SFFAS 3.

Materiality

3. The provisions of this Statement need not be applied to immaterial items. The determination of whether an item is material depends on the degree to which omitting or misstating information about the item makes it probable that the judgment of a reasonable person relying on the information would have been changed or influenced by the omission or the misstatement.

¹ The *measurement approach* is how an asset or liability is measured in periods after initial recording—i.e., at the historical cost or initial transaction amount (with subsequent adjustments for amortization, depreciation, or depletion, if applicable) or at an amount, such as fair value, measured at each financial statement date. A different measurement approach may be appropriate for different assets and liabilities. Amounts initially recorded are referred to as the "initial amount" and amounts measured at each subsequent financial statement date are "remeasured amounts." [SFFAC 7, Measurement of the Elements of Accrual-Basis Financial Statements in Periods After Initial Recording, par. 7a]

Proposed Standards

Scope and Applicability

4. This Statement applies when a reporting entity is presenting financial statements or elements of financial statements following generally accepted accounting principles (GAAP) promulgated by the Federal Accounting Standards Advisory Board (FASAB) either (1) for the first-time or (2) after a period during which existing systems could not provide the information necessary for producing such GAAP based financial statements. The application of this Statement based on the second condition is available once per reporting entity.
5. This Statement may be applied in establishing **opening balances** for the reporting period that the reporting entity, taken as a whole, makes an unreserved assertion that its financial statements, or this element of its financial statements, are presented fairly in accordance with GAAP. The alternative valuation methods permitted in this Statement may not be applied to transactions or events that increase inventory, OM&S, and stockpiled materials after opening balances are established. Thus, a reporting entity applying this Statement must be prepared to comply with the recognition, measurement, presentation and disclosure requirements in SFFAS 3.
6. This Statement does not apply to changes in accounting principles made by a reporting entity that already applies GAAP promulgated by FASAB. Such changes are the subject of:
 - (a) Requirements on Statement of Federal Financial Accounting Standards 21: *Reporting Correction of Errors and Changes in Accounting Principles*; and
 - (b) Specific transitional requirements in other SFFASs. The transitional provisions or implementation guidance in other SFFASs apply only to changes in accounting policies made by a reporting entity that already applies GAAP as established by the FASAB.

Definitions

7. **Deemed Cost**— An amount used as a surrogate for initial amounts that otherwise would be required to establish opening balances.
8. **Opening Balances**—Account balances that exist at the beginning of the reporting period. Opening balances are based upon the closing balances of the prior period and reflect the effects of transactions and events of prior periods and accounting

policies applied in the prior period. Opening balances also include matters requiring disclosure that existed at the beginning of the period, such as contingencies and commitments.²

Alternative Valuation Method for Opening Balances

9. **Deemed cost** is an acceptable valuation method for opening balances for inventory, OM&S, and stockpile materials for the reporting period that the reporting entity makes an unreserved assertion that its financial statements, or this element of its financial statements, are presented fairly in accordance with GAAP.
10. Because the reporting entity may have multiple component reporting entities using various valuation methods simultaneously, deemed cost may be based on one of or a combination of any of the following valuation methods:³
 - a. Standard price (selling price)⁴ or fair value⁵
 - b. Latest Acquisition Cost (LAC) Method⁶
 - c. Replacement cost⁷
 - d. Estimated historical cost (initial amount)
 - e. Actual historical cost (initial amount)
11. Once established using deemed cost, opening balances are to be considered consistent with SFFAS 3 requirements. Opening balances should be included in ongoing inventory valuation methods as a surrogate for the initial amounts that would have existed had an SFFAS 3 valuation method been used. No distinction of amounts arising from the opening balances is required.

² Adapted from U.S. Auditing Standards-American Institute of CPAs (Clarified), AU-C Glossary- Glossary of Terms.

³ The methods are not listed in any order of preference.

⁴ The latest known representative acquisition cost plus authorized cost recovery rate for each item of inventory and related property. This is established annually and is often referred to as selling price. Selling price and fair value may or may not be identical due to the intragovernmental nature of some sales.

⁵ Fair value is the amount at which an asset or liability could be exchanged in a current transaction between willing parties, other than in a forced or liquidation sale. (SFFAC 7, par. 38)

⁶ Latest Acquisition Cost (LAC) Method provides that all like units that are held be valued at the invoice price of the most recent like item purchased, less any discounts, plus any additional costs incurred to bring the item to a form and location suitable for its intended use. *FASAB Handbook Glossary as of June 30, 2014*

⁷ Replacement cost is the amount required for an entity to replace the remaining service potential of an existing asset in a current transaction at the reporting date, including the amount that the entity would receive from disposing of the asset at the end of its useful life. (SFFAC 7, par. 46)

Disclosure Requirements

12. A reporting entity adopting the provisions of this Statement should disclose the election to apply deemed cost in establishing opening balances for inventory, OM&S, or stockpile material and a description of the method used in the first period in which the reporting entity makes an unreserved assertion that its financial statements, or this element of its financial statements, are presented fairly in accordance with GAAP. No disclosure of the deemed cost of inventory, OM&S, or stockpile material included in the opening balance is required.

Effective Date

13. This Statement is effective for periods beginning after September 30, 2016. Earlier implementation is encouraged.

DRAFT

Appendix A: Basis for Conclusions

Project history

Department of Defense (DoD) Implementation Guidance Request Project

A1. In February 2014, the Department of Defense (DoD) identified several areas of concern for the board's consideration. The FASAB's goal was to assist DoD by providing practical guidance to resolve longstanding issues within the framework of existing accounting standards and where necessary provide the appropriate guidance to address remaining issues.

A2. This Statement is related to the request for guidance on the use of reasonable baseline estimates on the valuation of legacy inventory and operating materials and supplies (OM&S). Statement of Federal Financial Accounting Standards SFFAS 3, *Accounting for Inventory and Related Property*, requires valuation at historical cost (initial amounts).

A3. The Board contracted with AOC Solutions to assist on the project. The approach for the project was to meet with senior officials from DoD to develop a comprehensive list of inventory valuation methodologies in place and the status of implementation to an SFFAS 3 compliant system for each Military Department.

A4. Based on the meetings and information provided:

- a. The legacy systems do not maintain a record of the cost of previous purchases making it all but impossible for the Military Departments to revalue inventory at transition from a non-GAAP to a GAAP state (i.e., historical cost). Meaning, DoD legacy systems do not track the historical cost of inventory. Instead, most DoD systems have valued inventory at latest acquisition cost or standard cost (selling price).
- b. DoD components have transitioned from non-GAAP legacy systems to SFFAS 3 compliant systems at different times. While DoD has implemented systems that are SFFAS 3 compliant, it is difficult if not impossible to determine at what point DoD inventory valuation using a historical cost methodology (e.g. Moving Average Cost (MAC)) will be cleansed of legacy values.
- c. Military Departments advised that they do not have the information to provide historical turnover rates for the purpose of identifying items that have turnover rates such that the valuation would approximate historical cost.
- d. DoD has stated that it does not have the information for revaluation and that it is not practical or cost effective to develop models for revaluation.

Consideration of Other Accounting Standards

A5. During deliberation of the project, the Board considered the recently issued International Public Sector Accounting Standards (IPSAS) No. 33, *First Time Adoption of Accrual Basis International Public Sector Accounting Standards*. IPSAS No. 33 provided several relevant foundations:

- a. International Public Sector Accounting Standards Board (IPSASB) concluded use of deemed cost facilitates the introduction of IPSASs in a cost effective way
- b. IPSAS 33 provides multiple options for deemed cost and restricts the use of deemed cost to those circumstances where reliable information about the historical cost of the asset is not available
- c. IPSASB concluded use of deemed cost does not affect fair presentation

A6. The Board believes a similar approach should be adopted in this project. This guidance is intended to provide a cost-effective approach to the adoption of SFFAS 3 where historical records and systems do not support such balances.

Alternative Valuation Method for Opening Balances

A7. A reporting entity may use deemed cost as an alternative valuation method in establishing opening account balances for inventory, OM&S, and stockpile material addressed in SFFAS 3 for the reporting period that the reporting entity first makes an unreserved assertion that its financial statements, or this element of its financial statements, are presented fairly in accordance with GAAP.

A8. This guidance is intended to provide a cost-effective approach to the adoption of SFFAS 3 where historical records and systems do not support such balances. Therefore, most often deemed cost will be based on the reporting entity's valuation method or system used for managing inventory, OM&S, and stockpile material prior to the adoption of SFFAS 3.

A9. Large and complex reporting entities such as DoD may have used a variety of valuation methods prior to the adoption of SFFAS 3. Therefore, this Statement allows for deemed cost to include several approaches to valuation because the reporting entity may have components (1) using different approaches simultaneously and/or (2) adopting an approach permitted under SFFAS 3 at different times prior to establishing opening balances. Deemed cost may be one of or a combination of valuation methods. However, this Statement requires that the accounting for all activity after the opening balance is established comply with SFFAS 3.

A10. Opening balances in this Statement are the balances at the beginning of the first reporting period that the entity makes an unreserved assertion that its financial statements, or this element of its financial statements, are fairly presented in accordance with GAAP. Once established using deemed cost, opening balances are to be considered consistent with SFFAS 3 requirements.

A11. Meaning, opening balances should be included in ongoing inventory valuation methods as a surrogate for the initial amounts that would have existed had an SFFAS 3 valuation method been used. Further, no distinction or segregation of amounts arising from the opening balances is required. For example, cost of goods sold using deemed cost need not be distinguished from cost of goods sold at historical cost under a first-in first-out (FIFO) approach. The purpose of this Statement is to provide a cost effective approach for this narrow area. Absent a reliable record of transactions related to hundreds of thousands of individual types of inventory, OM&S and stockpiles materials, acceptance of non-GAAP values at the transition point to SFFAS 3 compliant systems is the most cost-effective approach.

A12. However, all activity after the opening balances for inventory, OM&S and stockpile material are established must comply with the recognition, measurement, presentation and disclosure requirements in SFFAS 3.

Implementation by Component Reporting Entities

A13. As stated above, complex reporting entities such as DoD may have used a variety of valuation methods prior to the adoption of SFFAS 3. Further, reporting entity components may have transitioned to an SFFAS 3 valuation method at different times; however, some components established balances for existing inventory, OM&S, and stockpile material at the time of transition using methods that were not in accord with SFFAS 3. Therefore, given the timing of the transition to an SFFAS 3 valuation methodology, opening balances for the reporting entity may be based on transitional values based on one of the other methods listed in paragraph 10 of this Statement and subsequent transactions consistent with SFFAS 3 methods. The result of combining these values is considered deemed cost.

A14. A component reporting entity that is in the process of implementing systems that are SFFAS 3 compliant is permitted to apply this Statement at the time it makes an unreserved assertion that its financial statements, or this element of its financial statements, are presented fairly in accordance with GAAP.

A15. Considering the alternative valuations in this Statement are available until the reporting entity makes an unreserved assertion that its financial statements, or this element of its financial statements, are presented fairly in accordance with GAAP, this

Statement recognizes that component reporting entities (e.g. Military Departments) may make the assertion before others as well as before the DoD reporting entity asserts. Therefore, this Statement considers the opening balances and subsequent transactions of these component reporting entities as deemed cost of the reporting entity (i.e. DoD).

A16. With the DoD example, certain Military Department may have transitioned at an earlier date to SFFAS 3 compliant systems; this allows them to assert independently of the larger DoD. DoD would make a DoD-wide assertion when all Military Departments are compliant. While the Military Department's "deemed cost" opening balance might be earlier than the DoD-wide opening balance, the consolidation of the various methods would be DoD's opening balance deemed cost at the beginning of the period DoD was able to make an unreserved assertion on its financial statements or this element of its financial statements.

Disclosure Requirements

A17. The election to apply the provisions of this Statement (deemed cost in establishing opening balances for inventory OM&S, or stockpile material) should be disclosed in the financial statements in the first reporting period in which the reporting entity makes an unreserved assertion that its financial statements, or this element of its financial statements, are presented fairly in accordance with GAAP. The reporting entity should also disclose a description of what valuation method(s) deemed cost is based on, but no disclosure of amounts are required.



Federal Accounting Standards Advisory Board

March 19, 2015

Mr. Mark Easton
Deputy Chief Financial Officer
Office of the Under Secretary of Defense (Comptroller)/DCFO
Department of Defense
1100 Defense Pentagon
Washington, DC 20301-1100

Dear Mr. Easton,

As you may recall, the Federal Accounting Standards Advisory Board (FASAB) initiated a project to address three areas identified by the Department of Defense (DoD) letter dated February 21, 2014.

We met with representatives from all Military Departments and appropriate Defense Agencies to discuss the request. Discussions regarding the (1) deployed assets and (2) research and development areas showed no need for FASAB guidance.

The FASAB is developing guidance in the third area identified; valuation of inventory and operating materials and supplies. We hope to seek input from DoD on the draft guidance and anticipate it will be discussed by the Board in the coming months.

We greatly appreciate the efforts of your staff to date. Please contact me by phone at 202-512-7357 or email at paynew@fasab.gov if you have any questions.

Sincerely,

A handwritten signature in cursive script that reads "Wendy M. Payne".

Wendy M. Payne
Executive Director

Cc: Members of the FASAB
Donjette Gilmore, Office of the Under Secretary of Defense (Comptroller),
Accounting and Finance Policy
Alaleh Jenkins, Office of the Under Secretary of Defense (Comptroller), Financial
Improvement and Audit Readiness
Norwood J. Jackson, Jr.; AOC Solutions

DoD Implementation Guidance Request Project History of Project and Board Decisions

February 2015

The Board was provided an update on the progress on the Department of Defense (DoD) Implementation Guidance Request project.

- In regards to the research and development area, staff held a kickoff meeting with DoD, but it was agreed that DoD was to assess whether FASAB assistance within the GAAP hierarchy is needed. However, FASAB staff will be a liaison with DoD FIAR working groups to assist on discrete issues. FASAB's role will be to assist if there is a need for GAAP guidance.
- It was agreed staff would consider the Board member comments regarding acceptable valuation methodologies for Inventory and Operating Materials & Supplies at transition to systems capable of accounting in accordance with SFFAS 3 when historical cost information is unavailable and develop a draft proposal for the Board's consideration at the April 2015 Board meeting. For example, the Board agreed that deemed cost should be written broadly or generically so that could be adapted to DoD. In addition, staff will consider broadening the scope (such as a first-time adopter standard and/or if it should be for all assets) and determine the best approach (standard, technical bulletin).

December 2014 Board meeting

The Board reviewed the DoD Implementation Guidance Request Project Plan and was provided an update on efforts to date from FASAB's contractor.

The Board did not make any decisions at the December 2014 meeting on this agenda item as this was an update. Important items discussed that are detailed in the minutes include the following:

- Staff anticipates making progress in the Research and Development area in the coming months contingent upon DoD providing contact information and more information about the request.
- The issue of "end user" will be researched further to determine how best to address it.
- Follow-up with the branches (as well with the Marines) will be held to confirm all results to date on the deployed assets issue. A final recommendation will be presented to the board for approval, vote and record in the minutes.
- FASAB staff (with contractor assistance) plans to continue research and gain more information in various areas as it relates to inventory—including reparables, principal items, and confirming our understanding of inventory accounting and valuation processes at each branch.
- FASAB staff plans to research various areas discussed by board members at the meeting such as IFRS 1, GASB 34, further analysis and consideration of turnover rates, etc. The members also suggested meeting with the DoD IG at a time deemed appropriate.