



February 27, 2014

Memorandum

To: Members of the Board

Wendy M. Payne

From: Wendy M. Payne, Executive Director

Subj: Addendum Regarding Department of Defense Request – **Tab H1**

Attachment 4 of the Tab H material is a letter from Department of Defense (DoD) Deputy CFO, Mark Easton, requesting attention to six projects. Note that the February 21st Tab H memo indicates that DoD no longer plans to request revisions to existing property, plant, and equipment (PP&E) standards. Those revisions would have been a broad revisiting of accounting for military equipment. A request for PP&E standards revisions was not included in the six projects Mr. Easton requests and we do not expect such a request in the future.

As explained in my February 21st Tab H memo, we do not have staff resources to support additional work at this time. I expect we can undertake one new initiative once the reporting entity standards are completed. Board direction on priorities will be essential in selecting which initiative(s) we support.

The DoD request is significant because addressing DoD's implementation questions (1) will affect audit readiness and progress to a government-wide clean opinion, and (2) may reduce the cost of implementation.

Some matters may be addressed through the Accounting and Auditing Policy Committee but this will not eliminate the need for staff support. While the AAPC relies on task forces of volunteers, we have historically devoted at least three-quarters of an FTE to support the AAPC when it has an active agenda. The AAPC has not been actively addressing issues for several months and staff support has been minimal; allowing for progress on revisions to lease accounting. The pending internal use software project and the DoD projects suggest that considerable staff support of the AAPC will again be needed. Absent additional resources, this will delay progress on current FASAB projects.

At next week’s meeting, I will look to the Board to set priorities going forward. Question 3 of the earlier memo is:

Does the Board wish to adjust its existing priorities for current and research projects?

If the Board wishes to act on any new initiatives (including expanding support for the AAPC), we will need to identify an active project to delay (that is, slow progress rather than halt work).

If new initiatives can be deferred until the reporting entity standards are complete (approximately 6 months), members should consider priorities among the research projects and the DoD request.

To help you consider ways the DoD request might be addressed, suggested approaches for each of the six projects requested are presented in Table 1 below.

TABLE 1

Requested Project:	Suggested Approach if Undertaken:
<p>Inventory and Related Property (SFFAS 3) – extend the use of reasonable baseline estimates (application of SFFAS 35, <i>Estimating the Historical Cost of General PP&E</i>)</p> <p>See Attachment 1 for DoD Note Disclosures and Appendix 1 for SFFAS 3 provisions.</p>	<p>1) First consider whether a less costly method for addressing valuation would be appropriate and, if so, provide guidance from FASAB</p> <p>2) If not, provide staff guidance clarifying that SFFAS 35 may be applied using the GAAP hierarchy</p>
<p>Contract financing payments (CFP) – clarify proper treatment as advances or construction in progress</p>	<p>Address through the AAPC by continuing prior efforts to draft a Technical Release</p>
<p>Deployed assets – is it appropriate to expense, rather than capitalize, deployed assets?</p>	<p>Address with FASAB</p>
<p>Revolving fund (business-type activities) – develop guidance for these activities</p>	<p>Address first with FASAB staff consultation and possible staff action to clarify. Elevate to FASAB or AAPC as needed.</p>
<p>Research and Development – determine the proper timing of capitalization in a changing R&D world (similar to IUS issues as methods move from linear to spiral development)</p>	<p>Possible AAPC technical release or FASAB action. (FASAB has not developed comprehensive R&D standards. Issues relating to the timing of capitalization may be addressed through the AAPC. Other issues may require FASAB consideration.)</p>

These issues will be addressed in the ongoing leases and public-private partnership projects.

In-Kind Lease Payments – guidance is needed for cases such as receipt of free or reduced utility fees, new assets, or improved assets in lieu of rent

If you have any questions before the meeting, please contact me.

1.M. Inventories and Related Property

The Department values approximately 84 percent of resale inventory using the moving average cost method. An additional 13 percent (fuel inventory) is reported using the first-in-first-out method. The Department reports the remaining 3 percent of resale inventories at an approximation of historical cost using latest acquisition cost adjusted for holding gains and losses. The latest acquisition cost method is used because legacy inventory systems were designed for materiel management rather than accounting. Although these systems provide visibility and accountability over inventory items, they do not maintain historical cost data necessary to comply with [*Statement of Federal Financial Accounting Standards \(SFFAS\) No. 3, "Accounting for Inventory and Related Property."*](#) Additionally, these systems cannot produce financial transactions using the USSGL, as required by the [*Federal Financial Management Improvement Act of 1996 \(PL 104-208\)*](#). The Department is continuing to transition the balance of the inventories to the moving average cost method through the use of new inventory systems. Most transitioned balances, however, were not baselined to auditable historical cost and remain noncompliant with [*SFFAS No. 3*](#).

The Department manages only military or government-specific materiel under normal conditions. Materiel is a unique term that relates to military force management, and includes items such as ships, tanks, self-propelled weapons, aircraft, etc., and related spares, repair parts, and support equipment. Items commonly used in and available from the commercial sector are not managed in the Department's materiel management activities. Operational cycles are irregular, and the military risks associated with stock-out positions have no commercial parallel. The Department holds materiel based on military need and support for contingencies. The Department is currently developing a methodology to be used to account for "inventory held for sale" and "inventory held in reserve for future sale."

Related property includes OM&S and stockpile materiel. The OM&S, including munitions not held for sale, are valued at standard purchase price. The Department uses both the consumption method and the purchase method of accounting for OM&S. Items that are centrally managed and stored, such as ammunition and engines, are generally recorded using the consumption method and are reported on the Balance Sheet as OM&S. When current systems cannot fully support the consumption method, the Department uses the purchase method. Under this method, materiel and supplies are expensed when purchased. During FY 2013 and FY 2012, the Department expensed significant amounts using the purchase method because the systems could not support the consumption method or management deemed that the item was in the hands of the end user. This is a material weakness for the Department and long-term system corrections are in process. Once the proper systems are in place, these items will be accounted for under the consumption method of accounting.

The Department determined that the recurring high dollar-value of OM&S in need of repair is material to the financial statements and requires a separate reporting category. Many high-dollar items, such as aircraft engines, are categorized as OM&S rather than military equipment.

The Department recognizes excess, obsolete, and unserviceable inventory and OM&S at a net realizable value of \$0 pending development of an effective means of valuing such materiel.

Inventory available and purchased for resale includes consumable spare and repair parts, and repairable items owned and managed by the Department. This inventory is retained to support military or national contingencies. Inventory held for repair is damaged inventory that requires repair to make it suitable for sale. Often, it is more economical to repair these items rather than to procure them. The Department often relies on weapon systems and machinery no longer in production. As a result, the Department supports a process that encourages the repair and rebuilding of certain items. This repair cycle is essential to maintaining a ready, mobile, and armed military force. Work in process balances include: (1) costs related to the production or servicing of items, including direct material, labor, and applied overhead; (2) the value of finished products or completed services that are yet to be placed in service; and (3) munitions in production and depot maintenance work with associated costs incurred in the delivery of maintenance services.

1.N. Investments in U.S. Treasury Securities

The Department reports investments in U.S. Treasury securities at cost, net of amortized premiums or discounts. Premiums or discounts are amortized over the term of the investments using the effective interest rate method or another method that yields similar results. The Department's intent is to hold investments to maturity unless they are needed to finance claims or otherwise sustain operations. Consequently, a provision is not made for unrealized gains or losses on these securities.

The Department invests in nonmarketable market-based U.S. Treasury securities issued to federal agencies by the U.S. Treasury's Bureau of Fiscal Services. These securities are not traded on any financial exchange but are priced consistently with publically traded U.S. Treasury securities.

The Department's net investments are held by various trust and special funds. These funds include the Military Retirement Fund, Medicare-Eligible Retiree Health Care Fund, Other Defense Organizations General Fund trust and special funds, donations (gift funds), and the U.S. Treasury managed trust funds reported by USACE including the South Dakota Terrestrial Habitat Restoration, Inland Waterways, and Harbor Maintenance Trust Funds.

Other investments represent joint ventures with private developers constructing or improving military housing on behalf of the Department under the authority of MHPI, authorized by [PL 104-106, Section 2801](#). These investments do not require market value disclosure. The Department's potential losses on these ventures are limited to the amounts invested.

1.O. General Property, Plant and Equipment

The Department uses the estimated historical cost for valuing military equipment. The Department identified the universe of military equipment by accumulating information relating to program funding and associated military equipment, equipment useful life, program acquisitions, and disposals to establish a baseline. The military equipment baseline is updated using expenditure, acquisition, and disposal information.

The Department's General Property, Plant, and Equipment (PP&E) capitalization threshold is \$100 thousand except for real property, which is \$20 thousand. The Department has not fully implemented the threshold for real property; therefore, the Department is primarily using the capitalization threshold of \$100 thousand for General PP&E, and most real property.

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NOTE 9. INVENTORY AND RELATED PROPERTY

Inventory and Related Property		<i>Dollars in Millions</i>	
<i>As of September 30</i>		2013	2012
Inventory, Net		\$ 85,368.0	\$ 90,156.8
Operating Materiel & Supplies, Net		168,110.0	152,591.5
Stockpile Materiel, Net		519.5	551.4
Total Inventory and Related Property		\$ 253,997.5	\$ 243,299.7

Inventory, Net				<i>Dollars in Millions</i>
<i>As of September 30</i>				
	2013			Valuation Method
	Inventory, Gross Value	Revaluation Allowance	Inventory, Net	
Inventory Categories				
Available and Purchased for Resale	\$ 57,101.0	\$ (3,402.3)	\$ 53,698.7	FIFO,LAC, MAC
Held for Repair	34,312.3	(4,105.8)	30,206.5	LAC,MAC
Excess, Obsolete, and Unserviceable	6,967.1	(6,967.1)	0.0	NRV
Raw Materiel	1,412.4	0.0	1,412.4	MAC,SP,LAC
Work in Process	50.4	0.0	50.4	AC
Total Inventory, Net	\$ 99,843.2	\$ (14,475.2)	\$ 85,368.0	
Legend for Valuation Methods:				
Adjusted LAC = Latest Acquisition Cost, adjusted for holding gains and losses			NRV = Net Realizable Value	
SP = Standard Price			MAC = Moving Average Cost	
AC = Actual Cost			FIFO = First In, First Out	

Inventory, Net				<i>Dollars in Millions</i>
<i>As of September 30</i>				
	2012			Valuation Method
	Inventory, Gross Value	Revaluation Allowance	Inventory, Net	
Inventory Categories				
Available and Purchased for Resale	\$ 61,608.0	\$ (2,602.5)	\$ 59,005.5	FIFO,LAC, MAC
Held for Repair	33,864.2	(4,143.9)	29,720.3	LAC,MAC
Excess, Obsolete, and Unserviceable	6,833.8	(6,833.8)	0.0	NRV
Raw Materiel	1,352.6	0.0	1,352.6	MAC,SP,LAC
Work in Process	78.4	0.0	78.4	AC
Total Inventory, Net	\$ 103,737.0	\$ (13,580.2)	\$ 90,156.8	
Legend for Valuation Methods:				
Adjusted LAC = Latest Acquisition Cost, adjusted for holding gains and losses			NRV = Net Realizable Value	
SP = Standard Price			MAC = Moving Average Cost	
AC = Actual Cost			FIFO = First In, First Out	

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Restrictions

The following are restrictions on the use, sale, or disposition of inventory:

- War reserve materiel valued at \$1.5 billion;
- Commissary items valued at \$375.9 million held for purchase by authorized patrons; and
- Dispositions pending litigation or negotiation valued at \$68.9 million.

There are no known restrictions on inventory disposition related to environmental or other liabilities.

General Composition of Inventory

Inventory includes spare and repair parts, clothing and textiles, and fuels held for sale. Inventory is tangible personal property:

- Held for sale, or held for repair and eventual sale;
- In the process of production for sale; or
- To be consumed in the production of goods for sale or in the provision of service for a fee.

The Department assigns inventory items to a category based on asset type and condition.

Operating Materiel and Supplies, Net				<i>Dollars in Millions</i>	
<i>As of September 30</i>	2013			Valuation Method	
	OM&S, Gross Value	Revaluation Allowance	OM&S, Net		
Inventory Categories					
Held for Use	\$ 142,845.3	\$ (8.7)	\$ 142,836.6	SP, LAC, MAC	
Held for Repair	25,285.3	(11.9)	25,273.4	SP, LAC, MAC	
Excess, Obsolete, and Unserviceable	2,134.8	(2,134.8)	0.0	NRV	
Total OM&S	\$ 170,265.4	\$ (2,155.4)	\$ 168,110.0		
Legend for Valuation Methods:					
Adjusted LAC = Latest Acquisition Cost, adjusted for holding gains and losses			NRV = Net Realizable Value		
SP = Standard Price			MAC = Moving Average Cost		

Operating Materiel and Supplies, Net				<i>Dollars in Millions</i>	
<i>As of September 30</i>	2012			Valuation Method	
	OM&S, Gross Value	Revaluation Allowance	OM&S, Net		
Inventory Categories					
Held for Use	\$ 134,535.9	\$ (28.0)	\$ 134,507.9	SP, LAC, MAC	
Held for Repair	18,882.2	(798.6)	18,083.6	SP, LAC, MAC	
Excess, Obsolete, and Unserviceable	1,925.0	(1,925.0)	0.0	NRV	
Total OM&S	\$ 155,343.1	\$ (2,751.6)	\$ 152,591.5		
Legend for Valuation Methods:					
Adjusted LAC = Latest Acquisition Cost, adjusted for holding gains and losses			NRV = Net Realizable Value		
SP = Standard Price			MAC = Moving Average Cost		

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Restrictions

Some munitions included in OM&S are restricted due to condition. Restricted munitions are considered obsolete or unserviceable when they cannot meet performance requirements. However, obsolete and unserviceable OM&S may be used in emergency combat situations when no other suitable munitions are immediately available.

General Composition of OM&S

OM&S include spare and repair parts, ammunition, tactical missiles, aircraft configuration pods, and centrally managed aircraft engines held for consumption. The Department assigns OM&S items to a category based on asset type and condition.

Stockpile Materiel, Net				Dollars in Millions
As of September 30	2013			Valuation Method
	Stockpile, Materiel Amount	Allowance for Gains (Losses)	Stockpile, Materiel, Net	
Stockpile Materiel Categories				
Held for Sale	\$ 424.5	\$ 0.0	\$ 424.5	AC, LCM
Held for Reserve for Future Sale	95.0	0.0	95.0	AC, LCM
Total Stockpile Materiel	\$ 519.5	\$ 0.0	\$ 519.5	
Legend for Valuation Methods:				
AC = Actual Cost			LCM = Lower of Cost or Market	

Stockpile Materiel, Net				Dollars in Millions
As of September 30	2012			Valuation Method
	Stockpile, Materiel Amount	Allowance for Gains (Losses)	Stockpile, Materiel, Net	
Stockpile Materiel Categories				
Held for Sale	\$ 522.1	\$ 0.0	\$ 522.1	AC, LCM
Held for Reserve for Future Sale	29.3	0.0	29.3	AC, LCM
Total Stockpile Materiel	\$ 551.4	\$ 0.0	\$ 551.4	
Legend for Valuation Methods:				
AC = Actual Cost			LCM = Lower of Cost or Market	

Restrictions

Materiel held by the National Defense Stockpile (NDS) is restricted unless released by congressional action and made available for sale on the open market. Stockpile materiel may not be disposed except for: (1) necessary upgrading, refining, or processing; (2) necessary rotation to prevent deterioration; (3) determination as excess with potential financial loss if retained; or (4) authorization by law.

Before selling any materiel, Congress must enact specific enabling legislation (e.g., the National Defense Authorization Act). When authorized to offer materiel for sale, NDS reclassifies from Materiel Held in Reserve to Materiel Held for Sale. The estimated market price of stockpile materiel held for sale as of 4th Quarter, FY 2013, is \$1.3 billion.

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Effective Date

16. The Board recommends that the accounting standards presented in this Statement become effective for fiscal year ending September 30, 1994, and thereafter. Earlier implementation is encouraged.

Inventory

17. **Definition.** “Inventory” is tangible personal property that is (1) held for sale, (2) in the process of production for sale, or (3) to be consumed in the production of goods for sale or in the provision of services for a fee. The term “held for sale” shall be interpreted to include items for sale or transfer to (1) entities outside the federal government, or (2) other federal entities. The principal objective of the sale or transfer of inventory is to provide a product or service for a fee that generally recovers full cost or an identified portion of the cost. “Other federal entities” may include entities within the same organization/agency. Sales transactions may be executed through transfer of funds between federal entities; it is not essential that the transaction be an exchange of goods for cash or cash equivalents. In addition, inventory may be acquired through donation or barter. Inventory excludes some other assets held for sale, such as (1) stockpile materials, (2) seized and forfeited property, (3) foreclosed property, and (4) goods held under price support and stabilization programs. These items may be sold; however, the purpose of acquiring them is not to provide a product or a service for a fee.
18. Inventory shall be categorized as (1) inventory held for sale, (2) inventory held in reserve for future sale, (3) excess, obsolete and unserviceable inventory, or (4) inventory held for repair. These categories are defined in paragraphs 17, 27, 29, and 32 respectively.
19. **Recognition.** Inventory shall be recognized when title passes to the purchasing entity or when the goods are delivered to the purchasing entity. Upon sale (when the title passes or the goods are delivered) or upon use in the provision of a service, the related expense shall be recognized and the cost of those goods shall be removed from inventory. Delivery or constructive delivery shall be based on the terms of the contract regarding shipping and/or delivery.
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

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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).
23. (2) The latest acquisition cost method provides that the last invoice price² (i.e., the specific item's actual cost used in setting the current year stabilized standard [sales] price) be applied to all like units held including those units acquired through donation or nonmonetary exchange. The inventory shall be revalued periodically but at least at the end of each fiscal year. Revaluation results in recognition of unrealized holding gains/losses³ in the ending inventory value. Upon adjustment for unrealized holding gains/losses, the latest acquisition cost method then results in an approximation of historical cost.
24. An allowance for unrealized holding gains/losses in inventory shall be established to capture these gains/losses. The ending balance of this allowance shall be the cumulative difference between the historical cost, based on estimated or actual valuation, and the latest acquisition cost of ending inventory. The balance shall be adjusted each time the inventory balance is adjusted. The adjustment necessary to bring the allowance to the appropriate balance shall be a component of cost of goods sold for the period as described below.
25. The cost of goods sold for the period shall be computed as follows:

Beginning inventory at beginning-of-the-period latest acquisition cost
 less: beginning allowance for unrealized holding gains/losses
plus: actual purchases
 Cost of Goods Available for Sale
 less: ending inventory at end-of-the-period latest acquisition cost
plus: ending allowance for unrealized holding gains/losses
Cost of Goods Sold

²This unit value is referred to as the latest acquisition cost for the remainder of this standard.

³“Holding gains (or losses)” result from holding assets in periods of changing prices. Under historical cost methods, holding gains (or losses) are not separately recognized even though they exist. Under the latest acquisition cost method, holding gains (or losses) will be recognized in the valuation of inventory since that value is adjusted periodically to present the more current latest acquisition costs. These gains or losses are unrealized holding gains or losses.

“Unrealized” refers to any gain or loss associated with inventory still held by the entity. “Realization” of the holding gain or loss occurs only when an item of inventory is sold.

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26. **Exception to Valuation.** Valuing inventories at expected net realizable value is acceptable if there is (1) an inability to determine approximate costs, (2) immediate marketability at quoted prices, and (3) unit interchangeability (e.g., petroleum reserves). Application of this exception may result in inventories being valued at greater than historical cost.
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Other Categories of Inventory

27. **Inventory Held in Reserve for Future Sale.** Inventory stocks may be maintained because they are not readily available in the market or because there is more than a remote chance that they will eventually be needed (although not necessarily in the normal course of operations). These stocks shall be classified as inventory held in reserve for future sale. Inventory held in reserve for future sale shall be valued using the same basis as inventory held for sale in normal operations. The value of inventory held in reserve for future sale shall be either (1) included in the inventory line item on the face of the financial statements with separate disclosure in footnotes or (2) shown as a separate line item on the face of the financial statements.
28. The criteria considered by management in identifying inventory held in reserve for future sale shall be disclosed. **Examples** of factors to be considered in developing the criteria are (1) all relevant costs associated with holding these items (including the storage and handling costs), (2) the expected replacement cost when needed, (3) the time required to replenish inventory, (4) the potential for deterioration or pilferage, and (5) the likelihood that a supply of the items will be available in the future. The above listed disclosure requirements are not applicable to the U.S. government-wide financial statements. SFFAS 32 provides for disclosures applicable to the U.S. government-wide financial statements.
29. **Excess, Obsolete, and Unserviceable Inventory.** “Excess inventory” is inventory stock that exceeds the demand expected in the normal course of operations because the amount on hand is more than can be sold in the foreseeable future and that does not meet management’s criteria to be held in reserve for future sale. “Obsolete inventory” is inventory that is no longer needed due to changes in technology, laws, customs, or operations. “Unserviceable inventory” is damaged inventory that is more economical to dispose of than to repair. The category “excess, obsolete and unserviceable inventory” shall be either (1) included in the inventory line item on the face of the financial statements with separate disclosure in footnotes or (2) shown as a separate line item on the face of the financial statements.
30. Such inventory shall be valued at its expected net realizable value. The difference between the carrying amount of the inventory before identification as excess, obsolete or unserviceable and its expected net realizable value shall be recognized as a loss (or gain) and either separately reported or disclosed. Any subsequent adjustments to its net realizable

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value or any loss (or gain) upon disposal shall also be recognized as a loss (or gain). The U.S. government-wide financial statements need not separately report or disclose the difference between the carrying amount of the inventory and its expected not realizable value.

31. Management shall develop and disclose in the financial statements its criteria for identifying excess, obsolete and unserviceable inventory.
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.
 - (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.
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.
34. Transition to either of these two methods may result in recognizing an accumulated amount of needed repairs that were not previously accounted for. To avoid overstating repair expense for the first period that repair expense is accrued, prior period amounts are to be separately identified or estimated. The estimated amount to repair inventory that is attributable to prior periods shall be credited to the repair allowance under the repair allowance method or to the inventory account under the direct method and reported as an adjustment to equity.

Disclosure Requirements

35.
 - 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.
 - 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.

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- 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
- The above listed disclosure requirements are not applicable to the U.S. government-wide financial statements. SFFAS 32 provides for disclosures applicable to the U.S. government-wide financial statements for these activities.

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

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.

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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).

Other Categories of Operating Materials and Supplies

45. **Operating Materials and Supplies Held in Reserve for Future Use.** Operating materials and supplies stocks may be maintained because they are not readily available in the market or because there is more than a remote chance that they will eventually be needed, although not necessarily in the normal course of operations. These stocks shall be classified as operating materials and supplies held in reserve for future use. Operating materials and supplies held in reserve for future use shall be valued using the same basis as operating materials and supplies held for use in normal operations. The value of operating materials and supplies held in reserve for future use shall be either (1) included in the operating materials and supplies line item on the face of the financial statements with separate disclosure in footnotes or (2) shown as a separate line item on the face of the financial statements. Such materials and supplies shall be valued the same as operating materials and supplies held for use in normal operations.
46. The criteria considered by management in identifying operating materials and supplies held in reserve for future use shall be disclosed. Examples of factors to be considered in developing the criteria are (1) all relevant costs associated with holding these items

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(including the storage and handling costs); (2) the expected replacement cost when needed; (3) the time required to replenish operating materials and supplies; (4) the potential for deterioration or pilferage; and (5) the likelihood that a supply of the item will be available in the future.

47. **Excess, Obsolete, and Unserviceable Operating Materials and Supplies.** “Excess operating materials and supplies” are operating materials and supplies stocks that exceed the amount expected to be used in normal operations because the amount on hand is more than can be used in the foreseeable future and that do not meet management’s criteria to be held in reserve for future use. “Obsolete operating materials and supplies” are operating materials and supplies that are no longer needed due to changes in technology, laws, customs, or operations. “Unserviceable operating materials and supplies” are operating materials and supplies that are physically damaged and cannot be consumed in operations. The category “excess, obsolete and unserviceable operating materials and supplies” shall be either (1) included in the operating materials and supplies line item on the face of the financial statements with separate disclosure in footnotes or (2) shown as a separate line item on the face of the financial statements.
48. Such operating materials and supplies shall be valued at their estimated net realizable value. The difference between the carrying amount of the operating materials and supplies before identification as excess, obsolete or unserviceable and their estimated net realizable value shall be recognized as a loss (or gain) and either reported separately or disclosed. Any subsequent adjustments to their estimated net realizable value or any loss (or gain) upon disposal shall also be recognized as a loss (or gain).
49. Management shall develop and disclose in the financial statements its criteria for identifying excess, obsolete, and unserviceable operating materials and supplies.

Disclosure Requirements

50. • General composition of operating materials and supplies.
- Basis for determining operating materials and supplies values; including 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.
 - 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.

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- The above listed disclosure requirements are not applicable to the U.S. government-wide financial statements. SFFAS 32 provides for disclosures applicable to the U.S. government-wide financial statements for these activities.

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

Stockpile Materials

51. **Definition.** “Stockpile materials” are strategic and critical materials held due to statutory requirements for use in national defense, conservation or national emergencies. They are not held with the intent of selling in the ordinary course of business. The following items are specifically excluded from stockpile materials: (1) items that are held by an agency for sale or use in normal operations (see proposed standards for inventory and operating materials and supplies), (2) items that are held for use in the event of an agency’s operating emergency or contingency (see proposed standard for operating materials and supplies), and (3) materials acquired to support market prices (see proposed standard for goods held under price support and stabilization programs).
52. **Recognition.** The consumption method of accounting for the recognition of expense shall be applied for stockpile materials. These materials shall be recognized as assets and reported when produced or purchased. “Purchase” is defined as the date that 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. The cost of stockpile materials shall be removed from stockpile materials and reported as an operating expense when issued for use or sale.
53. **Valuation.** Stockpile materials shall be valued on the basis of historical cost. 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. The first-in, first-out (FIFO); weighted average; or moving average cost flow assumptions shall be applied in arriving at the historical cost of stockpile materials. 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).
54. **Exception to Valuation.** The carrying amount of materials that have suffered (1) a permanent decline in value to an amount less than their cost or (2) damage or decay shall be reduced to the expected net realizable value of the materials. The decline in value shall be recognized as a loss or an expense⁴ in the period in which it occurs.

⁴The decline in value shall be considered an expense if it is an expected decline in the normal course of operations.