UPCOMING CHANGES TO THE MEASUREMENT OF INVENTORY

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Confucius said, "Life is really simple, but we insist on making it complicated". This truth can be said for the accounting profession and some of its related accounting pronouncements. With complex derivative instruments, hedging transactions, share-based compensation, and the newly revised revenue recognition standard, simplicity for accountants has been an after-thought, at best. However, things may be changing.

In 2014, the Financial Accounting Standards Board (FASB) launched the Simplification Initiative, which is still ongoing today. The goal of the Simplification Initiative is to improve and/or maintain the usefulness of the information reported to investors, shareholders, business owners and other concerned parties, while reducing the cost and complexity of financial reporting.

On July 22, 2015, the FASB addressed concerns about the complexity of the current guidance on measuring inventory by issuing Accounting Standards Update (ASU) Number 2015-11: Simplifying the Measurement of Inventory. It is important to note that in addition to simplifying current U.S. Generally Accepted Accounting Principles (GAAP), this new guidance is also a significant step forward in the inevitable convergence with International Financial Reporting Standards (IFRS). For public companies, the new guidance is effective for fiscal years beginning after December 15, 2016, including interim periods within those fiscal years (i.e., 2017 for calendar year companies). For all other entities, the new guidance is effective for fiscal years beginning after December 15, 2016, and interim periods within fiscal years beginning after December 15, 2017. The new guidance should be applied prospectively with earlier application permitted as of the beginning of an interim or annual reporting period.

The new guidance does not apply to inventory that is measured using last-in, first-out (LIFO) or the retail inventory method. All other inventory valuation methods, which includes first-in, first-out (FIFO) and average cost, are impacted by the new guidance. The new guidance mandates that inventory be measured at the lower of cost and net realizable value. Net realizable value is defined as the estimated selling prices in the ordinary course of business, less an approximate normal profit margin (which includes items such as costs of completion, disposal and transportation).

Currently, the guidance requires inventory to be valued at the lower of cost or market. Market is presently defined by one of three ways: net realizable value, net realizable value less an approximate margin or replacement cost. The major change in the new guidance is to narrow the field from three options to one: net realizable value.

In our ever-changing world with more complexity, the accounting standard setters are looking to simplify matters. To that extent, we applaud them. If you are looking to navigate your way through the sea of accounting changes, please let us know if we can help.

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