Federal Accounting Standards Advisory Board

October 14, 2015

Memorandum

To: Members of the Board

From: Melissa L. Batchelor, Assistant Director

Wendy M. Payne

Through: Wendy M. Payne, Executive Director

Subj: DoD Implementation Guidance Request - **Tab B2- DoD Proposal** [1]

As indicated in the Staff Analysis to **Tab B2, DoD Implementation Guidance Request** that accompanied the draft exposure draft, *Establishing Opening Balances for General Property, Plant and Equipment: Amending Statement of Federal Financial Accounting Standards (SFFAS) 6, SFFAS 10, SFFAS 23, and Rescinding SFFAS 35*, DoD planned to submit a paper on government property in the hands of contactors. Please see the attached DoD prepared paper "Department of Defense (DoD Proposal) for FASAB Consideration For Government Owned Equipment in the Possession of Contractors" which may be inserted in your binder materials at Tab B2.

As previously noted, there is no conceptual difference between these types of general property, plant and equipment (PP&E) so the accounting treatment should be consistent. Staff considered the alternatives provided by DoD and fully understands the significant challenges such as long-standing contracts lacking contractual terms and systems needed to accumulate the necessary information. However, conceptually it would not be reasonable to afford special treatment to these assets that are no different, especially when most would agree there should be accountability over government owned assets in the hands of others.

In reviewing the DoD alternatives A & B, staff had difficulty with the analogy to when the federal government provides grants to state and local governments for the acquisition of PP&E that are reversionary interests in PP&E or 'contingent assets' that should not be

[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.

recognized. The DoD situation is very different from the grant example because the federal government (or DoD) is receiving the benefit. Further, the proposal to "recognized at the point in time the DoD identifies it" seems quite selective and open for interpretation.

A key consideration with option B is the effectiveness of policy changes that took effect in 2012. (Note the concern from above also applies to Option B for those contracts in effect prior to 2012.) Staff wonders if DoD has assessed the effectiveness of the changes and also would like to know the status of the implementation efforts of the policy change. Staff notes on page 2 of the DoD paper, third bullet states:

> "Is currently in the process of modifying DFARS acquisition guidance to require CAP that exceeds the capitalization threshold to be immediately brought to record. In instances where unplanned capital CAP is acquired, the revised guidance will require timely recognition of the asset through contractor reporting, delivery against a Contract Line Item (CLIN) and acceptance by the Department."

While Option C appears to be the most labor-intensive, FASAB staff has not been provided any additional information to reach conclusions regarding the materiality or determine the significance of the cost and effort. Further, staff believes an approach similar to this, the alternative valuation method—deemed cost—that is applicable to general PP&E in the hands of others, is the most reasonable and conceptually sound approach.

Another alternative to consider if DoD determines it cannot resolve the issues would be to explain that they do have flexibility in providing the assertion on a line item basis and presentation of general PP&E held by DoD versus that held by others as separate line items. This may expand the options available and reduce the overall cost of implementation. For example, DoD components could apply deemed cost to establish opening balances on a different basis or timeline to the contractor held property than to the DoD help property.

As conveyed before, it is important to reiterate that DoD continue to focus its efforts on ensuring proper controls and systems are out in place prior to making the unreserved assertion on a line item or the financial statements taken as a whole.

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 batchelorm@fasab.gov with a cc to paynew@fasab.gov.

Attachment

Department of Defense (DoD Proposal) for FASAB Consideration
For Government Owned Equipment in the Possession of Contractors

Problem Statement

- For the purpose of this proposal, the use of the term CAP (Contractor Acquired Property) will only apply to equipment, although the management of CAP by contractors does not distinguish between equipment and material.
- The Department of Defense does not have a complete universe of General Equipment assets due to a lack of accountability of government property furnished to contractors or CAP.
- Conflicting regulations and accounting policies, insufficiently trained contracting and logistics personnel and limited Information Technology (IT) systems capability were the primary cause.
- The cost and effort to establish a beginning balance and validate this baseline is significant for DoD.
- As a result, the Department of Defense does not have an auditable beginning balance for General Equipment assets.

Background

- Until 2006, Federal Acquisition Regulations (FAR) stated contractor records would be official records of government property provided under contract. With revisions to the FAR published in 2007, this language regarding contractor records was removed. The Department refined this guidance in Defense Federal Acquisition Regulations Supplement (DFARS) to ensure contractors reported sufficient information regarding Government Furnished Equipment (GFE). The DFARS guidance was completed in 2012.
- Beginning in 2010, DoD Components (i.e., Air Force, Missile Defense Agency and Defense Threat Reduction Agency) declared a material weakness for their accountability over Government Furnished Property (GFP), which includes GFE. This led to DoD declaring a Department-wide Material Weakness for GFP in its Fiscal Year 2011 Statement of Assurance.
- In January 2012, the Office of the Undersecretary of Defense for Acquisition, Technology and Logistics (OUSD (AT&L)) issued memorandum guidance to Components for establishing a GFE baseline. Concurrently, OUSD (AT&L) established the GFP Working Group to report progress metrics, challenges and to share lessons learned.

DoD Corrective Actions Taken

In addition to declaring material weaknesses in the Statement of Assurance, DoD has implemented significant improvements to address the GFE/CAP accountability concerns:

- Aligned contracting and accountability policies to enable accounting for and financial reporting of GFE assets. For example, GFE summary reporting requirements were replaced with unique item reporting to a central enterprise reporting repository.
- The Material Weakness corrective action plan prioritized implementing corrective actions to prevent unreported GFE from occurring first before addressing baseline establishment. To address this OUSD (AT&L):
  - Developed and delivered training to acquisition and logistics professionals to ensure a working knowledge of the current regulatory environment, to establish the foundation for appropriate treatment for accountability over GFE. Training extends from policy basics to advanced application using the DoD systems in place to ensure visibility and compliance.

  - Revised the DFARS Procedures, Guidance and Instruction (PGI) guidance to require Components to perform a cost/benefit analysis justifying that it is in DoD's best interest to provide government property to a contractor and standardize the reporting of GFE.
  - Developed and implemented performance metrics to measure contract clause compliance for the Government Property and associated clauses.
  - Is currently in the process of modifying DFARS acquisition guidance to require CAP that exceeds the capitalization threshold to be immediately brought to record. In instances where unplanned capital CAP is acquired, the revised guidance will require timely recognition of the asset through contractor reporting, delivery against a Contract Line Item (CLIN) and acceptance by the Department.
  - Performs contract administration and property reviews as required by regulation. Currently the Department conducts Peer Reviews, contract deficiency reviews, property management systems analyses and cost accounting system reviews. Deficiencies are identified and corrective action initiated.
- In the process of implementing electronic property transfer capabilities to and from DoD components and contractors using the Wide Area Workflow. Full implementation of this capability will ensure property movement between the Department and contractors is captured supports accountability over GFE.
- Continuing to improve and enhance the sharing of data between the Component, the contractor, Plant Clearance Automated Reutilization Screening System (PCARSS), the Property Loss Tool and the Item Unique Identification (IUID) Registry for enhanced enterprise level visibility and promoting periodic reconciliations with Accountable Property Systems of Record (APSR) (e.g., the Defense Property Accountability System (DPAS).

Challenges

The Department has encountered significant challenges with establishing a baseline for DoD GFE and CAP as follows:

- The United States has been at war for more than a decade in an environment where emphasis was placed on immediate operational results in a less controlled business process environment, taxing DoD's ability to properly record and account for property.
- DoD operating business policies were not synchronized to manage GFE prior to 2012, therefore no complete enterprise level visibility exists at the Department or Component level.
- Many legacy contracts do not have the required government property clauses incorporated, limiting DoD's ability to compel reporting of this property.
- CAP are items that are neither listed on contract line items, nor itemized in the voucher or request for payment (e.g., test equipment fabricated to build deliverables and charged to indirect costs).
- Acquisition and contracting regulations are not explicitly designed to support preparation of the Department's financial statements. Sufficient documentation supporting the existence, completeness and valuation of existing GFE/CAP is lacking.

The above conditions make it virtually impossible for DoD to successfully complete an audit of its GFE/CAP in accordance with current federal financial accounting standards.

Proposed Solutions

In order for the DoD to become auditable, DoD requests that the Federal Accounting Standards Advisory Board (FASAB) consider issuing new standards/guidance that would allow an entity presenting financial statements for audit for the first time with an alternative when the entity's existing contracts, processes, and systems cannot provide the required information for previous periods necessary to support an audit.

The following accounting treatment options are proposed in order to establish the initial baseline of GFE/CAP assets on the balance sheet. Once the initial baseline is established, accounting for GFE/CAP assets would be in accordance with current existing accounting standards.

Option A – DoD Recommended Option

GFE/CAP has neither been tracked in a GAAP compliant manner nor properly inventoried for decades. As contracts are closed out, some of the GFE/CAP will be identified and returned to the DoD and some GFE/CAP will be disposed by authorized means and not recorded in an APSR. As a result, GFE/CAP should be viewed as contingent assets and therefore recorded in the financial statements only when it is known that the DoD will receive these assets. There is precedent in GAAP for treating the GFE/CAP as contingent assets in Statement of Federal Financial Accounting Standards (SFFAS) 6. Although the facts and circumstances are not exactly the same, the principle of not recording a contingent asset is the same. Paragraph 150 in SFFAS 6 titled **Reversionary Interests in PP&E** states:

The Board also received a request to address reversionary interests in PP&E. In some instances, the Federal Government provides grants to state and local governments for the acquisition of PP&E. If the state or local government eventually decides that it is no longer needs to use the PP&E for the purpose specified in the original grant there is often a provision that the PP&E must revert to Federal ownership. In these cases, the Federal Government maintains a reversionary interest in the PP&E. In essence, these are contingent assets and should not be recognized on the balance sheet. The Board elected to specifically exclude these items from PP&E.

Accounting for unrecorded GFE/CAP as contingent assets would be addressed in the following manner:

- For all contracts currently in existence, GFE/CAP will be recognized at the point in time the DoD identifies it - either at contract closeout or when a contract is modified and GFE/CAP is identified.
- If the value is above the Component's capitalization threshold, the GFE/CAP will be recorded on the balance sheet at its estimated value (and depreciated if appropriate), which could be net realizable value, with a corresponding entry recorded on the Statement of Net Cost.
- For all new contracts on a go forward basis, GFE/CAP will be tracked when acquired and recorded on the balance sheet in accordance with SFFAS 6.
- Footnote disclosure of these accounting policies will fully disclose the treatment of GFE/CAP both before and after the effective baseline date.

Pro:

- o Most efficient method to account for the thousands of GFE/CAP assets that have been acquired over the last several decades and not tracked by the DoD.
- o Accounting follows the established business practices that the DoD has used in the past.

- Because of past practices, GFE/CAP are in effect contingent assets and this accounting recognizes this.

Con:

- May not have a complete universe of GFE/CAP until all existing contracts are closed out.

Option B

The accounting for this option follows the business policies that DoD had in place in the past. These policies did not require the DoD to track GFE/CAP assets until it took possession of them from the contractor. This policy changed in 2012. Therefore the accounting for GFE/CAP would be addressed as follows:

- For all contracts in existence prior to the effective date of the policy change in 2012, GFE/CAP will be recognized at the point in time the DoD identifies it - either at contract closeout or when the contract is modified and GFE/CAP is identified.
- The GFE/CAP will be recorded on the balance sheet at its estimated value (and depreciated if appropriate), which could be net realizable value, and corresponding entry recorded on the Statement of Net Costs.
- For all new contracts executed subsequent to the effective date of the policy change date in 2012, GFE/CAP will be tracked when acquired and recorded on the balance sheet in accordance with SFFAS 6.
- Footnote disclosure of these accounting policies will fully disclose the treatment of GFE/CAP pre and post the effective policy change date.

Pro:

- Accounting for GFE/CAP follows the accounting policies in effect at the time.
- Not required to research contracts prior to the effective policy change date in 2012, making it more likely that the research that is conducted would yield results.
- Because of past practices, GFE/CAP assets are in effect contingent assets and this accounting recognizes this.

Con:

- This approach does not cover the entire useful life range of possible capital assets, presenting a potential material completeness risk to the GPP&E Balance Sheet line item.
- Research of contracts from 2012 forward will take thousands of hours and cost millions of dollars.
- It will take several years to complete a review of contracts.

Option C

This option has the DoD research all contracts for activity since 2008 that would identify GFE/CAP. The reason for the 10 year lookback is that most GFE/CAP would have a maximum useful life of 10 years. GFE/CAP acquired prior to 2008 would likely have a nominal book value if it should have been recorded as PP&E when acquired, or would have previously been delivered to the DoD as a component of a deliverable from the contractor. The accounting for GFE/CAP would be addressed as follows:

- For all contracts in in 2008 and afterwards, a review of contract activity would be performed and GFE/CAP identified would be accounted for appropriately.
- Footnote disclosure of the accounting policies will fully disclose the treatment of GFE/CAP pre and post 2008.

Pro:

- Reduces the likelihood of a material completeness risk related to the GPP&E Balance Sheet line item.
- Because of past practices, GFE/CAP prior to 2008 are effectively contingent assets and this accounting recognizes this.

Con:

- May not have a complete universe of GFE/CAP until all existing contracts are closed out.
- Research effort for lookback period of 10 years presents a significant personnel and resource challenge that could require thousands of labor hours and millions of dollars
- Due to past policies and practices, there is a high degree of uncertainty of available information in legacy contracts. Given the projected costs, the cost/benefit of performing a 10 year lookback is questionable.