



June 11, 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 consider options regarding baseline estimates of general property, plant, and equipment (GPP&E.) This agenda item resulted from a request from DoD to clarify whether capital improvements are included when estimating the historical cost of GPP&E.

BRIEFING MATERIAL

The staff analysis is attached along with questions for the Board on page 9. You may electronically access all of the briefing material at <http://www.fasab.gov/board-activities/meeting/briefing-materials/>.

Attachment A - Staff Analysis

Appendix 1- Excerpt from Standards

BACKGROUND

At the April 2015 meeting, staff presented the Board with a staff draft interpretation clarifying whether capital improvements are included when estimating the historical cost of general property, plant, and equipment and whether estimates are permitted to capture the historical cost of construction in progress. The Board directed staff to move towards issuing the draft. However, shortly after the meeting, a member raised concerns regarding the proposal and therefore the matter is being discussed at the June meeting.

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.

NEXT STEPS

Staff will consider the Board member responses and provide a draft Statement for the August 2015 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

At the April 2015 meeting, staff presented the Board with a staff draft interpretation, *Accounting for Property, Plant, and Equipment as amended by SFFAS 35, Estimating the Historical Cost of General Property, Plant, and Equipment: Amending Statements of Federal Financial Accounting Standards 6 and 23* clarifying whether capital improvements are included when estimating the historical cost of general property, plant, and equipment and whether estimates are permitted to capture the historical cost of construction in progress.² In short, the draft interpretation was prepared on the basis of SFFAS 6, *Accounting for Property, Plant, and Equipment*, SFFAS 23, *Eliminating the Category National Defense Property, Plant, and Equipment*, and SFFAS 35, *Estimating the Historical Cost of General Property, Plant, and Equipment: Amending Statements of Federal Financial Accounting Standards 6 and 23* and provided that the estimated current cost of similar assets may include all capital improvements. The draft explained that separately estimating the cost of capital improvements is permitted but not necessary and such costs may be included in a single estimate. To accomplish the goal of reasonable estimates established by SFFAS 35, an estimate of the current cost of similar assets discounted for inflation since the time of original acquisition is sufficient and may be applied to all classes of G-PP&E.

The Board directed staff to move towards issuing the draft. Shortly after the meeting, staff provided the Board with a pre-ballot draft and a member raised concerns regarding capital improvements made in recent years as well as future capital improvements. After sharing this concern with the Board, several members joined in suggesting the Board should discuss the matter further.

The member's concerns were that the proposal would allow an entity to understate the depreciated costs of material capital improvements made in recent years as well as future capital improvements by allowing the entity to deflate the cost of the capital improvement(s) to the estimated original in-service year or actual original year of acquisition of the G-PP&E item itself.

Paragraph 9 of SFFAS 35 revised SFFAS 6 to allow the use of reasonable estimates for existing assets as well as for assets acquired in the future. In effect, it allows reasonable estimates to be applied on an ongoing basis. It also retained the provision of SFFAS 6 (paragraph 40) that such estimates may be based on:

- a. cost of similar assets at the time of acquisition,
- b. current cost of similar assets discounted for inflation since the time of acquisition (i.e., deflating current costs to costs at the time of acquisition by general price index), or
- c. other reasonable methods, including those estimation methods specified in SFFAS 23 paragraph 12.

² This memo does not address the issue of Construction in Progress. Although this matter was also included in the draft interpretation, it will be addressed through staff level guidance to DoD.

The member's concern is that because the underlying standard is applicable to future capital improvements, the draft interpretation would also apply to future capital improvements. Therefore, new capital improvements to fully or substantially depreciated assets could be similarly deflated to the original in-service year, effectively writing them off. The interpretation would allow similar write-downs or write-offs for capital improvements that were recently constructed, but nonetheless significantly extend the life or capacity of the original asset. Such capital improvements would include improvements to buildings as well as major overhauls of ships.

Staff notes that while reasonable estimates are allowed, the measurement basis for G-PP&E remains historical cost. Further, the estimates and methods used should be reasonable. Professional judgement will be required in making the decision whether to use estimates, estimated historical cost, or original transaction based data. As intended with SFFAS 35, it would be reasonable for entities that have not previously prepared financial reports or that did not have adequate controls or systems to capture these costs to use estimates when establishing initial baseline estimates of historical cost in accordance with SFFAS 6 for the first time. However, it would not be considered reasonable to continuously reassess and use estimates in future years once the initial baseline has been established. This appears consistent with DoD's request because they have conveyed that they would like to apply a one-time baseline vs trying to identify past capital improvements.

Staff notes that the Board members that deliberated SFFAS 35 considered whether to establish a date-certain time frame or have an open-ended approach for the use of reasonable estimates when determining the historical cost values of G-PP&E. [See complete excerpt from SFFAS 35 at **Appendix 1- Excerpt from Standards.**] Their rationale is provided in the Basis for Conclusions of SFFAS 35 paragraphs A15. – A17.:

A15. The Board decided against a proposal that would establish a date-certain time frame for the use of reasonable estimates when determining the historical cost values of G-PP&E. The Board does not want to penalize an entity simply because it may take the entity longer to implement the necessary systems and processes to ensure the adequate capture of historical cost values. In addition, the Board believes that the use of reasonable estimates is proper given the appropriate disciplines surrounding the use of estimates.

A16. The Board encourages those federal entities that use estimates to approximate the historical cost values of G-PP&E to establish processes and practices (i.e., adequate systems and internal control practices) for future acquisitions that will capture and sustain transaction based data that meet the G-PP&E historical cost valuation requirements.

A17. The Board believes that acknowledging the continuing appropriateness of estimates based on non-traditional documentation as provided by SFFAS 23 is prudent under the current circumstances. Estimates that do not lead to material misstatements are acceptable without guidance from the Board.

Originally FASAB staff hoped to accomplish the DoD request through the issuance of an Interpretation because staff believed “reasonable estimates” as provided in SFFAS 35 that were subject to audit with the professional judgement of auditors and preparers would lead to amounts that are fairly presented. Thus, judgment would safeguard against the member’s concerns. However, it appears based on feedback from the Board that language should be added to ensure that entities are only allowed to apply the deflation method inclusive of capital improvements once and explicitly safeguard against unintended consequences. Staff believes the only way to accomplish this is to restrict the estimations rather than permit continuous estimation as currently allowed under SFFAS 6 as amended by SFFAS 35.

Paragraph 9 of SFFAS 35 revised SFFAS 6 to allow the use of reasonable estimates upon initial capitalization as entities implement G-PP&E accounting for the first time, as well as by those entities who previously implemented G-PP&E accounting. In effect, it allowed reasonable estimates to be applied on an ongoing basis and expressly eliminated a timeframe based limitation to existing property. Consequently, it is inconsistent to interpret the standard to impose any sort of timeframe-based limitation related to capital additions. Staff does not see how an interpretation can be used to address the issue. Staff had explored ways within an Interpretation by further elaborating on reasonable estimates and materiality but this is a very slippery slope and not one that appears to be viable. Therefore, staff believes a proposed standard is the best vehicle to resolve the member concerns. It would require a Statement of Federal Financial Accounting Standards that amends certain provisions of SFFAS 6, 23 and 35.

The real property environment at DoD cannot provide the necessary information for the previous periods and they wish to establish an initial baseline of related property assets for the balance sheets. As described in the *Draft RP Baseline Business Case* prepared by DoD FIAR (provided to the Board at the April 2015 Board meeting.) The current condition of real property at DoD:

- DoD has approximately **440,000** separate real property (RP) assets.
- Many RP assets facility built dates are beyond 40 years.
- There are 3 Military Departments and over 20 other DoD agencies that have acquired RP assets.
- Many organizations and systems are involved in acquiring RP assets and executing capital improvement projects.
- DoD has not had any consistent or documented processes for retaining source documentation related to RP acquisitions.
- Capital improvement projects related to RP assets have not been reliably tracked in systems (difficult to determine the date they were placed in service, or establish a valuation baseline.)
- All systems that the DoD has utilized for acquisitions of RP and capital improvement projects have either never been audited, or when audited had significant deficiencies or material weaknesses related to them.

Staff considered the member concerns with the goal to develop a reasonable approach that would reduce implementation costs for DoD and determined the following options for the Board’s consideration:

1. One-time Use - Allow one-time application of current cost deflated to the original in-service date to establish an initial baseline. This option provides a clear cutoff for deflating capital improvements to the original in-service date of the asset and may more easily facilitate establishing a one-time threshold for recognizing existing capital improvements. This option would preclude such deflation to the original in-service date of the asset for all future capital improvements.

PROS	CONS
Cost effective	Potential to understate depreciated cost of recent capital improvements
Clear cutoff, line in the sand	Departs from SFFAS 35 and would require a Standard
Meets DoD need and request	
Future improvements would not be deflated	
Doesn’t prohibit or preclude recent improvements from being estimated separately (permissive language)	

2. One-time Use but Identify Recent Material Improvements - Allow one-time application of current cost deflated to the original in-service date but require consideration of recent material improvements that may need to be estimated separately to establish an initial baseline. This option provides a clear cutoff for deflating capital improvements to the original in-service date of the asset and precludes such deflation to the original in-service date of the asset for all future capital improvements. This option would require and provide for the review and possible deflation of more recent material capital improvements to the date of the capital improvement.

PROS	CONS
Clear cutoff, line in the sand	May cost approximately the same as the status quo (based on information provided regarding the environment at DoD)
Future improvements would not be deflated	Departs from SFFAS 35 and would require a Standard
Recent material capital improvements would be reviewed and separately estimated	May not meet DoD request because of documentation issues
	Requires judgment about “recent” (or a definition) and may not be substantively different than current guidance that allows for materiality judgments

3. One-time Use but Identify Significant Added Space or Functions Allow deflation of current cost to the original in-service date if improvements did not (1) significantly expand the capacity of an asset (for example, expand the square footage) or (2) otherwise upgrade it to serve needs different from, or significantly greater than, its current use or add significant new capabilities to establish an initial baseline. This differs from option 2 because it focuses not on cost but on physical or functional changes which may facilitate use of non-financial records.

PROS	CONS
Future improvements would not be deflated	May cost approximately the same as the status quo (based on information provided regarding the environment at DoD)
Material capital improvements would be more likely to be separately estimated	Departs from SFFAS 35 and would require a Standard
	May not meet DoD request because of documentation issues
	Could be time consuming process and require judgment

Staff recommendation:

After considering the three options above, staff believes the first option is the best alternative because it:

- Is a cost-effective manner to implement SFFAS 6 given the DoD request.
- is closest within the spirit of SFFAS 35 and does not place too many restrictions or barriers on judgement and flexibility necessary when considering reasonable estimates.
- Addresses the members concerns by ensuring future improvements would not be deflated but does not prohibit or preclude recent improvements from being estimated separately (permissive language will be included.)

Questions for the Board:

Does the Board agree with staff’s recommendation- Option 1, One Time Use?

Does the Board agree that a proposed Statement of Federal Financial Accounting Standards should be issued that also amends certain provisions of SFFAS 6, 23, and 35?

Staff considered draft language to accomplish this through a standard. Staff believes the most efficient and direct way is to build on the Board agreed upon language from paragraph 6 of the draft Interpretation for a proposed Standard and refer to existing standards. It will also require appropriate amendments to SFFAS 6, 23 and 35.

Staff proposed language:

The estimated current cost of similar assets includes all past capital improvements. Separately estimating the cost of capital improvements is permitted but not necessary and such costs may be included in a single estimate. To accomplish the goal of reasonable estimates established by SFFAS 35 as amended by this Statement, an estimate of the current cost of similar assets discounted for inflation since the time of original acquisition is sufficient and may be applied to all classes of G-PP&E.

This approach may be applied to all classes of G-PP&E to establish initial estimates of the historical cost. Thereafter, capital improvements should be addressed in accordance with SFFAS 6, paragraph 37.

[Note: SFFAS 6 paragraph 37 “Costs which either extend the useful life of existing general PP&E, or enlarge or improve its capacity shall be capitalized and depreciated/amortized over the remaining useful life of the associated general PP&E.”]

If the Board generally agrees, staff will develop the Introduction and other parts of the Statement. Staff will also determine the amendments to SFFAS 6, 23 and 35 and provide the Board a complete package at the August meeting. Staff has included the pertinent parts of SFFAS 6, 23 and 35 that may be subject to amendment at Appendix 1 beginning on page 13.

Question for the Board:

Does the Board generally agree with the above proposed language that will be incorporated into a draft Statement for the August 2015 meeting?

Questions for the Board:

- 1. Does the Board agree with staff's recommendation- Option 1, One Time Use?**
- 2. Does the Board agree that a proposed Statement of Federal Financial Accounting Standards should be issued that also amends certain provisions of SFFAS 6, 23, and 35?**
- 3. Does the Board generally agree with the above proposed language (see page 8) that will be incorporated into a draft Statement for the August 2015 meeting?**

Appendix 1- Excerpt from Standards

SFFAS 35

Estimation of G-PP&E Historical Cost

9. This standard amends SFFAS 6 and 23 to clarify that reasonable estimates of original transaction data historical cost may be used to value G-PP&E. Reasonable estimates may be used upon initial capitalization as entities implement G-PP&E accounting for the first time, as well as by those entities who previously implemented G-PP&E accounting.

10. This standard clarifies that federal entities should report their G-PP&E based on historical cost information in accordance with the asset recognition and measurement provisions of SFFAS 6, as amended. However, reasonable estimates of historical cost may be used to value G-PP&E assets.

Basis for Conclusions (Excerpts)

Initial Proposal for Implementation Guidance

A5. Regarding the permissibility of estimates (issue a), the Board agreed that it should consider amending the standards. It is not unreasonable to read SFFAS 6, as amended, to provide for the use of the SFFAS 23 initial capitalization methods only when assigning cost to G-PP&E acquired before the effective dates of SFFAS 6 or 23. The Board agreed to clarify this through a relatively narrow amendment of SFFAS 23. A draft exposure draft (omitting the Board's basis for conclusions) was presented at the December 2007 FASAB meeting. The draft (1) provided an additional five year window for the Department of Defense and a rolling five year window for agencies not previously producing financial reports to rely on SFFAS 23 methods and (2) provided new guidance regarding estimation of the in-service date. Subsequent Board discussions discouraged a proposal that would establish a date-certain timeframe for the use of reasonable estimates when determining the historical cost values of G-PP&E.

A6. Staff did not request immediate action by the Board on the draft ED. The Board generally supported the proposal so staff's next steps were to inquire with selected agencies and members of the audit community to confirm that the guidance is needed. In addition, staff reviewed fiscal year 2007 agency reports to determine if agencies other than the Department of Defense face similar challenges with respect to developing G-PP&E systems, using SFFAS 23 methods, and could be expected to incur significant costs to arrive at acceptable estimates absent explicit guidance.

A7. With respect to the three remaining issues noted in par. A3., (group/composite depreciation, deployed assets, and cost accounting), staff recommended and the Board agreed to request that the Accounting and Auditing Policy Committee (AAPC) consider

these issues. Staff suggested that a task force develop implementation guidance within the boundaries of the current standards. The AAPC has accepted the project and a task force is actively engaged in developing guidance.

Member Views

A8. SFFAS 6 was issued in November 1995 and was effective in fiscal year 1998. In addition, SFFAS 23, Eliminating the Category National Defense PP&E, was issued in May 2003 and was effective in fiscal year 2003. In 2002, the Accountability of Tax Dollars Act established a requirement for many agencies that did not previously produce audited financial statements to do so. As a result, in fiscal year 2003 many agencies were required to comply with SFFAS 6 for the first time. Therefore, certain entities were not afforded an implementation period because they began preparing financial statements after the effective date of SFFAS 6.

A9. This Statement permits continued application of the SFFAS 23 initial capitalization guidance. The Statement's primary objective is a cost effective method for attaining compliance with SFFAS 6 as amended. This method is available to reporting entities that have not previously prepared financial reports but who may be required or elect to do so in the future and do not yet have adequate controls or systems to capture these costs. In addition, these amendments also apply in those cases where entities decide to use estimates to determine the historical cost values of G-PP&E.

A10. An entity may find that it is not practical to determine the historical cost of G-PP&E based on the original transaction data because it is either not cost effective to do so or documentation is inadequate. Cost effectiveness may be based on an analysis of various cost factors associated with determining those historical cost values. An entity may also determine it impractical when the original transaction data historical cost documentation has not been maintained or when the historical cost data has been maintained but not in a manner that facilitates the timely valuation of G-PP&E. An entity's inadequate systems and/or processes that do not facilitate the ready and timely collection of data for the valuation of G-PP&E may lead to an assessment that valuation based on original transaction data is not cost effective.

A11. The Board initially included "cost effectiveness" and "practical" as the basic criteria to be met before the use of reasonable estimates when valuing G-PP&E in accordance with the asset recognition and measurement provisions of SFFAS 6, as amended, would be permitted. The Board later decided against including the above basic criteria. Such criteria are open to interpretation and likely to lead to subjective and inconsistent application.

A12. The Board stresses to federal entities that the measurement basis for G-PP&E remains historical cost; however, reasonable estimates are allowed. The Board believes entities should use judgment regarding the decision to use estimated historical cost in lieu of original transaction based data. The Board also notes that estimates are widely

used throughout the financial statements. In this case, estimates should provide a reasonable approximation of historical cost; the measurement basis required for G-PP&E.

A13. The Board is aware that these amendments will not resolve all the concerns surrounding accounting for G-PP&E. However, allowing estimates as entities are working towards implementing systems and processes that can capture historical data would be beneficial. The Board is also relying on other means, such as laws and regulations relating to systems and controls, to encourage entities to continue to develop adequate systems and processes.

A14. The Board also debated at length whether to establish a date-certain time frame or have an open-ended approach for the use of reasonable estimates when determining the historical cost values of G-PP&E. The debate included both pros and cons to a date-certain approach. One of the pros to the date-certain approach is that entities will have a specific goal (i.e., time frame) to work towards. The con to the date-certain approach is that there is a risk that the benefits of the standard could be voided if the entity does not or cannot meet the date-certain time frame. The debate also included pros and cons to an open-ended approach. The pros include flexibility and the opportunity to test various methodologies when determining the best estimation method. The cons include the prolonged use of estimates when not appropriate.

A15. The Board decided against a proposal that would establish a date-certain time frame for the use of reasonable estimates when determining the historical cost values of G-PP&E. The Board does not want to penalize an entity simply because it may take the entity longer to implement the necessary systems and processes to ensure the adequate capture of historical cost values. In addition, the Board believes that the use of reasonable estimates is proper given the appropriate disciplines surrounding the use of estimates.

A16. The Board encourages those federal entities that use estimates to approximate the historical cost values of G-PP&E to establish processes and practices (i.e., adequate systems and internal control practices) for future acquisitions that will capture and sustain transaction based data that meet the G-PP&E historical cost valuation requirements.

A17. The Board believes that acknowledging the continuing appropriateness of estimates based on non-traditional documentation as provided by SFFAS 23 is prudent under the current circumstances. Estimates that do not lead to material misstatements are acceptable without guidance from the Board.

SFFAS 35

Estimation of G-PP&E Historical Cost

9. This standard amends SFFAS 6 and 23 to clarify that reasonable estimates of original transaction data historical cost may be used to value G-PP&E. Reasonable estimates may be used upon initial capitalization as entities implement G-PP&E accounting for the first time as well as by those entities who previously implemented G-PP&E accounting.

10. This standard clarifies that federal entities should report their G-PP&E based on historical cost information in accordance with the asset recognition and measurement provisions of SFFAS 6, as amended. However, reasonable estimates of historical cost may be used to value G-PP&E assets.

11. This standard also allows the use of reasonable estimates when an entity determines it is necessary to revalue G-PP&E assets previously reported.

12. The text of SFFAS 6, par. 40 and 45, and SFFAS 23, par. 10 through 18, is amended as shown below (original paragraph numbers are retained).
[SFFAS 35 provides marked amendments to SFFAS 6 and 23 resulting from the amendments of SFFAS 35 but is omitted here.]

SFFAS 6

40. Although the measurement basis for valuing G-PP&E remains historical cost, reasonable estimates may be used to establish the historical cost of G-PP&E, in accordance with the asset recognition and measurement provisions herein. Estimates may be based on:

- cost of similar assets at the time of acquisition,
- current cost of similar assets discounted for inflation since the time of acquisition (i.e., deflating current costs to costs at the time of acquisition by general price index), or
- other reasonable methods, including those estimation methods specified in SFFAS 23 paragraph 12.

41. Accumulated depreciation/amortization shall be recorded based on the estimated cost and the number of years the PP&E has been in use relative to its estimated useful life. Alternatively, the PP&E may be recorded at its estimated net remaining cost and depreciation/amortization charged over the remaining life based on that net remaining cost.

42. For general PP&E that would be substantially depreciated/amortized had it been recorded upon acquisition based on these standards, materiality and cost-benefit should be weighed heavily in determining estimates. Consideration should be given to:

- recording only improvements made during the period beyond the initial expected useful life of general PP&E, and
- making an aggregate entry for whole classes of PP&E (e.g., entire facilities rather than a building by building estimate).

43. In recording existing general PP&E, the difference in amounts added to asset and contra asset accounts shall be credited (or charged) to Net Position of the entity. The amount of the adjustment shall be shown as a “prior period adjustment” in the statement of changes in net position. For published financial statements presenting prior year information, no prior year amounts shall be restated.

44. In the period that these standards are implemented, disclosure of the adjustments, by major class of PP&E, made to general PP&E and accumulated depreciation/amortization is required.

Disclosure Requirements

45. The following are minimum G-PP&E disclosure requirements:

- the cost, associated accumulated depreciation, and book value by major class;
- the use and general basis of any estimates used;
- the estimated useful lives for each major class;
- the method(s) of depreciation for each major class;
- capitalization threshold(s) including any changes in threshold(s) during the period; and
- restrictions on the use or convertability of G-PP&E.

SFFAS 23

Implementation Guidance

Initial Capitalization

10. The capitalization amount for G-PP&E assets previously considered ND PP&E should be based on historical cost in accordance with the provisions of SFFAS 6, as amended, and should be the initial historical cost for the base unit4A, including any major improvements or modifications.

11. [paragraph 11 was rescinded by SFFAS 35]

12. When establishing the historical cost of G-PP&E, in accordance with the asset recognition and measurement provisions of SFFAS 6, as amended, reasonable estimates may be used. Estimates may be based on information such as, but not limited to, budget, appropriations, engineering documents, contracts, or other reports reflecting amounts to be expended.

13. Alternatively, estimates of historical cost may be derived by estimating the current replacement costs of similar items and deflating those costs, through the use of price-level indexes, to the in-service year or estimated in-service year if the actual in-service year is unknown. Other reasonable approaches for estimating historical cost may also

be utilized. For example, latest acquisition cost may be substituted for current replacement cost in some situations.

13A. In estimating the year that the base unit was placed in service, if only a range of years can be identified then the mid-point of the range is an acceptable estimate of the in-service date.

14. A contra asset account--accumulated depreciation--for the assets should be calculated under the provisions provided in paragraphs 41, 42, and 43 of SFFAS 6, as amended.

15. For military equipment that is eligible for capitalization under this standard, cleanup cost liabilities should be adjusted, as needed.

Adjustment to Cumulative Results of Operations

16. Changes to previously reported G-PP&E amounts resulting from the application of this standard should be treated as a corrections of an error in accordance with SFFAS 21.

17. [paragraph 17 was rescinded by SFFAS 35]

18. [paragraph 18 was rescinded by SFFAS 35]