Federal Accounting Standards Advisory Board

April 16, 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 G**[1]

MEETING OBJECTIVES

The objective of this session is to review a staff draft interpretation regarding the treatment of capital improvements when estimating the historical cost of general property plant and equipment (G-PP&E) and whether estimates are permitted to capture the historical cost of construction in progress.

BRIEFING MATERIAL

The staff analysis is attached along with a question for the Board on page 3. You may electronically access all of the briefing material at http://www.fasab.gov/board-activities/meeting/briefing-materials/.

Attachment A- Staff Analysis

Attachment B- Staff Draft Interpretation, *Interpretation of SFFAS 6 as amended by SFFAS 35*

Appendix A- Draft RP Baseline Business Case, prepared by DoD FIAR

BACKGROUND

At the February meeting, staff explained that they would be participating as a liaison with the DoD Financial Improvement and Audit Readiness (FIAR) working groups to assist on discrete issues. FASAB's role is to assist if there is a need for GAAP

[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.

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guidance. This particular request and proposed Interpretation resulted from the DoD FIAR work groups.

NEXT STEPS

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

QUESTIONS FOR THE BOARD

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

Attachment A- Staff Analysis

1. <u>Draft Interpretation- (See Attachment B-*Interpretation of SFAFS 6 as amended by SFFAS 35*)</u>

The DoD requested FASAB to clarify the treatment of capital improvements when estimating the historical cost of general property plant and equipment (G-PP&E) and whether estimates are permitted to capture the historical cost of construction in progress.

The DoD Real Property Financial Improvement and Audit Readiness (FIAR) working group provided staff the Draft FIAR RP Baseline Business Case for consideration upon the request. See **Appendix A, Draft RP Baseline Business Case**. This may provide background and a better understanding of the options DoD was considering.

SFFAS 35, *Estimating the Historical Cost of General Property, Plant, and Equipment: Amending Statements of Federal Financial Accounting Standards 6 and 23*, and SFFAS 6 *Accounting for Property, Plant, and Equipment* provide for reasonably estimating the historical cost and accumulated depreciation of G-PP&E.

Question for the Board:

Does the Board have any questions or comments regarding the staff draft interpretation, *Interpretation of SFAFS 6 as amended by SFFAS 35*?

Interpretation of SFFAS 6 as amended by SFFAS 35

Introduction

1. The Federal Accounting Standards Advisory Board was asked to clarify the treatment of capital improvements when estimating the historical cost of general property plant and equipment (G-PP&E) and whether estimates are permitted to capture the historical cost of construction in progress.

2. This interpretation has been prepared on the basis of the following Statements:
   - Statement of Federal Financial Accounting Standards 6, *Accounting for Property, Plant, and Equipment*
   - Statement of Federal Financial Accounting Standards 23, *Eliminating the Category National Defense Property, Plant, and Equipment*
   - Statement of Federal Financial Accounting Standards 35, *Estimating the Historical Cost of General Property, Plant, and Equipment: Amending Statements of Federal Financial Accounting Standards 6 and 23*

Materiality

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

Interpretation

4. The objective of Statement of Federal Financial Accounting Standards (SFFAS 35) was to establish a cost effective method to comply with SFFAS 6 by amending SFFAS 6 (and 23) to clarify that reasonable estimates of original transaction data historical cost may be used to value G-PP&E.

5. SFFAS 6, paragraph 37, provides that: “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.” Paragraph 40 states that: “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:
   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.”

6. The current cost of similar assets would include all capital improvements present at the time the estimates are developed. It is not necessary to separately estimate the cost of capital improvements. 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. For example,

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in the case of a real property asset, Plant Replacement Value which includes all capital improvements should be deflated to the estimated in-service year or actual year of acquisition. It may not be reasonable to identify the Plant Replacement Value associated with individual capital improvements so that these improvements can be deflated to their in-service year.

7. SFFAS 6, paragraph 34, provides that; "In the case of constructed PP&E, the PP&E shall be recorded as construction work in process until it is placed in service, at which time the balance shall be transferred to general PP&E." As noted, paragraph 40 as amended states "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." G-PP&E includes construction work in process, therefore estimates may be applied.

Effective Date

8. This Interpretation is effective for periods beginning after September 30, 2015.

Appendix A: Basis for Conclusions

This appendix discusses some factors considered significant by Board members in reaching the conclusions in this Interpretation. It includes the reasons for accepting certain approaches and rejecting others. Individual members gave greater weight to some factors than to others.

A1. Accounting for the federal government's general property plant and equipment (G-PP&E) that are held as assets is complex and continues to be a challenge for certain large federal departments. This topic has been addressed in numerous Federal Accounting Standards Advisory Board (FASAB) Statements and Interpretations as well as guidance issued by the Accounting and Auditing Policy Committee. The FASAB finds that questions remain in this difficult area as federal departments encounter questions and the FASAB clarifies areas where there may need clarifications to ensure proper application of the principles and consistent treatment within federal departments.

A2. The Department of Defense (DoD) requested clarification of the treatment of capital improvements when estimating the historical cost of G-PP&E and whether estimates are permitted to capture the historical cost of construction in progress.

A3. Statement of Federal Financial Accounting Standards (SFFAS) 35, *Estimating the Historical Cost of General Property, Plant, and Equipment: Amending Statements of Federal Financial Accounting Standards 6 and 23*, and SFFAS 6 *Accounting for Property, Plant,* and Equipment and provide for reasonably estimating the historical cost and accumulated depreciation of G-PP&E. The purpose was to establish a cost effective means for the use of reasonable estimates to be available to reporting entities that have not previously prepared financial reports but who may be required to do so and do not yet have adequate controls or systems to capture these costs.

A4. After considering the principles within SFFAS 6 and 23 and the intent, the interpretation clarifies that:

- current cost would include all capital improvements
- this approach may be applied to all classes of G-PP&E
- estimates may be applied to construction work in process in accordance with SFFAS 35

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ENVIRONMENT

The current condition of real property in the Department of Defense is:

1) Department of Defense (DoD) has approximately 440,000 separate real property (RP) assets that must be valued in order to establish a baseline for real property on the general ledger for the initial audit.
2) Many RP assets facility built dates are beyond 40 years.
3) There are 3 Military Departments (MilDeps) and over 20 other DoD agencies that have acquired RP assets.
4) Many organizations (e.g. MilDeps, DoD agencies, construction agents) and systems are involved in acquiring RP assets and executing capital improvement (CI) projects.
5) DoD has not had any consistent or documented processes for retaining source documentation related to RP acquisitions.
6) CI(s) related to RP assets have not been reliably tracked in systems, therefore it difficult to identify CIs with any confidence, determine the date they were placed in service, or establish a valuation baseline.
7) All systems that the DoD has utilized for acquisitions of RP and CIs have either never been audited, or when audited had significant deficiencies or material weaknesses related to them.

The above conditions make it virtually impossible for the DoD to successfully complete an audit of its RP assets and CIs in accordance with current accounting standards.

In order for the DoD to become auditable, DoD requests that FASAB consider issuing new standards/guidance that would allow an entity presenting financial statements for audit the first time with alternatives when the entity's existing systems cannot provide the required information for previous periods necessary to support an audit.

PROPOSED SOLUTIONS

In order to successfully complete DoD's first financial statement audit, with financial statements presented in accordance with generally accepted accounting principles (GAAP), the following accounting treatment options are proposed in order to establish the initial baseline of RP assets on the balance sheet. Once the initial baseline is established, accounting for RP assets would be in accordance with SSFAS #6 and/or #35.

Option A

1) The RP asset, as it currently exists, is valued at Plant Replacement Value (PRV). This valuation would be in current year dollars and based on the current status of the asset, including all CIs that are evident.

2) Use evidence discovered during existence and completeness testing (e.g. DD Form 1354, contracts, etc.), to identify CIs that are part of the PRV calculated in (1) above, and deduct their cost from the RP PRV in (1) above. This will allow the value of the CI(s) to be recorded as a separate asset component, with depreciation beginning at the CI's estimated placed in service date.
3) Individually deflate the value of the RP asset and any separate CI(s), using an appropriate discount rate, to their estimated placed in service date.
4) Individually calculate depreciation on the deflated RP asset and CI(s) values using an appropriate estimated useful life.

- **Pro:** Best estimate in accordance with SSFAS #35
- **Con:** Very time consuming and costly
  Low confidence in availability of CI supporting documentation
  Must be done at the installation level
  May not be done in the time needed to meet established auditability dates

Option B

1) The RP asset, as it currently exists, is valued at PRV. This valuation would be in current year dollars and based on the current status of the asset. The current PRV is inclusive of all CI's.
2) Deflate the entire PRV to the estimated placed in service date, using an appropriate discount rate, in order to calculate depreciation.

- **Pro:** Cost effective
  Achievable within needed timeframe
- **Con:** Risk of understating value of CI(s)
  Risk of overstating depreciation for CI(s) in earlier years and understating in current and future years

Option C

1) Accept the values in the system for RP assets and CI(s) as of the initial baseline date. This would include cost and accumulated depreciation.
2) Continue depreciating assets based on annual amounts being used in prior years for the RP assets included in the baseline value.
3) Carry assets included in the baseline valuation (both RP and CI(s)) at the costs already in the property systems, without any requirement to support or substantiate the amounts with supporting documentation (e.g. invoices, contracts, payment support, etc.).
4) For any RP assets where there is no cost in the property system (as determined based on a reconciliation of known RP assets to the applicable general ledger accounts), calculate and record a valuation in accordance with the methodology in Option B above.

- **Pro:** Very cost effective
  Not required to validate RP assets and CI(s) in the property systems
  Easiest to implement and execute
  Smaller population of assets needing to be valued
- **Con:** No supporting documentation for RP assets and CI(s) already in the property systems
  Risk of undervaluing CI(s) for RP assets needing to be valued