Federal Accounting Standards Advisory Board

August 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 J**[1]

MEETING OBJECTIVES

The objective of this session is to consider options regarding baseline estimates of general property, plant, and equipment (GPP&E.)

BRIEFING MATERIAL

The staff analysis is attached along with questions for the Board on page 12. You may electronically access all of the briefing material at http://www.fasab.gov/board-activities/meeting/briefing-materials/.

Attachment A - Staff Analysis and Recommendations

Attachment B - Summary of Brainstorming Session with DoD

Attachment C - Summary of the FASAB Roundtable Meeting with Auditors

Attachment D- List of Options Raised for General PP&E Baseline Valuation

Attachment E- Department of Defense (DoD) Prepared Memo – Real Property and General Equipment Environment

Attachment F- Department of Defense (DoD) Prepared Memo - Internal Use Software (IUS) Environment

[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.

441 G Street NW, Mailstop 6K17V, Washington, DC 20548 ♦(202) 512-7350 ♦fax 202 512-7366

BACKGROUND

At the June 2015 meeting, staff presented the Board with options to consider regarding baseline estimates of general property, plant, and equipment (GPP&E.) The Board agreed that issuing a Statement and making the appropriate amendments to standards should provide a cost effective go forward approach for DoD. While the Board did not decide on a particular approach, many good points and options regarding baseline estimates of general GPP&E were discussed. It was agreed that FASAB staff would work with DoD and facilitate meetings to gather input from their auditors. In addition, the issues related to all GPP&E, including real property, military equipment and land can be addressed in one Statement.

NEXT STEPS

Staff will consider the Board member views and begin developing a more thorough draft for the Board's consideration at the October 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

Background

As you may recall, this area of the DoD project resulted from a request from DoD to clarify whether capital improvements are included when estimating the historical cost of GPP&E. At the April 2015 meeting, staff presented the Board with a staff draft interpretation that provided that the estimated current cost of similar assets would 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 deflated to the original in-service date. However, a member raised concerns regarding capital improvements made in recent years being deflated to the original in-service date as well as future capital improvements.

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. At the June 2015 meeting, staff presented the Board with three options for consideration:

1. **One-time Use** - Allow one-time application of current cost deflated to the original in-service date to establish an initial baseline.
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.
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, it's current use or add significant new capabilities to establish an initial baseline.

While the Board did not decide on a particular approach, a robust discussion was held with additional options regarding baseline estimates of general GPP&E discussed. The Board directed FASAB staff to work with DoD and facilitate meetings with the audit community to gather input and to discuss the approaches further. In addition, after further discussion, it was agreed that the scope of the project should include all GPP&E, including real property, military equipment and land and that it may be addressed in one Statement.

Meetings

FASAB staff facilitated two meetings to gather more input to inform the Board's response to the Department of Defense's request for implementation guidance.

Brainstorming Session with DoD- July 20, 2015

The first meeting was a Brainstorming Session with members of DoD FIAR team, other DoD staff and FASAB staff to learn more about plant replacement value (PRV) and to discuss other options for valuation. In addition, the group discussed ways to shrink the universe of assets. A key point made by DoD representatives was that the PRV is used in decision making at DoD. Therefore, improving the reliability of PRV would be helpful to DoD and the services. There was general agreement that it is possible to improve the PRV so that it can be relied upon for audited financial statements. **See Attachment B-Summary of Brainstorming Session with DoD**.

FASAB Roundtable with Auditors - DoD PP&E Issues - August 3, 2015

The second meeting FASAB facilitated was an auditor roundtable meeting with partners and senior managers from audit firms and the DoD FIAR Team to discuss cost effective options for estimating the cost of GPP&E, audit issues and emerging issues.

Staff recommends that Board members read **Attachment C- Summary of the FASAB Roundtable with Auditors** as it provides an overview of the discussion regarding DoD PP&E Issues.

A key point shared by all participants was they believed that DoD should focus on ensuring adequate systems and controls are in place. The focus should be prospective; that is, capturing the cost of acquisitions going forward. Most participants believed that at best DoD may get a qualified opinion for several years—the qualification would relate to the general PP&E line item and related cost. However, at least it provides a mark to move forward and avoids expending funds on amounts that may not be successfully estimated and documented. Focusing on moving forward to implement systems and get the right information in the future was viewed as a better use of resources.

As for the discussion of options, most participants noted concern with PRV or any type of model that is used because the assumptions and cost factors have not been tested. The majority believed the utility or benefit in auditing something such as the PRV at this point would be very little and the audit outcome may be worse. For example, an adverse opinion could result.

As for limiting the universe of assets or providing more guidance on baseline materiality, most participants believed that there was ample guidance and did not see much of a need for additional guidance from FASAB.

The participants identified several areas that they considered to be challenges for DoD. These are identified in **Attachment C** and will be raised at an appropriate time as the project progresses.

Consideration of Options for DoD

Providing implementation guidance for the Department of Defense (DoD) requires consideration of cost-benefit as well as the current resource constraints. DoD has indicated that they do not have systems capable of capturing the information needed to capitalize new general PP&E acquisitions. Thus, they face the dual challenge of establishing general PP&E opening balances and updating them over time through the use of estimates rather than actuals.

Many of the decisions on approaches have an associated cost attached. The decision is ultimately DoD's to make and often may have other associated consequences such as acceptance of a certain audit opinion. For example, as recommended at the audit roundtable meeting, DoD may choose to spend little money on the past information and focus on the information and systems going forward but this may result in a qualified audit opinion.

The sections that follow will discuss the specific areas where the Board might provide guidance or amendments to reduce the cost of implementation.

Real Property

Real property is the area of the original request from DoD. Specifically, DoD requested clarification whether capital improvements are included when estimating the historical cost of GPP&E. Over the course of the past few months, we have learned more about the real property environment, systems and methodologies employed by DoD. Capital improvement projects related to real property assets have not been reliably tracked in systems so it is 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 real property and capital improvement projects have either never been audited, or when audited had significant deficiencies or material weaknesses related to them. In addition to the staff suggestions, a robust discussion was held at the last Board meeting and follow up discussions, with additional options regarding baseline estimates of general GPP&E. A complete list of options for DoD's general PP&E baseline values was developed and distributed for further consideration, see **Attachment D-List of Options Raised for General PP&E Baseline Valuation**.

Staff considered the following options to limit the cost of capitalizing real property:

1. Use **deemed cost** for real property opening balances. For example, real property could be valued at replacement cost, estimated historical cost, or fair value. DoD currently uses PRV (a replacement cost model) for management but not financial reporting purposes. This valuation would be in current year dollars and not deflated to the in-service year. PRV is inclusive of capital improvements. Accumulated depreciation would be recognized based on the remaining useful life compared to the original useful life. This would not systematically understate the historical cost since capital improvements would not be deflated. However, it may overstate the historical cost and subsequent years' depreciation expense.

2. **DoD Option A (See Attachment E- Department of Defense (DoD) Prepared Memo – Real Property and General Equipment Environment)** Provide for use of deflated PRV (replacement cost) to estimate historical cost based on:
   a. real property placed in service after October 1, 1975 (40 years ago) (older items would be excluded)
   b. separate treatment of material capital improvements made after September 30, 2009 (material being greater than $750,000)
   c. (see details DoD Option A per attachment)
3. **DoD Option B (See Attachment E- Department of Defense (DoD) Prepared Memo – Real Property and General Equipment Environment)** Provide for values in the Accountable Property System of Record (APSR) and related systems for real property and capital improvements as of the baseline date of 10/1/15.
   a. general ledger for each DoD component would be adjusted to the APSR and related system values
   b. no documentation
   c. depreciation would continue based on prior amounts

Staff Recommendation for Real Property:
Staff recommends option 1- use of deemed cost for real property opening balances that would provide for it to be valued at replacement cost, estimated historical cost, or fair value. As discussed in our brainstorming session with DoD, DoD believes it is important and helpful to focus on improving the reliability of PRV because it is used in decision making.

Staff believes this is the most cost effective option given the DoD request while also considering concerns raised by Board members. This valuation would be in current year dollars and not deflated to the in-service year. PRV is inclusive of capital improvements. Accumulated depreciation would be recognized based on the remaining useful life compared to the original useful life. This would not systematically understate the historical cost since capital improvements would not be deflated. However, it may overstate the historical cost and subsequent years' depreciation expense. Prospective treatment of new general PP&E acquisitions would be accounted for in accordance with accounting standards.

From our meeting with the auditors, most participants noted concern with PRV or any type of model that is used because the assumptions and cost factors have not been tested. The majority believed the utility or benefit in auditing something such as the PRV at this point would be very little and the outcome may be worse. While staff understands the auditors' concern, there must be a starting point and considering the PRV is the model that DoD has stated they use in decision making, it appears this should be the one that they focus on improving for use in the future. Therefore, this should be available for use as the opening balance.

Regarding alternatives to the use of PRV, it was suggested that other methods would be costly and that the budget records may not be sufficiently detailed or complete for such purposes. Staff does not see the benefit in recommending other alternatives as the costs associated would outweigh the benefits that could be obtained. For example, in considering Option A as presented by DoD, it appears detailed and complex and therefore it would take some time to go through the process to develop a valuation based on several systems and different methodologies that have not been tested and will not be used by management. One may question the utility or benefit in performing such an exercise that would have an associated cost, and then auditing it—which would also have a cost and with the questionable approach, the audit outcome may be worse.

Option B as presented by DoD was discussed previously and most agreed that this was the least desirable alternative because it would be difficult to describe as a valuation method. Participants also noted concern that what was in the system may not be complete or exist as there have been numerous problems with the information, so that would be problematic.

Question for the Board: Does the Board generally agree with the staff recommendation to use deemed cost for real property opening balances and allow several alternatives similar to the inventory approach?

Land

The DoD has indicated records of the cost of land are not adequate. (While plant replacement value is being used for facilities, the cost factors exclude land.)

Land records are centrally managed but not in a structured, searchable manner. Naval Facilities Engineering Command maintains Navy and Marine Corps land records. Army Corps of Engineers maintains the Army's land records and pre-1947 Air Force records. These records are not digitized and accessing them involves searching boxed records in a warehouse.

If deeds can be located, they generally provide the price paid upon transfer of the deed (historical cost). However, land holdings have expanded over the decades through multiple small purchases so there are many records. Also, deeds may not be complete – there may be gaps in contrast to the area controlled by the services. There may also be gaps in court records given the length of time involved.

In addition to land, land rights[2] must be considered. Records regarding easements, the original cost, and needed adjustments to value are a challenge.

SFFAS 6 provides the following guidance regarding land and land rights:

> Land and land rights acquired for or in connection with other general PP&E[3] shall be included in general PP&E. In some instances, general PP&E may be built on existing

[2] "Land rights" are interests and privileges held by the entity in land owned by others, such as leaseholds, easements, water and water power rights, diversion rights, submersion rights, rights-of-way, and other like interests in land.

[3] "Acquired for or in connection with other general PP&E" is defined as land acquired with the intent to construct general PP&E and land acquired in combination with general PP&E, including not only land used as the foundation, but also adjacent land considered to be the general PP&E's common grounds.

> Federal lands. In this case, the land cost would often not be identifiable. In these instances, general PP&E shall include only land and land rights with an identifiable cost that was specifically acquired for or in connection with construction of general PP&E. (SFFAS 6, par. 25)
>
> Depreciation expense shall be recognized on all general PP&E, except land and land rights of unlimited duration. Land rights that are for a specified period of time shall be depreciated or amortized over that time period. (SFFAS 6, par. 35)

DoD will incur considerable cost to identify or estimate the historical cost of land and land rights. Because land is not depreciated, the benefits of capitalizing it are primarily in the period of acquisition. That is, the cost of the land is identified so the acquisition can be evaluated and the period operating costs not overstated. The ongoing benefit is that accountability for the asset is established.

Staff considered the following options to limit the cost of capitalizing existing land and land rights:

1. Provide for prospective capitalization of land, but require disclosure of physical units for currently held land
2. Allow capitalization based on current values
    a. average per acre cost in the region
    b. appraisals
    c. other valuation assessments such as county property tax assessments
3. Provide for capitalization of land acquired more recently (perhaps since 2009)

Staff recommendation for Land:
Staff recommends option 1- prospective capitalization of land, but require disclosure of physical units for accountability. Considering that appraisals may be costly or valuation assessments supported by records may not be complete or difficult to substantiate because the records are not adequate, staff does not believe it would be cost beneficial for DoD to establish a balance for land. Instead, it would be more effective to consider a prospective treatment of land acquired for purposes of general PP&E.

Doing so, would enable DoD to devote its resources toward working on systems and other implementation issues. However, staff believes accountability must be promoted and FASAB should ensure that DoD continues the proper existence and completeness work for Land. Therefore, staff believes a disclosure of the amount of land in terms of physical units should be required—similar to that for Stewardship Land. As with Stewardship Land, the appropriate level of aggregation and physical units of measure for each major category of land use should be meaningful and determined by the preparer based on the entity's mission, types of land use, and how it manages the assets.

Question for the Board: Does the Board generally agree with the recommendation for prospective capitalization of Land with disclosure of physical units for accountability?

Internal Use Software (IUS)

DoD does not have a complete inventory of its IUS. Costs of IUS have not traditionally been captured. DoD has not had any consistent procedures, or documented processes for retaining source documentation related to IUS acquisitions. In addition, substantially all systems the DoD has utilized to track IUS have either never been audited or when audited had significant deficiencies or material weaknesses related to them. The lack of supporting documentation for IUS is a significant challenge for DoD to establish an auditable baseline of IUS in accordance with GAAP.

Based on these conditions and others described in **Attachment F <u>Department of Defense (DoD) Prepared Memo - Internal Use Software (IUS) Environment</u>**, DoD requested that IUS be implemented prospectively given SFFAS 10 initial provisions.

SFFAS 10 provides the following regarding implementation

Implementation

36. Cost incurred prior to the initial application of this statement, whether capitalized or not, should not be adjusted to the amounts that would have been capitalized, had this statement been in effect when those costs were incurred. However, the provisions of this statement concerning amortization and impairment should be applied to any unamortized cost capitalized prior to the initial application of this statement that continue to be reported as assets after the effective date.

DoD will incur considerable cost to identify or estimate the capitalizable amount of IUS. This would take limited resources away from establishing systems and processes to properly account for IUS on a go forward basis.

Staff considered the following options to limit the cost of capitalizing existing IUS:

1. Provide for prospective capitalization of IUS
2. Provide for capitalization based on major contracts/CLINS
3. Provide for capitalization of IUS acquired more recently (perhaps since 2013)

Staff Recommendation for IUS:

Staff agrees with DoD's request and recommends option 1- prospective capitalization of IUS. Considering that documentation for determining what costs should be capitalized or expensed often does not exist and that IUS costs have not been consistently and accurately accounted for, staff does not believe it would be cost beneficial to research and correct the recorded balances. Further, based on what DoD explained, the contract lines (CLINS) have not been structured so that determining which costs should be capitalized or expensed is possible from information in the contract. The previous Board in effect provided for prospective implementation of SFFAS 10 with paragraph 36 by stating that "Cost incurred prior to the initial application of this statement, whether capitalized or not, should not be adjusted to the amounts that would have been capitalized, had this statement been in effect when those costs were incurred.." While DoD has had numerous years to implement this and other standards, the fact remains they have not and the conditions remain that existed when many of these standards were issued. Therefore, staff recommends a prospective capitalization of IUS and providing similar relief to DoD that was initially provided when SFFAS 10 was implemented.

Question for the Board: Does the Board generally agree with the recommendation for prospective capitalization of IUS?

Equipment

While staff has not gathered as much information in this area, it appears that the military services are not planning to use deflated replacement cost for equipment. Instead, budget and other records would be used. The general equipment is a broad category that consists of hundreds of thousands of assets. DoD does not have procedures in place now to accurately account for 2014 or 2015 capital acquisitions (but indicated in their proposal that records after October 1, 2002 are more reliable than those before). Based on discussion at the auditor roundtable, SFFAS 35 will provide the basis for identifying costs to be capitalized each year going forward. Meaning, some services are <u>not</u> planning on establishing a systematic transaction-based approach to identifying the cost of new assets.

From our Auditor RoundTable meeting, there was concern with the fact that SFFAS 35 allows for estimates to be used in the future and DoD may continue relying on estimates without actually addressing the problem of fixing systems to get cost accounting information and historical cost information. DoD explained that they continue to get push back from components because the standards allow for estimates. Some suggested FASAB rescind these provisions of SFFAS 35 to discourage reliance on estimates for future acquisitions.

Some suggested DoD may get a qualified opinion for several years related to general PP&E balances (and depreciation expense) for those items acquired prior to the date sound systems and controls are established. Despite the qualification, the financial statements would be useful and provide a mark to move forward. A qualified opinion may be the correct outcome for public reports, and would allow resources to be focused on systems improvements and avoid wasting resources on a potentially unsuccessful effort to address existing asset balances.

Staff considered the following options to limit the cost of capitalizing equipment:

1. Use **deemed cost** for equipment opening balances. For example, equipment could be valued at replacement cost, estimated historical cost, or fair value.
2. **DoD Option A (See Attachment E- Department of Defense (DoD) Prepared Memo – Real Property and General Equipment Environment)**:
    a. Prospective treatment of SFFAS 23 and retroactive application of current capitalization thresholds to existing assets
    b. Equipment and capital improvement is separated into classes based on useful lives then calculate estimated values of assets based on similar assets, contracts or budgets and also calculate depreciation
    c. (see detailed DoD Option A per attachment)

3. **DoD Option B (See Attachment E- Department of Defense (DoD) Prepared Memo – Real Property and General Equipment Environment)** Provide for values in the APSR and related systems for real property and capital improvements as of the baseline date of 10/1/15.
   a. general ledger for each DoD component would be adjusted to the APSR and related system values
   b. no documentation
   c. depreciation would continue based on prior amounts

Staff Recommendation for equipment:
Staff believes a similar approach may be used that was used for Real Property and Inventory. Staff recommends option 1- use of deemed cost for equipment opening balances that would provide for it to be valued at replacement cost, estimated historical cost, or fair value. Prospective treatment of new general PP&E acquisitions would be accounted for in accordance with accounting standards.

In regards to Option A as presented by DoD, it appears more complex than Option 1 due to the need to deflate current values. Also, Option A appears to seek a materiality decision from the Board because it refers to retroactive application of the current capitalization threshold. Another aspect of Option A is the suggestion to apply SFAFS 23 as if prospective implementation had been provided effective FY2002. Staff notes that prospective application of SFAFS 23 could be considered in conjunction with a deemed cost approach.

While all the options involve an estimation methodology, Option A limits DoD to a single approach. It is questionable if the necessary information could be obtained to perform the valuation, and if so, it would take some time to go through the process to develop a valuation based on several systems and different methodologies that have not been tested and will not be used by management. For that reason, staff prefers the flexibility available through the deemed cost approach.

Option B as presented by DoD was discussed previously and most agreed that this was the least desirable alternative because it would be difficult to describe as a valuation method. Users would not understand the basis for the amounts. Participants also noted concern that what was in the system may not be complete or exist as there have been numerous problems with the information, so that would be problematic.

Questions for the Board: Does the Board generally agree with the staff recommendation to use deemed cost for equipment opening balances and allow several alternatives similar to the inventory approach? Does the Board wish to pursue any aspects of DoD Options A or B?

Questions for the Board

Does the Board generally agree with the staff recommendation to use deemed cost for real property opening balances and allow several alternatives similar to the inventory approach?

Does the Board generally agree with the recommendation for prospective capitalization of Land with disclosure of physical units for accountability?

Does the Board generally agree with the recommendation for prospective capitalization of IUS?

Does the Board generally agree with the staff recommendation to use deemed cost for equipment opening balances and allow several alternatives similar to the inventory approach? Does the Board wish to pursue any aspects of DoD Options A or B?

Attachment B - Summary of Brainstorming Session with DoD

Brainstorming Session – Baseline Real Property Values
July 20, 2015 Meeting Notes - DRAFT

Attendees:

Steve Chad, Deloitte
Bob Coffman, DoD ATL
Sara Hewitt, Booze Allen Hamilton
Bill Hughes, PwC
Alaleh Jenkins, DoD FIAR
Wendy Payne, FASAB
Domenic Savini, FASAB
Monica Valentine, FASAB
Tom Vanneman, Marine Corps

Action Items:

FASAB Staff:

1. Develop options to:
    a. Provide for use of deflated replacement cost to estimate historical cost with separate treatment of capital improvements:
        i. Funded by Military Construction (MILCON) budgets and
        ii. Within the last ten years
    b. Land – request that the Board consider prospective treatment of land acquired for purposes of general PP&E construction/use
2. Consider cost-beneficial ways to shrink the universe of PP&E requiring valuation.

DoD:

1. Improve quality (auditability) of plant replacement values (PRV) and consider the quality of physical inventory data (for example, accuracy of square footage and facility type)
2. Identify factors that may influence the number of years MILCON funded improvements are identified (currently proposed for 10 given Marine Corps data availability to 2006)
3. Consider requesting that IUS be implemented prospectively given SFFAS 10 initial provisions (cost/benefit argument – high cost of inventorying soft assets)

Key Discussion Points:

1. Plant replacement value (PRV) is based on replacement unit cost factors. Current cost factors are not documented sufficiently to pass audit. The cost factors are calculated from:
    a. Averages of contractual cost data from the prior three years (50%)
    b. Commercially available cost data (25%)
    c. Models using general price information (25%)
2. Improving the reliability of PRV would be helpful to DoD and the services because it is used in decision making. General agreement was reached that it is possible to improve the PRV so that it can be relied upon for audited financial statements. Some

consideration should be given to first focusing on the cost factors for high value and larger facility types.

3. The group briefly discussed ways to narrow the population of PP&E requiring valuation. Generally, a cut-off based on in-service year seemed most viable.
4. Marine Corps representatives identified the following challenges:
    a. Capital improvements may have been funded by operating and maintenance funds (O&M) or by MILCON funds.
    b. A form DD1354 (real property transfer document) was produced for MILCON funded improvements but not for O&M funded improvements. The form has limited informational value but does document the existence of an improvement.
        i. 90% of improvements made after 9/30/05 have an associated DD 1354.
        ii. For FY2013, 69% of projects had delayed paperwork (creating timeliness and record access issues).
    c. The Marine Corps is validating the inventory of property (existence and completeness). A financial review is then needed to establish valuation.
    d. Establishing a baseline may require them to apply the capitalization threshold applicable to the in-service year. An alternative suggested was to consider what threshold is needed at the baseline year to avoid materially misstating the balance sheet.
5. Regarding alternatives to use of PRV, it was suggested that appraisals would be too costly and that budget records are not sufficiently detailed or complete.
6. Other issues relating to real property included:
    a. What entity should recognize the asset? Sometimes ownership, funding, and use relate to different entities.
    b. Land values are needed but records are not as expected. If deeds can be located, they often provide the transfer price (historical cost). Because facilities have expanded over the decades through multiple small purchases there are many records.
        i. Naval Facilities Engineering Command maintains Navy and Marine Corps land records. Army Corps of Engineers maintains the Army's land records and pre-1947 Air Force records. These records are not digitized and accessing them involves searching boxed records in a warehouse.
        ii. Deeds may not be complete – there may be gaps in contrast to the area controlled by the services. There may also be gaps in court records.
        iii. Easements – records and adjustments to value are a challenge.
        iv. It was noted that land is not depreciated and the absence of values would not affect reported cost of operations.
7. Regarding equipment (formerly referred to as "military equipment"), military services are not planning to use deflated replacement cost. Budget and other records will be used. In addition, SFFAS 35 will provide the basis for identifying costs to be capitalized each year going forward. (That is, establishing a systematic transaction-based approach to identifying the cost of new assets is not planned.)

Attachment C - Summary of the FASAB Roundtable Meeting with Auditors

FASAB Roundtable Summary
DoD PP&E Issues
August 3rd 2015, 9-11

Objective of Roundtable: The roundtable is intended to inform the Board's response to the Department of Defense's request for implementation guidance as well as to prepare to address issues arising from ongoing auditability efforts at DoD.

Participants: Partners and Senior Managers from audit firms and DoD FIAR Team

- **DoD Implementation Guidance Request Project- PP&E area**
  - DoD requested guidance regarding:
    - Use of plant replacement value to estimate real property historical cost
    - The need for separate identification of capital improvements made to real property
  - Guidance in this area is likely to apply to other than real property assets as well

- **Overall comments**
  - Primary concern of the auditors is the assurance that DoD has fixed or will fix the systems and controls to move forward. Most agree the ability to capture actual cost for current and future acquisitions should be the top priority. Finding a proxy for the past is of questionable utility. They believed that DoD should focus on fixing the internal controls and ensuring adequate systems are in place. The focus should be prospective.
    - When asked, DoD participants indicated that DoD does not have procedures in place now to accurately account for 2014 or 2015 capital acquisitions. DoD explained that is a goal and a work in progress. They explained they need to arrive at a supportable position so they can move forward.
    - There was concern with the fact that SFFAS 35 allows for estimates to be used in the future and DoD may continue relying on estimates without actually addressing the problem of fixing systems to get cost accounting information and historical cost information. DoD explained that they continue to get push back from components because they do say the standards allow for estimates. Some suggested FASAB rescind these provisions of SFFAS 35 to discourage reliance on estimates for future acquisitions.
  - Most participants believed that at best, DoD may get a qualified opinion for several years. The qualification would relate to general PP&E balances (and depreciation expense) for those items acquired prior to the date sound systems and controls are established. Despite the qualification, participants believed the financial statements would be useful and provide a mark to move forward. The participants noted that there may also be existence and completeness issues.

  - Participants expressed that accounting standards should be written with stakeholders and fair presentation of the financial statements in mind, not written with the audit in mind. Instead, the audit is a distinct and separate process. If the result is a Qualified opinion, it may be the correct outcome for public reports. If DoD accepted this as the likely outcome, it would allow resources to be focused on systems improvements and avoid wasting resources on a potentially unsuccessful effort to address existing asset balances. Thus, the focus can be on moving forward to implement systems and get information right in the future. Participants noted if this conversation had happened years ago, much money would have been saved and DoD may be further along.

- **Options discussed for estimating the cost of general property, plant, and equipment**

  - Plant replacement values (PRV) to estimate real property- Most participants noted concern with this or any type of model that is used because the assumptions and cost factors have not been tested. The majority believed the utility or benefit in auditing something such as the PRV at this point would be very little and the outcome may be worse (for example, an adverse opinion).

    One participant believed that there were ways to screen out certain assets using certain models such as the PRV, they believed it fell under implementation guidance and not that of standard setters to provide additional guidance. The participant stated it should not prevent DoD from focusing on assets prospectively and continuing to implement systems as they work on bettering the model. When DoD believes the models were feasible, the models could be tested by an appraiser. However, this type of model and methodology can only be applied to real property and the universe of assets is much larger.

    While the participants agreed coming to agreement on valuation does not satisfy existence and completeness concerns.

  - The Board could revise standards to focus on PP&E acquired through Major Programs. That is, narrow the population of PP&E to be valued in the baseline through implementation guidance defining criteria for PP&E to be included in the opening balance. Through such guidance, PP&E acquired through other than military construction funds or major programs documented in budget justifications might be excluded. (These would be included prospectively.) Budget documents could be used to determine significant investment programs. SFFAS 6, paragraph 22 currently allows: “In determining which category PP&E should be placed in, it will be necessary to identify the “base unit” of PP&E against which the category definitions will be applied. For example, units as large as entire facilities or as small as computers could be categorized. In determining the level at which categorization takes place, an entity should consider the cost of maintaining different accounting methods for property and the usefulness of the information, the diversity in the PP&E to be categorized (e.g., useful lives, value, alternative uses), the programs being served by the PP&E, and future disposition of the PP&E (e.g., transferred to other entities or scrapped)."

- Another option discussed was to cut off work looking back as far as valuation at a certain period and just ensure existence and completeness for all types of property.

- The Budget office should have information that could be used and that TR 13 provided this as an example. Most agreed that the budget document may be the only reliable documentation that readily exists.

- DoD suggested an alternative of accepting a baseline based on the subsidiary records in the system. It was noted that this may be difficult to describe as a valuation method. Participants discussed that what was in the system may not be complete or exist as there have been numerous problems with the information, so that would be problematic.

- **Population considered in Opening Balances**

  - As for limiting the universe of assets or providing more guidance on baseline materiality, most participants believed that there was ample guidance and did not see much of a need for additional guidance from FASAB. Most agreed it was not feasible or appropriate for FASAB to provide guidance on baseline materiality. They mentioned that there is existing guidance within the FASAB standards, A-123, Financial Audit Manual, etc.

  - In determining "buckets of assets" that could be removed from consideration, one could exclude fully depreciated assets but often it would difficult and costly to go through the necessary procedures to actually prove that an item should be fully depreciated.

- **Emerging Issues or Challenge Areas**

  - *Reporting entity*-there is a lot of interplay at DoD. Participants explained that DoD may need guidance and/or FASAB should be prepared for questions in this area.

  - *Estimates*- clarity around when estimates are allowed. Also, additional clarity should be provided about which in-service date for capital improvements should be used.

  - *Ownership issues*- especially implementation guidance needed in determining ownership in various scenarios at DoD where risk and benefit varies. Example- fuel owned by one component stored in facilities owned by another.

  - *Intelligence agency issues*- significant transactions between DoD and the intelligent agencies

Attachment C - Summary of the FASAB Roundtable Meeting with Auditors

- *Service provider*- what is the definition for service provider? For example, if all of a smaller agency's activity is executed through DoD—would DoD be considered a service provider?

- *Leases*--Should DoD be spending resources and potential effort implementing the current lease standards considering there is a change in the near future. Also there are non-monetary exchange lease like arrangements that should be considered, such as the base in Okinawa, Japan. For example, the host nation provides facilities in exchange for a US military presence.

- *Internal Use Software*- especially in the area of cyclically billed IUS and those absent a system

- *Other items* -WCF issues, Building transfers TI-97 & assets titled to someone else, Sub-allocations (probably not something FASAB would assist with)

Attachment D- List of Options Raised for General PP&E Baseline Valuation

List of Options Raised for General PP&E Baseline Values

1. Valuation
    a. Plant replacement value (is it auditable?)
        i. Cost factors
        ii. Requirements to apply to particular asset type
        iii. Useful life by asset type
        iv. In-service year (SFFAS 23 provides: 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.)
    b. Suggestions for addressing the understatement resulting from deflating current cost (inclusive of improvements) to original in-service date or overstatement resulting from use of current cost valuation
        i. Establish PRV, identify remaining useful life, calculate the ratio of that remaining life to the expected life of a similar asset acquired today, capitalize the PRV and recognize accumulated depreciation for the ratio (e.g., 5 year remaining useful life, similar asset newly acquired would have a 15 year life, establish asset at PRV ($75) and accumulated depreciation of 1/3 ($25))
        ii. Require deflation only to a certain point in the life (e.g., in-service year 10-years ago then only deflate current cost by 5 years)
        iii. Require that depreciation start later than the in-service date (e.g., in-service year was 10-years ago, deflate the full ten-years, establish accumulated depreciation for only five years to offset the excessive deflation)
        iv. Allow PRV deflated to original in-service date EXCEPT for the largest assets – for the largest assets, require a review for recent material capital improvements
        v. Reduce PRV based on the deferred maintenance and condition assessment; then deflate the reduced result (no general adjustments for deflation)
        vi. Exclude real property more than 40 years old even if it has been improved
        vii. Allow PRV with no deflation but with accumulated depreciation for the estimated years in service vs the useful life (for example, depreciated replacement cost)
        viii. GASB 34 approach – reasonable basis with method disclosed
        ix. Apply SFFAS 6 prospectively
2. Consider ways to narrow the population DoD must review
    a. Capitalization threshold guidance applicable only to the baseline
    b. Limit capitalization to assets with more than X years remaining life (suggests X be between 10 and 20 years)
    c. Original expected useful life already exceeded (SFFAS 6 excerpts with existing exceptions shown below)

Attachment D- List of Options Raised for General PP&E Baseline Valuation

Existing Implementation Guidance (SFFAS 6) (Note that several technical releases also address PP&E – see especially TR 13 – Estimating the Historical Cost of General PP&E at http://www.fasab.gov/pdffiles/handbook_tr_13.pdf)

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[31] 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).

Attachment E- Department of Defense (DoD) Prepared Memo – Real Property and General Equipment Environment

ENVIRONMENT

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

1) Department of Defense (DoD) has approximately 440,000 separate real property (RP) assets and hundreds of thousands general equipment (GE) capital assets that must be valued in order to establish a baseline for real property and for general equipment on the general ledger/financial statements for the initial audit.
2) GE is a broad category that encompasses diverse classes of assets such as information technology hardware, aircraft carriers, satellites, gantry cranes, coach busses, and portable generators. RP includes buildings, land, structures and linear structures.
3) Many RP asset facilities were built more than 40 years ago. Many of the GE assets with the highest historical costs were built one or more decades ago (e.g. vessels and aircraft).
4) There are 3 Military Departments (MilDeps) and over 20 other DoD agencies that have acquired RP assets. The majority of GE value is in the form of weapons systems and is held by the Military Departments, the Special Operations Command and the Missile Defense Agency.
5) Many organizations (e.g. MilDeps, DoD agencies, construction agents) using multiple systems/processes are involved in acquiring RP and GE assets and executing capital improvement (CI) projects.
6) DoD does not have any consistent or documented processes for retaining source documentation related to RP and GE acquisitions.
7) CI(s) related to RP and GE assets have not been reliably tracked in systems, therefore it is difficult to identify CIs with any confidence, determine the date they were placed in service, or establish a valuation baseline.
8) Systems that the DoD has utilized for acquisitions of RP, GE and CIs have either never been audited, or when audited had significant deficiencies or material weaknesses related to them.
9) The capitalization threshold for the General Funds and Working Capital Funds (excluding the United States Corps of Engineers which is $25,000 and the Marine Corps which is $100,000) since October 1, 2013 has been $250,000 for all DoD Components except the Department of the Navy and the Department of the Air Force which are $1,000,000. Prior to October 1, 2013, General Fund capitalization thresholds varied over time from $25,000 to $100,000. The Working Capital Fund capitalization thresholds ranged from $15,000 to $100,000.

The above conditions make it virtually impossible and inefficient for the DoD to establish an auditable beginning baseline for its RP assets and RP CIs and of its GE and GE CIs in accordance with current Federal accounting standards.

The DoD does not utilize the book value of RP or GE for decision making or other management purposes. DoD has other metrics used when decisions are made regarding RP and GE. For example, with regard to RP, one of these methods is Plant Replacement Value (PRV). To some extent, the PRV is updated annually for all of the DoD capitalized RP assets with the exception of land. Based on many of the conditions above, an effort to identify all DoD RP, GE and related CIs would take thousands of labor hours (both government employees and their contractors), costing millions of dollars, and would most likely not produce a complete listing of RP and GE assets that is auditable. This situation is the result of decades of systems and processes designed and used for budgetary purposes, not to sustain an audit performed in accordance with Generally Accepted Government Auditing Standards. This situation was not created by the government personnel in place today that have operational responsibility or accounting/finance responsibilities. These individuals cannot create auditable DoD financial statements for DoD's first time audit since documentation does not exist and issues relating to systems and processes from the past cannot be reasonably remediated.

The DoD does maintain subsidiary ledgers for RP and GE assets called the Accountable Property System of Record (APSR). Although it is not 100% complete or accurate, it has been used throughout the years to track RP and GE assets and related CIs. It contains line items for asset description, cost, and in-service dates, in addition to other information. Although cost information is included for most items, it is not feasible to obtain source documents to support the costs shown in the APSR.

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 for 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 and GE assets on the balance sheet. Once the initial baseline is established, accounting for RP and GE assets would be in accordance with SSFAS #6 and/or #35.

Option A – Real Property

1) The RP assets with placed in service dates from October 1, 1975 (40 years ago), as identified in the APSR, are valued at Plant Replacement Value (PRV). This valuation would be in current year dollars. Real Property capital improvements (RP CIs) will be addressed in the following manner:

   a. RP CIs with placed in service dates from October 1, 2009 will be identified separately from the base asset. This date was chosen because it is when DoD implemented the requirement to list RP CIs separately in APSRs.
   b. The RP CIs above $750,000 will be identified and valued by evaluating existing CI records against Military Construction (MILCON) budgets.
   c. RP CI historical costs will be removed from the PRV of the base asset and depreciated separately.

2) Individually deflate the value of the RP asset using an appropriate discount rate, to their estimated placed in service date. If only an approximate range for the estimated placed in service date can be determined, the mid-point of that range will be used.

3) Individually calculate depreciation on the deflated RP asset and CI(s) values using an appropriate estimated useful life for the base asset and the established FMR useful life for the CI.

4) The capitalization threshold of $250,000 (this threshold may be less for DoD Components preparing "stand alone" financial statements for audit) will be retroactively applied for the 40 year period to establish the baseline valuation of RP. Retroactive application of the current capitalization threshold will eliminate assets previously capitalized under lower thresholds.

<u>Option A – General Equipment</u>

1) There are two key changes that would significantly improve the likelihood of DoD establishing auditable balances of General Equipment:

   a. Prospective implementation of SFFAS 23 from its effective date (October 1, 2002)
   b. Retroactive application of the current capitalization thresholds to existing assets

2) The GE and GE CI will be separated into asset classes based on useful lives. Using the placed in service dates as identified in the APSR for each asset class, the baseline would be established as of October 1, 2015 with only those assets having a placed in service date on or after the dates described in the table below. For asset class A, the useful life is 5 years, using an in service date of October 1, 2011 will result in at least 1 year net book value for the assets comprising the valuation baseline. For asset classes B through E, an in service date of October 1, 2002 was selected because it coincides with the effective date of SFFAS 23. DoD considers values recorded after this date to be more reliable. In addition, prior to SFFAS 23, the highest value equipment assets were properly expensed as National Defense PP&E. This change would simply make the implementation of SFFAS

23 prospective rather than retroactive. The useful life for these asset classes range from 20 to 50 years:

Asset Class	Include In Service Dates From	Time Elapsed From In Service Date
A. General purpose vehicles, computers, medical equipment, radio and TV broadcasting equipment	October 1, 2011	4 years ago
B. Missile defense systems, UAVs, armored/assault vehicles (e.g. Humvees)	October 1, 2002	13 years ago
C. Aircraft	October 1, 2002	13 years ago
D. Submarines, full tanks, combat ships	October 1, 2002	13 years ago
E. Aircraft carriers, cargo ships	October 1, 2002	13 years ago

3) Calculate estimated values of the GE assets (including CI and CIP) to be included in the baseline, based on Similar Assets (Like-Kind Analysis), Contracts or Budgets.

4) Individually calculate depreciation on the estimated GE asset and CI values using an appropriate estimated useful life.

5) The capitalization threshold of $1,000,000 for the Department of the Air Force and Department of the Navy GE general fund assets and $250,000 (this threshold may be less for DoD Components preparing "stand alone" financial statements for audit) for all other GE assets and CI will be retroactively applied for purposes of establishing the baseline. Retroactive application of the current capitalization threshold will eliminate assets previously capitalized under lower thresholds.

- **Pro:** Best estimate in accordance with SSFAS #6 and SSFAS #35
  Leveraging data used to manage RP and GE
- **Con:** Very time consuming and costly
  May not be done in the time needed to meet established auditability dates
  "Precise" historical cost of existing assets is likely not a priority for DoD stakeholders or users of the financial statements. The establishment of systems and processes to generate more reliable financial information on a "go-forward" basis is the priority.

Option B – Real Property

1) Accept the values in the APSR and related systems (if any) used to supplement the APSR (e.g. to track depreciation) for RP assets and CI(s) as of the initial baseline date of October 1, 2015. This would include cost and accumulated depreciation.

2) These amounts would be supported by the detail line items in the APSR. Other than the information in the APSR, no further documentation (e.g. invoices, contracts, payment support, etc.) would be required to support the balances.

3) The general ledger(s) for each DoD Component (i.e. the source for compiling the financial statements) would be adjusted to the APSR and related systems value as of October 1, 2015.

4) Continue depreciating assets based on annual amounts being used in prior years for the RP and CI assets included in the baseline value.

Option B-General Equipment

1) Accept the values in the APSR and related systems (if any) used to supplement the APSR (e.g. to track depreciation) for GE assets and related CI(s) and CIP as of the initial baseline date of October 1, 2015. This would include cost and accumulated depreciation.

2) These amounts would be supported by the detail line items in the APSR. Other than the information in the APSR, no further documentation (e.g. invoices, contracts, payment support, etc.) would be required to support the balances.

3) The general ledger(s) for each DoD Component (i.e. the source for compiling the financial statements) would be adjusted to the APSR and related systems value as of October 1, 2015.

4) Continue depreciating assets based on annual amounts being used in prior years for the GE and CI assets included in the baseline value.

- **Pro:** Very cost effective
  Not required to validate RP and GE assets and CI(s) in the property systems
  Easiest to implement and execute

- **Con:** No supporting documentation for RP and GE assets and CI(s) already in the property systems

Existence, completeness and valuation assertions for the opening balance will not be subjected to full audit procedures under existing FASAB Standards.

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Department of Defense (DoD) Internal Use Software (IUS) Environment

1) DoD does not have a complete inventory of its IUS.
2) Systems to track IUS exist but the use of such systems is not consistent among all military services and agencies. In most cases there is no differentiation of IUS from other software.
3) There are 4 military services and over 20 other DoD agencies that have software that may qualify as IUS in accordance with generally accepted accounting principles (GAAP).
4) Costs of IUS have not traditionally been captured.
5) DoD has not had any consistent procedures, or documented processes for retaining source documentation related to IUS acquisitions.
6) Until very recently, there has been a lack of clear guidance to address the proper accounting treatment of IUS.
7) Substantially all systems the DoD has utilized to track IUS have either never been audited or when audited had significant deficiencies or material weaknesses related to them.
8) For IUS currently in use, there is a lack of supporting documentation for cost and date placed in service.
9) Costs related to IUS changes that add capabilities and/or enhancements is not consistently and accurately accounted for.
10) Currently DoD policy for accounting for bulk purchases of software that qualify as IUS is not in accordance with GAAP and therefore these costs may be inaccurately recorded.
11) Documentation for determining what cost should be capitalized or expensed often does not exist.
12) IUS costs that should be capitalized from costs incurred by contractors and internal payroll has not been consistently and accurately accounted for and limited, if any, documentation exists to research and correct the recorded balances.
13) Contract lines (CLINS) have not been structured so that determining which costs should be capitalized or expensed is not possible from information in the contract.
14) Financial reporting rights have not been identified for IUS that is jointly developed, funded, and used across the DoD.

As a result of the above conditions, it is virtually impossible for the DoD to successfully go through an audit of its IUS assets which are not currently accounted for in accordance with generally accepted accounting principles (GAAP). The lack of supporting documentation for IUS is a significant challenge to achieving GAAP compliant accounting and financial reporting of IUS.

For DoD to establish an auditable baseline of IUS in accordance with GAAP for its initial audit, each military service and agency would have to invest collectively thousands of hours to:

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1) Identify IUS that should be recorded and ensure completeness,
2) Determine which activities and related costs incurred to develop existing IUS should be expensed versus capitalized,
3) Identify/ establish an alternative valuation methodology for existing IUS since determining actual cost is not feasible.
4) Identify/establish the universe of IUS currently in development.

This effort would take limited resources away from other audit related initiatives such as establishing systems and processes to properly account for IUS on a go forward basis; remediating known weaknesses in current systems; and performing other needed activities for audit readiness.

PROPOSED SOLUTIONS

Statement of Federal Financial Accounting Standards 10: Accounting for Internal Use Software states the following:

"Effective Date

7. The provisions of this statement are effective for reporting periods that begin after September 30, 2000. Paragraphs 27 and 28 of SFFAS No. 6, Accounting for Property, Plant, and Equipment, which pertain to internally developed software, are rescinded upon this standard's issuance. Federal entities may continue their current accounting practices for internal use software for accounting periods beginning before October 1, 2000. Early implementation of this statement is encouraged.

Implementation

36. Cost incurred prior to the initial application of this statement, whether capitalized or not, should not be adjusted to the amounts that would have been capitalized, had this statement been in effect when those costs were incurred. However, the provisions of this statement concerning amortization and impairment should be applied to any unamortized cost capitalized prior to the initial application of this statement that continue to be reported as assets after the effective date."

To assist government organizations in successfully undergoing their first financial statement audit (DoD and certain Intel agencies) where the financial statements are presented in accordance with generally accepted accounting principles (GAAP) in an efficient and cost effective manner, it would be very beneficial to revise the effective date stated above in paragraph 7, of October 1, 2000, to a more current date such as October 1, 2016. The other provisions of paragraphs 7 and 36 as shown above should be retained.