FASAB

Federal Accounting Standards Advisory Board

January 11, 2008

Memorandum

To: Members of the AAPC

From: Monica R. Valentine, Assistant Director

Subject: **General PP&E Issues**[1]

The purpose of this paper is to present a project plan and background information on three general PP&E issues.

This project was initiated by Ms. Payne after the topic was briefly discussed in September during FASAB's discussions on the technical agenda options. At the December FASAB meeting Ms. Payne presented to the Board a draft exposure draft (ED) illustrating guidance that could be developed to address the issue of initial capitalization of general PP&E. At the conclusion of the discussion the Board decided that staff will develop the exposure draft further and request that the AAPC consider guidance related to the other PP&E issues outlined in the staff memo. In addition, the Board will consider further evaluation of the existing standards as a potential project when it considers the technical agenda at the February meeting.

The staff objective for the January AAPC meeting is to review the project plan and vote on adding the project to the AAPC agenda. If you have any questions or comments prior to the meeting, please contact me by telephone at 202-512-7362 or by e-mail at valentinem@fasab.gov.

[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.

Purpose of this Paper

The purpose of this paper is to present a proposed AAPC project plan and background information on the general PP&E projects. As noted in the background material, there will be two projects – one conducted by the FASAB to amend initial capitalization guidance and another conducted by AAPC to address questions regarding depreciation methodologies, deployed assets, and cost accounting.

This effort was initiated when the topic was briefly discussed in September during FASAB's discussions on the technical agenda options. Several members expressed some support for an effort to reduce the cost expected to be incurred at the Department of Defense as they establish values for general PP&E during the coming years. At the December FASAB meeting Ms. Payne presented to the Board a draft exposure draft (ED) illustrating guidance that could be developed to address the issue of initial capitalization of general PP&E.

Background on the Issue

At the September FASAB meeting during the technical agenda options discussion, members expressed some support for addressing the issue. The minutes related to this discussion are presented below.

> Mr. Werfel expressed interest in a project on valuation of assets at fair value. He believes the timing is right for a project on this due to the work at DoD to value items at historic value. If we find that estimating historical cost is less meaningful than a more current value that is useful to facility managers, the time to make that finding is before DoD devotes significant resources to estimating historical cost. His understanding is that historical cost is not the component of any decision making model but that fair value is.
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> Mr. Jackson responded that valuing weapons system stock – including weapons systems acquired since SFFAS 23 became effective – has become a nightmare. He noted that some believed that FASAB would need to provide assistance to DoD with respect to efforts to value existing stock because there is an expectation that items acquired since fiscal year 2003 would be very precisely costed – at full cost. He considers this an insurmountable task. He suggested that the Board discuss this issue sooner rather than later. He asked that the Board explore what the benefit of the precision is and ask if the benefit is worth the enormous cost. The valuation hurdle is significant.
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> Mr. Werfel indicated that the audit plan for DoD calls for investment of considerable resources in the next ten years on valuation. He likes the notion that we would evaluate all existing standards but he believes this area is especially timely.
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> Mr. Allen asked if the issue is a standards problem. He noted GASB's acknowledgement that estimation would be needed to implement its GASB 34 asset standards.
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> Mr. Steinberg noted that the Board has run the gauntlet with PP&E. He recalled that initially, SFFAS 6 exempted weapons systems from valuation. He noted that, next, DOD,

with the Board's support, explored the inclusion of condition information since it was of great importance to DOD. He believes that had the Board gone fully down that path, DOD would have produced valuable information. The Board did not go down that path because DOD requested removing the exemption regarding weapons systems.

Mr. Farrell noted the difference between accounting and accountability. If one proposed an accounting solution then one would get hung up on accountability. The ability to report on "eaches" was viewed as essential to accountability. Building a system that addressed both accounting and accountability was insurmountable. His view is that DoD never got too far because such a system was impossible.

Mr. Jackson noted that determining existence of military equipment was a problem. He believes they should be able to do this. The language in SFFAS 23 has been interpreted to mean that assets acquired after the implementation date are subject to the full rigors of valuation and can not be valued under the initial capitalization guidance which provided not only for estimation but also for options regarding documentation. A technical release affirming that you have a period of time to implement SFFAS 23 so that people can take advantage of the initial capitalization flexibilities until they are capable of capturing actual cost.

Mr. Allen suggested that staff explore the issue.

Mr. Reid noted that this arose because DOD was unable to determine what cost of a prior acquisition of a system was when they were planning for a new acquisition of the same system. He noted that there was value in knowing what the systems cost and that management believed that the historical cost would be helpful to them.

Mr. Werfel suggested that the Board should consider the cost of the standards. He noted that when you look at condition, value is an important component of condition. If you look at functional replacement value you have captured the condition information.

Mr. Reid argued that we should only revisit when the department is able to comply because a great deal of flexibility was provided. When they can comply on a go forward basis then we should consider the legacy assets. Mr. Jackson indicated that a significant amount of money would be invested by then and he felt that would be irresponsible. Mr. Steinberg agreed. He noted that to capitalize at cost you must answer these questions:

1. What is a weapons system (is it the single unit or all the support items associated with it)?
2. What part of the Research Development Test and Evaluation (RDT&E) is a cost of the weapons systems?
3. During RDT&E, we lose some assets during testing; is this cost?
4. What about systems within systems (aircraft carrier with fire control systems)?
5. What about the cost of modifications?
6. What about losses in war time?
7. What about the times you are unable to verify existence?

Ms. Payne noted that some agencies had no implementation period because they were only recently required to have audited financial statements.

[section on other issues omitted]

Mr. Jackson asked if we needed to offer explicit guidance on SFFAS 6, Accounting for PP&E, and its applicability to property in a war zone. He noted that there is some discussion of what accounting is appropriate for assets in a war zone. Mr. Dacey agreed but that he was not sure whether the issue was impairment or an ability to track the asset. Mr. Jackson indicated that often tanks are refurbished to the condition of a new tank. He suggested that there may be cohorts of assets to be addressed.
Mr. Farrell noted that he thought people went overboard. He thought we could add value by giving broad guidance such as “if you put something in theater, then write it off and if it comes back to service then consider restoring it to the books.” Mr. Steinberg noted that these items are not the same as non-governmental assets. He suggested writing the standard so that it addresses these unique items.

Mr. Allen noted that this issue is important and timely. …

The discussion above documents a number of concerns relating to DoD accounting. In addition, concerns regarding group and composite depreciation have been raised since the meeting. Collectively, concerns regarding general PP&E can be summarized as follows:

1) Guidance for implementing existing standards
   a) Continued use of estimates in the absence of a system
   b) Options for group/composite depreciation
   c) Accounting for assets deployed to a war zone
   d) Cost accounting (assignment of R&D, support and overhead to general PP&E)
2) Evaluation of existing standards and the potential for adopting fair value as the measurement basis

In considering these issues, staff recommended and Board agreed that the issues in group 1, guidance for implementing existing standards, can and should be addressed quickly due to the potential that more costly solutions will be found in the absence of guidance. The staff proposal regarding group 1 follows.

With respect to issue 2, evaluation of existing standards, staff recommended and the Board agreed this issue should be considered early next year when the Board makes decisions on its technical agenda. As noted by one of the members, considerable time has been devoted to the question of PP&E accounting. A project on this topic is likely to be controversial and demand considerable staff and Board time. Therefore, undertaking the project should be considered in the broad context of agenda setting.

Regarding the permissibility of estimates (issue 1(a) above), the Board is considering 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 general PP&E acquired before the effective dates of SFFAS 6 or 23. The Board is considering clarifying this through a relatively narrow amendment of SFFAS 23. The draft would (1) provide additional time for the Department of Defense and other agencies not previously producing financial reports to rely on SFFAS 23 methods and (2) provide new guidance regarding estimation of the in-service date.

Staff also would inquire with selected agencies and members of the audit community to confirm that the guidance is needed and clear. In addition, staff would review fiscal year 2007 agency reports to determine if agencies other than the Department of Defense face similar challenges with respect to developing general PP&E systems, use of SFFAS 23 methods, and could be expected to incur significant costs to arrive at acceptable estimates absent explicit guidance.

With respect to the three remaining group 1 issues (group/composite depreciation, deployed assets, and cost accounting), the Board requests that the Accounting and Auditing Policy Committee consider these issues. A task force may be able to develop implementation guidance within the boundaries of the current standards and that no amendments to existing standards would be required. The Board's views are presented below.

Excerpts from Minutes of the December 2007 FASAB Meeting

Ms. Payne introduced the project, Initial Capitalization of General PP&E, which began as a discussion at the September 2007 meeting with the technical agenda options discussion. She reminded the Board that during that discussion the members expressed some support for an effort to reduce the cost expected to be incurred at the Department of Defense (DoD) as they establish values for general PP&E during the coming years. Ms. Payne noted to the Board that FASAB staff member Monica Valentine would be leading the project from this point on, as well as leading the AAPC phase of the project.

Ms. Payne presented to the Board a draft exposure draft (ED) showing guidance that could be developed to address the issue of initial capitalization of general PP&E. She stated that there is a perception that after the implementation of SFFAS 23 in FY 2003 the "bar" had been raised as far as the estimating of general PP&E. So in order to reduce the cost of estimating the initial capitalization of general PP&E new guidance is being proposed. The draft guidance would provide relief to agencies who are not yet required to report PP&E and those who still need to develop their systems to accomplish the requirements of SFFAS 6 & 23. The proposal would give new implementers of the standards 5 years from the date an entity begins to report PP&E. The entities would be allowed to estimate PP&E under the guidelines of this standard for the 5 years while putting their systems in place to eventually report PP&E in accordance with SFFAS 6 & 23. In the absence of viable systems in place, estimating PP&E values is the only option to reporting a value for PP&E. This proposal would amend the current standards to make it clear that estimating of PP&E values in accordance with SFFAS 6 & 23 is permissible. Ms. Payne asked the Board if they wanted to staff the project to develop a standard and what areas of the project should be passed onto the AAPC.

Mr. Werfel reiterated what he envisioned as the three broad objectives for this project:

- the five-year rolling implementation period,
- the work of the AAPC, and
- a discussion for the agenda-setting session to address the larger fundamental issues of valuing general PP&E.

Mr. Patton asked what incentives do the agencies have to put the needed systems in place to track PP&E. Ms. Payne replied that her belief was that having an unqualified opinion by virtue of accurately reporting PP&E, which ultimately affects the Statement of Net Costs would serve as a motivator. Mr. Jackson noted that since the effective date of SFFAS 23 in FY 2003 through the proposed date of 2012 several billion dollars worth of military equipment would have been acquired by DoD through its many acquisition programs. In order to meet the requirements of SFFAS 6 & 23 DoD would need to change its contractor acquisition processes, business processes, as well as its systems to meet these requirements. He reminded the Board that when DoD spoke to the Board in 2000 about the implementation of SFFAS 23 in FY 2003 they did not take due consideration of the major implications involved in such an undertaking. He also noted that DoD will need a systematic method/process to capturing their assets and that it will take several years to put in place. However, they are moving towards improving their precision in valuing military equipment.

Mr. Werfel expressed his interest in the Board also discussing the possibility of valuing PP&E at replacement cost or fair value, especially with the FASB's interest in fair value accounting. Mr. Patton asked if the proposal was essentially amending a standard even before it gets implemented. Ms. Payne addressed the commonalities between replacement cost vs. historical cost. She noted that both historical and replacement costs require acquisition costs to be captured, cost allocations, and periodic adjustments in reported values. Mr. Werfel acknowledged that whether DoD were required to report costs at historical or replacement value, the systems cost would still be great. However, he did note that the return on investment when using replacement cost is greater because it produces better valuations, more useful for decision-making, and would lead to better integration between the users of the information.

Mr. Patton cautioned the Board as it considered changing its foundational principles because a few entities find them objectionable; it could jeopardize the Board's stability and status. Mr. Werfel reminded the Board that there have been no major changes in PP&E valuation since its adoption over ten years ago. Mr. Steinberg also reminded the Board that the Board's original philosophy on DoD PP&E was to view their military assets differently than general PP&E, but DoD later asked to have their asset treated the same as other general PP&E. He also expressed a concern that the eventual guidance of the AAPC may still not produce decision useful information. Ms. Payne reiterated that the purpose of the proposed guidance in the exposure draft is not to revisit the principles of SFFAS 6, but to provide a more cost effective vehicle for the implementation of the PP&E standards.

Mr. Jackson stated that DoD is not looking to avoid the implementation of SFFAS 6 & 23, but simply needs a mechanism for orderly transition while recognizing the complexity of the implementation issues. Secondly, the Board should consider the enormous cost involved to achieve a level of precision that we are not certain was ever intended.

Mr. Werfel suggested that the Board consider a public hearing on the valuing of PP&E that would be similar to the public hearing on social insurance. Mr. Reid suggested also conducting a survey to determine what other countries use to value various types of assets.

Mr. Farrell made the point that there should not be as much emphasis placed on the level of precision on the PP&E value but look to providing a meaningful and cost-beneficial depreciation calculation. He went on to say that the Board should really take a look at ways to reduce the cost of accounting for PP&E throughout the government.

Ms. Payne noted that there appeared to be support from the Board on asking the AAPC to develop implementation guidance for PP&E. She informed the Board that staff would develop a project plan for the AAPC's work and that the Board would have an opportunity to review it. She then polled the Board on their support for the proposed exposure draft that would amend

SFFAS 6 and provide guidance on how to estimate PP&E. Mr. Patton questioned the use of the 2012 date-certain as an effective date for the amendment. The Board agreed to use some other type of mechanism to trigger the full implementation of SFFAS 6 that would coincide with having systems capable of accurately tracking PP&E. Mr. Jackson suggested using the FFMIA system certification as a possible benchmark. Ms. Payne also suggested using the reporting of material weakness as a benchmark.

CONCLUSIONS: Staff will develop the exposure draft further and request that the AAPC consider implementation guidance related to the issues outlined in the staff memo. In addition, the Board will consider further evaluation of the existing standards as a potential project when it considers the technical agenda at the February meeting.

What are the issues for AAPC?

The AAPC is being asked to develop guidance regarding issues options for group/composite depreciation, accounting for assets deployed to a war zone, and cost accounting (assignment of R&D, support and overhead to general PP&E). Below is a brief description of each of those areas.

Group or Composite Depreciation Method: Generally, depreciation is described as applicable to a unit of property. So that each unit has a book cost, an estimated useful life and salvage value, and accumulated depreciation. Group or composite depreciation is used to reduce the clerical burden associated with estimating and tracking depreciation of units.

Group depreciation is based on groups of similar items with approximately the same useful lives. Depreciation is based on the common useful life.

Composite depreciation is based on groupings of dissimilar items with different useful lives. Depreciation is based on a composite life of the grouping. Groupings may be based on (1) a common function or (2) geographic assignment. (Other logical groupings may be considered.)

Guidance may be needed in the following areas:

1 – Is guidance needed to clarify what constitute “similar” items for groups?
2 -- Is group depreciation of dissimilar items with a common useful life acceptable?
3 – If composite depreciation is used, what bases are acceptable for groupings?
4 – Retirement of units included in groups or pools is accomplished by estimating the book value of the units and crediting the plant account and debiting the accumulated depreciation account. Is any deviation from this convention warranted?
5 – What type of audit issues might come up and is guidance needed?

Accounting for Assets Deployed to a War Zone:

Is SFFAS 6, applicable to military equipment deployed to war zones? Is explicit guidance needed to address this issue? Is this simply an impairment of an asset issue?

Cost Accounting (assignment of R&D, support and overhead to general PP&E):

What costs should be capitalized in general PP&E? What direct labor should be capitalized? Should contract administration be added?

*SFFAS 6, Accounting for Property, Plant & Equipment, par 26 states: "*All general PP&E shall be recorded at cost. Cost shall include all costs incurred to bring the PP&E to a form and location suitable for its intended use." Then the paragraph goes on to give a list of example costs that may be included.

Existing Guidance on the Issues

Excepts from SFFAS 6 & 23

Statement of Federal Financial Accounting Standard (SFFAS) 6 as amended, *Accounting for Property, Plant and Equipment*, provides guidance regarding base unit, composite/group depreciation and costs to be capitalized in general PP&E.

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. This amendment provides that national defense PP&E is subject to the same standards as other assets. Therefore, national defense PP&E qualifying as general PP&E is to be capitalized and depreciated.

SFFAS 6 Par. 22: In determining which category PP&E should be placed in, it will be necessary to identify the "base unit"[1] 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).[2]

SFFAS 6 Par. 26: **All general PP&E** shall be recorded at cost. Cost shall include all costs incurred to bring the PP&E to a form and location suitable for its intended use. For example, the cost of acquiring property, plant, and equipment may include:

[1]"Base unit" refers to the level of detail considered in categorizing PP&E. Generally, the base unit is the smallest or least expensive item of property to be categorized. The term "base unit" may be used by others to have a different meaning--the meaning intended in this standard is limited to that specified above.

[2]The concept described here is intended for PP&E categorization purposes only. However, for the purpose of record keeping, greater detail may be necessary to maintain accountability for PP&E so that assets can be safeguarded against loss, theft, misappropriation, etc. Categorizing PP&E with less detail considered does not necessarily mean that (1) accounting systems or (2) property records must follow the same level of detail.

- amounts paid to vendors;
- transportation charges to the point of initial use;
- handling and storage costs;
- labor and other direct or indirect production costs (for assets produced or constructed);
- engineering, architectural, and other outside services for designs, plans, specifications, and surveys;
- acquisition and preparation costs of buildings and other facilities;
- an appropriate share of the cost of the equipment and facilities used in construction work;
- fixed equipment and related installation costs required for activities in a building or facility;
- direct costs of inspection, supervision, and administration of construction contracts and construction work;
- legal and recording fees and damage claims;
- fair value of facilities and equipment donated to the government; and
- material amounts of interest costs paid.[3]

SFFAS 6 Par. 35: Depreciation expense is calculated through the systematic and rational allocation of the cost of general PP&E, less its estimated salvage/residual value, over the estimated useful life of the general PP&E. Depreciation expense shall be recognized on all general PP&E[4], except land and land rights of unlimited duration.[5]

- Estimates of useful life of general PP&E must consider factors such as physical wear and tear and technological change (e.g., obsolescence).
- Various methods can be used to compute periodic depreciation expense so long as the method is systematic, rational, and best reflects the use of the PP&E.
- Any changes in estimated useful life or salvage/residual value shall be treated prospectively. The change shall be accounted for in the period of the change and future periods. No adjustments shall be made to previously recorded depreciation or amortization.

SFFAS 23 Par. 9f: SFFAS No. 6 is amended by adding the following sentence to paragraph 35 as a separate bulleted line item:

[3]"Interest costs" refers to any interest paid by the reporting entity directly to providers of goods or services related to the acquisition or construction of PP&E.

[4]Software and land rights, while associated with tangible assets, may be classified as intangible assets by some entities. In this event, they would be subject to amortization rather than depreciation. "Amortization" is applied to intangible assets in the same manner that depreciation is applied to general PP&E--tangible assets.

[5]Land rights that are for a specified period of time shall be depreciated or amortized over that time period.

A composite or group depreciation methodology[6], whereby the costs of PP&E are allocated using the same allocation rate, is permissible.

SFFAS 6 Par. 39: General PP&E shall be removed from general PP&E accounts along with associated accumulated depreciation/amortization, if prior to disposal, retirement or removal from service, it no longer provides service in the operations of the entity. This could be either because it has suffered damage, becomes obsolete in advance of expectations, or is identified as excess. It shall be recorded in an appropriate asset account at its expected net realizable value. Any difference in the book value of the PP&E and its expected net realizable value shall be recognized as a gain or a loss in the period of adjustment. The expected net realizable value shall be adjusted at the end of each accounting period and any further adjustments in value recognized as a gain or a loss. However, no additional depreciation/amortization shall be taken once such assets are removed from general PP&E in anticipation of disposal, retirement, or removal from service.

[6] The composite methodology is a method of calculating depreciation that applies a single average rate to a number of heterogeneous assets that have dissimilar characteristics and service lives. The group methodology is a method of calculating depreciation that applies a single, average rate to a number of homogeneous assets having similar characteristics and service lives.

Task	Completion Date (*Estimated*)
1. Request that the AAPC consider implementation guidance related to the issues outlined in the FASAB staff memo and proposed project plan.	*January 2008*
2. Staff meeting with Department of Defense personnel to discuss their specific issues on PP&E.	*January 2008*
3. Organize an AAPC task force to address issues.	*February 2008*
4. First meeting with AAPC PP&E task force.	*March 2008*
5. Develop list of questions to address (including outreach to community to ensure completeness)	*May 2008*
6. Develop answers to question for AAPC consideration	*July 2008*
7. Issue ED	*September 2008*
8. Finalize guidance	*Early 2009*