



General Services Administration
Office of Acquisition Policy
Washington, DC 20405

JUL 1 1996

MEMORANDUM FOR FAR SECRETARIAT

FROM:

Edward Loeb
EDWARD LOEB

CHAIRMAN

CIVILIAN AGENCY ACQUISITION COUNCIL

SUBJECT: FAR Case 95-003, Impairment of Long-lived Assets

Please take appropriate action to publish the attached final rule. The CAAC approved the case on June 26, 1996, and the DARC approved the rule on May 6, 1996.

This document shall not be sent to the Federal Register until specific approval is obtained from the Director or Acting Director.

Please contact Mr. Jeremy F. Olson if there are any questions.

Enclosures
Draft final rule

cc: Director, DARC

Rec'd July 2, 1996



FAR CASE 95-003
IMPAIRMENT OF LONG-LIVED ASSETS

The baseline is the FAR through FAC 38. Changes are represented by **[bold print in brackets]** for new language and ~~strikethrough~~ for deleted language.

31.205-11 Depreciation.

* * * * *

(o) In the event of a write-down from carrying value to fair value as a result of impairments caused by events or changes in circumstances, **[allowable]** depreciation of the impaired assets shall ~~not exceed~~ **[be limited to]** the amounts **[that would have been allowed had the assets not been]** ~~established on depreciation schedules in use prior to the write-down~~ **[written down]** (see 31.205-16(g)). **[However, this does not preclude a change in depreciation resulting from other causes such as permissible changes in estimates of service life, consumption of services or residual value.]**

* * * * *

31.205-16 Gains and losses on disposition or impairment of depreciable property or other capital assets.

* * * * *

(g) With respect to long-lived tangible and identifiable intangible assets held for use, no loss shall be ~~recognized~~ **[allowed]** for a write-down from carrying value to fair value as a result of impairments caused by events or changes in circumstances (e.g., environmental damage, idle facilities arising from a declining business base, etc.). **[If depreciable property or other capital assets have been written down from carrying value to fair value due to impairments, gains or losses upon disposition shall be the amounts that would have been allowed had the assets not been written down.]** ~~Depreciation or amortization on pre-write-down carrying value of impaired assets not yet disposed of shall continue to be recoverable under established depreciation or amortization schedules to the extent it is not otherwise unallowable under other provisions of the FAR.~~

Draft Federal Register Notice

**DEPARTMENT OF DEFENSE
GENERAL SERVICES ADMINISTRATION
NATIONAL AERONAUTICS AND SPACE ADMINISTRATION**

**48 CFR Part 31
[FAR Case 95-003]**

**Federal Acquisition Regulation;
Impairment of Long-Lived Assets**

AGENCIES: Department of Defense (DoD), General Services Administration (GSA), and National Aeronautics and Space Administration (NASA).

ACTION: Final rule.

SUMMARY: The Civilian Agency Acquisition Council and the Defense Acquisition Regulations Council have agreed on a final rule to amend the Federal Acquisition Regulation (FAR) to clarify the cost allowability rules concerning the recognition of losses when carrying values of impaired assets are written down for financial reporting purposes.

DATES: This rule is effective _____.

FOR FURTHER INFORMATION CONTACT: Mr. Jeremy Olson at (202) 501-3221 in reference to this FAR case. For general information, contact the FAR Secretariat, Room 4037, GS Building, Washington, DC 20405 (202) 501-4755. Please cite FAR Case 95-003.

SUPPLEMENTARY INFORMATION:

A. Background

This final rule clarifies that impairment losses recognized for financial accounting purposes under the Financial Accounting Standards Board Statement of Financial Accounting Standards (SFAS), No. 121, Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to be Disposed Of, dated March 1995, are not allowable for Government contract costing.

The SFAS applies to long-lived assets (such as land, buildings, and equipment), certain identifiable intangibles, and related goodwill. If impaired assets are to be held for use, the SFAS requires a write-down to fair value when events or circumstances (e.g., environmental damage, idle facilities arising from declining business, etc.) indicate that carrying values may not be fully recoverable. Once written down, the previous carrying amount of an impaired asset could not be restored if the impairment was subsequently removed.

In contrast to the SFAS provisions, Cost Accounting Standard (CAS) 9904.409, Depreciation of Tangible Capital Assets, provides quite different criteria and guidance to recognize gains and losses for Government contract purposes. The language at CAS 9904.409-40(a)(4) and (b)(4), CAS 9904.409-50(j), and related Promulgation Comment 10, Gain or Loss, makes it clear that gains and losses are recognized only upon asset disposal; no other circumstances trigger such recognition. The language at CAS 9904.409-50(i) makes it clear that changes in depreciation may result from other permissible causes, e.g., changes in estimated service life, consumption of services, and residual value.

The final rule amends Subsections 31.205-11, Depreciation, and 31.205-16, Gains and Losses on Disposition or Impairment of Depreciable Property or Other Capital Assets, to clarify that these subsections reflect the CAS provisions that an asset be disposed of in order to recognize a gain or loss. Consequently, for Government contract purposes, (1) an impairment loss is recognized only upon disposal of the impaired asset and is measured, like other losses, as the difference between the net amount realized and the impaired asset's undepreciated balance; (2) Government contractors recover the carrying values of impaired assets held for use by retaining pre-write-down depreciation or amortization schedules as though no impairment had occurred; and (3) changes in depreciation are allowable from other permissible causes.

An interim rule was published in the Federal Register on December 14, 1995 (60 FR 64254). Four sources submitted public comments. All comments were considered in developing the final rule.

B. Regulatory Flexibility Act

The Department of Defense, the General Services Administration and the National Aeronautics and Space Administration certify that this final rule does not have a significant economic impact on a substantial number of small entities within the meaning of the Regulatory Flexibility Act, 5 U.S.C. 601, et seq., because most contracts awarded to small

entities are awarded on a competitive fixed-price basis and do not require application of the cost principles contained in this rule.

C. Paperwork Reduction Act

The Paperwork Reduction Act of 1995 (Pub. L. 104-13) does not apply because the changes to the FAR do not impose any new reporting or recordkeeping requirements which require Office of Management and Budget approval under 44 U.S.C. 3501, et seq.

FAC Introductory Item

ITEM XX--

This final rule amends FAR 31.205-11 and 31.205-16 to clarify the cost allowability rules concerning the recognition of losses when carrying values of impaired assets are written down for financial reporting purposes.



The Implications of FAS 121 and the Interim FAR Rule For Government Contractors: A Sensible Approach to the Determination of Impaired Assets

Howard N. Kenyon Jr. and Gregory L. Fordham*

Introduction

An interim Federal Acquisition Regulation (FAR) rule was recently issued that requires government contractors to deviate from Generally Accepted Accounting Principles (GAAP) with respect to impaired assets and threatens to diminish a government contractor's cost recovery and revenue stream.

Since the decision to characterize an asset as impaired under GAAP is a decision founded in market-based pricing, the issue for government contractors is whether impairment can occur for contractors doing business in a cost-based environment. The FAR cost principles provide several avenues for recovering the undepreciated carrying value of assets that otherwise would not exist for commercial enterprises. But these cost recovery potentials can be used fully only if there has been no write-down of the asset to recognize an impairment loss for financial statement purposes. Once an impairment loss has been recognized, the interim rule and existing cost principles operate to preclude recovery of the write-down.

Consequently, a government contractor must carefully assess the status of underutilized facilities in order to avoid their unwarranted characterization as "impaired" and the associated potential loss of cost recovery. The following explains the requirements of the new accounting principle and interim FAR rule, and how those contractors that would be affected most can legitimately avoid, or at least minimize, their effect.

The Accounting Issue

The Financial Accounting Standards Board (FASB), which establishes GAAP to be followed by commercial enterprises in reporting financial position and results of operations, recently addressed impairment of the carrying value of assets held for use and those to be disposed of. The FASB Statement (FAS) No. 121, Accounting for Impairment of Long-Lived Assets and for Long-Lived Assets To Be Disposed Of, generally requires a write-down from carrying value to fair value of assets whose expected future cash flows are less than the carrying value. Indicators for the need for testing to determine whether the criterion applies are prevalent in the government contracting community. Examples include loss of value, less usefulness from reduced market potential, and obsolescence.

* Howard N. Kenyon Jr. is a principal in the Washington, D.C., office of K&F Consulting Inc. Gregory L. Fordham is a principal in the Atlanta office of the firm. Both are CPAs with extensive experience in advising government contractors on cost and pricing matters, accounting systems, audits, equitable adjustments, etc. The firm's home page is:
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FAS 121, ¶ 6, considers an asset to be impaired if expected future cash flows from its use are less than its carrying value. It generally requires that an asset having a carrying value less than the expected future cash flows be written down to fair value of the asset for financial statement presentation. And assets selected for disposal pursuant to a plan committed to by management (that are not already covered by provisions of Accounting Principles Board (APB) Opinion No. 30¹) must be written down to fair value less cost to sell. Losses recognized from these required write-downs must be reported currently in the income statement as part of continuing operations. This Statement is effective for financial statements for fiscal years beginning after Dec. 15, 1995.

The Allowability Issue

Reacting to the possibility that many contractors may be subject to the requirement to write down assets and then attempt to recover the costs of the write-down under cost-based contracts, the FAR Councils issued an interim rule in Federal Acquisition Circular (FAC) 90-35, dated Dec. 14, 1995, which prohibits recovery of the write-down in the period in which it was taken. The interim rule reaffirms the existing requirement that losses on disposition of capital assets be recognized only in the period of disposition in accordance with FAR 31.205-16.

FAR 31.205-16, Gains and losses on disposition of depreciable property or other capital assets, has been changed to "Gains and losses on disposition *or impairment* of depreciable property or other capital assets." [Emphasis added.] And paragraph (g) has been added to deal specifically with impairment losses:

With respect to long-lived tangible and identifiable intangible assets held for use, no loss shall be recognized for a write-down from carrying value to fair value as a result of impairments caused by events or changes in circumstances (e.g., environmental damage, idle facilities arising from a declining business base, etc.). Depreciation or amortization on pre-write-down carrying value of impaired assets not yet disposed of shall continue to be recoverable under established depreciation or amortization schedules to the extent it is not otherwise unallowable under other provisions of the FAR.

On the surface it may appear that the cost of such impaired assets can eventually be recovered through normal pre-write-down depreciation practice. But look out! For contracts not fully CAS covered, what does "to the extent it is not otherwise unallowable under other provisions of the FAR" mean, especially to a government auditor? FAR 31.205-11, Depreciation, requires that in order to be allowable, depreciation cannot exceed that which is used for book or financial statement purposes and shall be determined in a manner consistent with policies and procedures used in the same cost center for non-government business. If on the financial statements an impairment loss has been recognized, wouldn't the carrying value of the asset be less and, consequently, the depreciation less? How, then, would pre-write-down depreciation be fully allowable?

If the contracts were subject to CAS 409, the limitations based on financial statement depreciation amounts would not apply, since requirements of CAS take precedence over cost principles with respect to measurement and allocation of allowable costs.

There are other hurdles. FAR 31.205-11, Depreciation, was also changed by FAC 90-35. Paragraph (o) was added:

In the event of a write-down from carrying value to fair value as a result of impairments caused by events or changes in circumstances, depreciation of the impaired assets shall not exceed the amounts established on depreciation schedules in use prior to the write-down (see 31.205-16(g)).

On the surface this too may be misleading. It does not say pre-write-down depreciation is recoverable; it only says that depreciation cannot exceed pre-write-down amounts. This language thwarts any attempt to circumvent the prohibition on recoverability of impairment loss by shortening the life of the asset to accelerate depreciation. If an impairment loss has already been recognized for financial

statement purposes, the contractor is not only precluded from recovery of asset cost through a shortened life consistent with a new estimate of life, but is in danger of not recovering pre-write-down amounts for the reason discussed above.

The Dilemma

The net result of the interim rule could very well be that an impairment loss is forever lost to the contractor. It is clear that it cannot be an allowable cost in the period in which it is recognized for financial statements; it most likely would not be allowed as normal pre-write-down depreciation charges being in excess of financial statement depreciation. And at the time of disposition, the asset's book value would be determined by "applicable" depreciation, not "allowable" depreciation. Thus, at the time of disposition, when the loss could be recognized as allowable, the loss would not be based on the unrecovered costs with respect to government contracts but rather on the lesser undepreciated book value.

Is There a Way Out?

However, there are ways to avoid potential loss of cost recovery in some circumstances. Recognition of an impairment loss pursuant to FAS 121 could create a problem when none should exist. The new paragraph (o) of FAR 31.205-11 starts with, "In the event of a write-down from carrying value to fair value as a result of impairments . . ." And the new paragraph (g) of FAR 31.205-16 states, "Depreciation or amortization on pre-write-down carrying value of impaired assets . . ." Both of these statements make it clear that the new provisions promulgated by FAC 90-35 address only assets that have been written down as a result of impairment. If no impairment loss is recognized, the new provisions of FAR 31.205-11 and 31.205-16 are not invoked and business is carried on as usual. Depreciation can be continued as before, asset lives can be shortened to reflect prospective economic usefulness, cost of idle facilities may be allowed, and loss on disposition would be allowable at the actual loss amount.

But is there really a dilemma? Maybe there is only the paradox of the self-extinguishing cost principle in the interim rule. First, contractors that do only or mostly sealed bid contracting or whose pricing is market driven—not cost driven—need not be concerned with the interim rule. Their pricing structures will not be affected by unallowable costs. Second, contractors that do all or a substantial amount of cost-based pricing have available several means of recovering costs of underutilized assets. Consequently, if they can recover the costs of the questionable assets, those assets can pass the test for future cash flows and avoid the characterization as impaired. And if the assets are not characterized as impaired, the interim rule does not apply.

For the contractor doing substantial cost-based contracting (negotiated contracts), the necessary course of action is to convince its certified public accountant (CPA) that it can pass the expected cash flow test of FAS 121 and thereby avoid the requirement for an asset write-down. While the CPA will argue a need to invoke FAS 121 because of changes in business climate, etc., the contractor must be ready to counter this argument with projections of full cost recovery. To demonstrate that the depreciation (or other characterization of the asset's cost) will generate the required cash flow, the contractor would have to demonstrate that the total indirect cost pool will be recovered. Recovery would be accomplished by pricing contracts using the full indirect cost rate generated by the pool to which the depreciation is charged. If the rate is being accepted in current negotiations for new contracts or for actuals on cost reimbursement contracts, the contractor would have proved its case of expected future cash flow being a likely occurrence. Arguably, some amount of profit could be imputed to the depreciation cost, further assuring recoverability.

This argument, however, would have to be based on realistic projections that are well supported. The CPA is bound by the FASB accounting principles and will not be able to overlook a write-down requirement on weak evidence. A mere potential for recovery is not by itself enough. It must be linked to a likely realization of future cash flow.

Available Options for Cost Recovery

Recovery potential is inherent in several FAR cost principles but the application of these principles can be quite different among contractors. Thus, the realization of cash flow from the assets would not necessarily be the same for all contractors. Consequently, all contractors could not necessarily avoid the write-down required by FAS 121 and the loss of cost recovery under the interim rule.

Suppose the asset in question was associated with a program that was canceled and there was absolutely no further use for the asset or its use could be projected for only a part of its originally estimated life. Would the CPA have to invoke FAS 121? Not necessarily. When the contractor became aware of a reduced economic service value, it could:

1. Continue normal depreciation if the economic life of the asset has not changed but capacity utilization has;²
2. Adjust the depreciation to reflect the reduced service life and recover the cost within the remaining life of the program;³
3. In the following period, assuming the asset is not being used, recover depreciation as idle facilities cost;⁴
4. Recover the loss on disposition as an allowable cost;⁵ or
5. In the special circumstances of a contract termination for convenience or the cancellation of a multiyear contract, recover the loss of useful value of assets acquired specifically for the contract.⁶

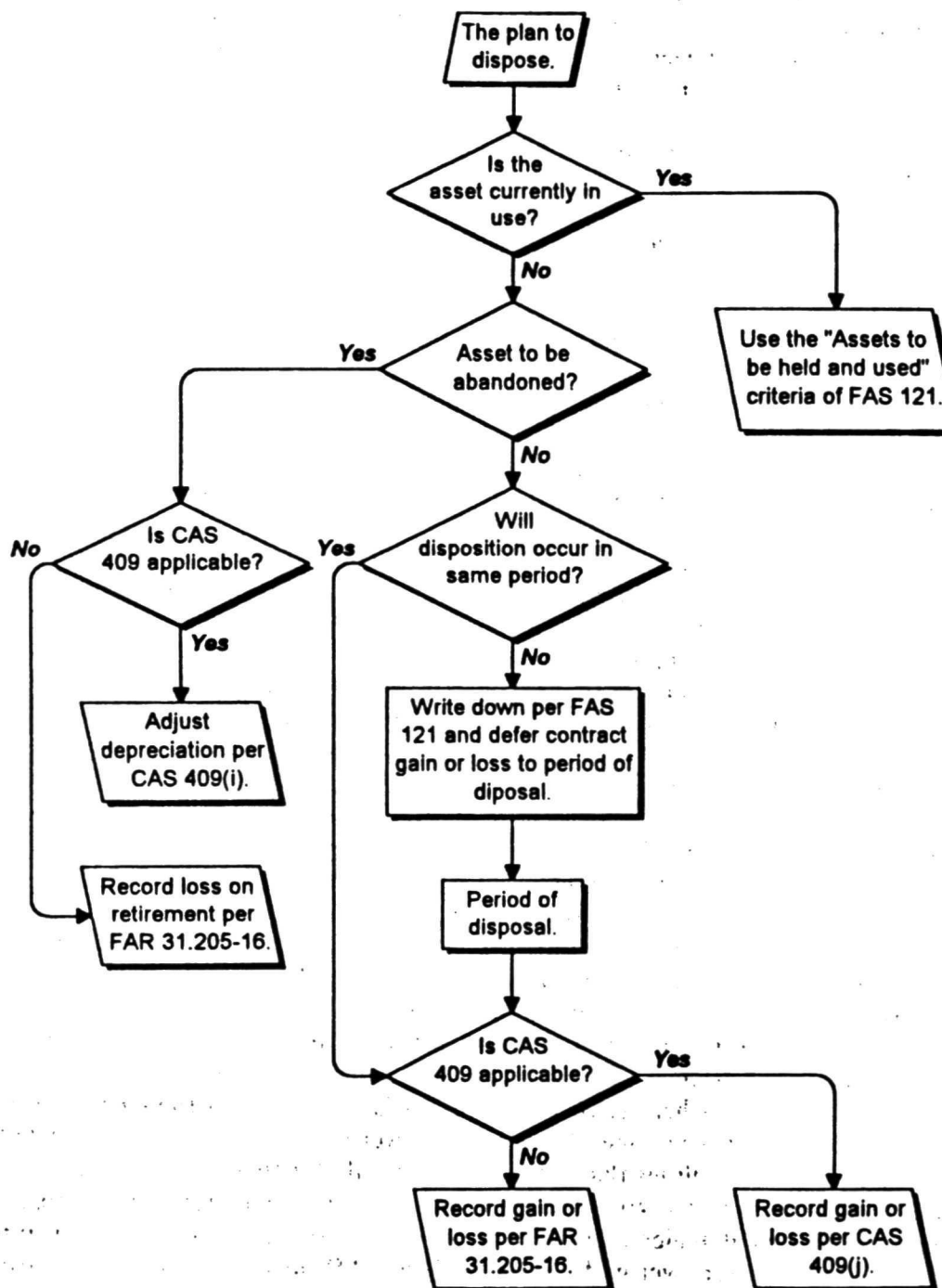
While all the above potentials for cost recovery are in the FAR, the actual results may vary depending upon the circumstances in which they are applied. For example, Contractor A has all cost reimbursement contracts while Contractor B has only sealed bid type contracts. Both have facilities used almost exclusively for certain government work. As a result of budget cuts neither contractor gets anticipated follow-on work. Thus, both have assets that are underutilized and are candidates for impairment write-down under FAS 121. Contractor A can take advantage of the several cost principles discussed above to recover the cost of the subject assets charged as depreciation, etc., since its indirect costs will be redetermined each year. Contractor B has no such opportunity with its sealed bid firm-fixed-price contracts.

But conditions may not be just black or white. For example, Contractor A is performing only cost reimbursement work and has its indirect costs adjusted annually based on actual cost experience. Contractor B is performing only negotiated firm-fixed-price work and projects its rates at the time of negotiating the contract. Obviously, Contractor A has an opportunity to recover costs on ongoing contracts that Contractor B does not have. In the current period Contractor A can shorten the life of an asset and recover more depreciation. Contractor B is locked into rates projected earlier.

As another example, Contractor A has one large government contract and some commercial business. Contractor B has many government contracts and some commercial business. Contractor A does not get expected follow-on contracts when its current contract is completed in the current year. Contractor B does not get follow-on work when one of its several government contracts is completed in the current year. Both contractors had facilities that were used primarily for their completed government contracts. Contractor A is now no longer a government contractor and cannot recover the cost of the impaired assets from the government under any circumstances. Contractor B still has substantial government work so it has a potential to recover under several of the FAR provisions mentioned earlier. But suppose Contractor A's contract was a multiyear contract canceled after the first year and the contract had cancellation ceilings established that would provide full recovery of the undepreciated cost of the facilities. In that case Contractor A would have no impairment loss.

So far, the discussion has concerned assets which have a diminished or terminated service potential which could have been caused by government downsizing or obsolescence due to technology changes.

ASSET DISPOSITION UNDER FAS 121 AND FAC 90-35



But a government contractor could be exposed to other circumstances or events which appear more daunting in trying to avoid the impairment write-down. Such might be the case when laws are enacted making the operation of certain contractor facilities illegal for safety or environmental reasons. This type of sudden, and perhaps sovereign, act could instantly reduce the asset's future cash flows to its expected salvage value, zero, or a negative amount resulting from the cost of disposal. Certainly it would appear to be a candidate for impairment write-down. But it is not necessarily one.

Again, so long as the contractor has not designated the asset as impaired, there may be a chance to generate sufficient cash flow from the useless asset and avoid the impairment loss. The decision by others to make the asset useless is not the same as a decision by management to dispose of the asset. So if management avoids the initial impulse to make a decision, it has cleared one hurdle posed by FAS 121. The next hurdle is to elect the manner in which the unrecovered cost will be made allowable. It appears that some of the potential recovery means mentioned above are also applicable in this situation. But maybe the best solution would be to *retire* the asset immediately without necessarily disposing of it. An asset is treated as retired when it is permanently withdrawn from use in the business.⁷ FAR 31.205-16 provides for the allowability of losses from retirement. Being a retired asset, it is no longer an asset held for use, but rather one being held for non-use. Since the prohibition on allowability of write-downs in new paragraph (g) of FAR 31.205-16 applies only to assets held for use, the loss on retirement would be allowable as it always has been. For contracts covered by CAS 409, the contractor may use the provisions of 48 CFR 9904.409-50(i) or (j) for the necessary adjustment to depreciation.

Regarding the sovereign acts aspect of such an impairment, it should pose no problem. The contractor's actions of ceasing to operate the assets are merely those of compliance with the law, the cost of which is ordinary and necessary for doing business.

With these options available for cost recovery, under various circumstances, many cost-based contractors should be able to project full cost recovery and, therefore, adequate cash flow to avoid the write-down criterion.

The Decision to Dispose of an Asset

FAS 121 also requires that assets that are subject to a plan for disposition be written down to fair value less cost to sell, if fair value is less than carrying value. Under the interim rule the write-down would not be an allowable cost. The interim rule maintains that losses on disposition still be recorded in the period of disposition. Thus, the impact of the interim rule is to defer the loss, not to make it totally unallowable as it would be with regard to assets held for use. Furthermore, if the decision or plan to dispose were made in the same accounting period as the actual disposition, the actual disposition would obviate any FAS 121 write-down. (See decision tree, opposite, for asset dispositions in accordance with FAS 121 and FAC 90-35.)

A contractor that had redundant assets all in use at some level may consider immediate retirement (permanent withdrawal of the asset from use in the business) of the excess assets. This would result in the remaining carrying value being written off as a loss on disposal, recoverable under FAR 31.205-16 or under 48 CFR 9904.409-50(i) or (j). By doing this, a contractor could avoid the recognition of an "impairment loss" or the need to establish that there would be no impairment loss. Further, this approach may ease the burden of establishing that the remaining assets held for use are not impaired.

Strategy to Avoid Loss

The crucial and first step in a strategy for maximum cost recovery by a government contractor using cost-based pricing and having a suspected "impaired" asset should be to avoid the fatal mistake of unnecessarily writing down the value of the asset. To make the write-down is to forfeit the many options otherwise available for cost recovery. Designating the asset as impaired is generally the only impairment it can suffer. Only a careful analysis of the circumstances causing the appearance of impairment can lead to selection of the best option to avoid actual loss of some part of the carrying value of the asset. Professional advice should be sought to ensure the best means of recovery are selected.

In situations where impairment cannot be avoided by full cost recovery, its effects may be minimized by projecting a large partial cost recovery. FAS 121, § 7, requires that an impaired asset be written down from its carrying value to its fair value. The usual means of establishing fair value—the amount at which the asset could be bought or sold in a current transaction between willing parties—might not be available for highly specialized facilities of government contractors in a shrinking market. Therefore, as an alternative, the present value of estimated expected cash flows could be used. Obviously, the greater the expected cash flow, the greater the fair value and the smaller the write-down that would ensue.

Other Considerations

If a write-down were made to depreciable assets in recognition of an impairment loss, it may appear that the asset book value and, therefore, the base for computing cost of money and for computing fee potential using the weighted guidelines would be reduced. But such is not the case. CAS 414—cost of money as an element of facilities capital, techniques for application, ¶ (a), states, "The investment base used in computing the cost of money for facilities capital shall be computed from accounting data used for contract cost purposes." Since the write-down of an impaired asset is not recognized by the interim rule and pre-write-down depreciation schedules must be used for contract costing, the proper base for computing cost of money and the weighted guideline fee potential is the net book value before write-down.

What, then, of a nondepreciable asset that has been written down as impaired, such as contaminated land? Its net book value may be zero while it is still being used to support contract activity. Appendix A to CAS 414, under Basis, states, "... land which is integral to the regular operation of the business unit *shall* be included." [Emphasis added.] And since any write-down would not have been recognized by the interim rule, the full value of the land should be included for computing cost of money.

Conclusion

The interim FAR rule was intended to avoid a surge in write-down losses that otherwise would have resulted from FAS 121, and thus maintain the existing means for a contractor to recover the cost of depreciable assets. While it should not be viewed as a new means to disallow yet another cost, the contractor's own actions of mistakenly recognizing impairment losses could trigger the provisions of the interim rule which could then result in an actual loss of write-downs, not only in the current period but irrevocably.

There is no concise formula to determine whether a government contractor has impaired assets. There are variables in circumstances and contract provisions, as well as differences between CAS and the cost principles, all of which have a bearing on impairment. Each situation requires careful analysis to determine the factors and their effects on cost recovery.

New regulations always come as bad news, but the good news here is that there are sound strategies for avoiding, or at least minimizing, the potential loss created by the interim rule.

Endnotes

¹ Accounting Principles Board (APB) Opinion No. 30, *Reporting the Results of Operations—Reporting the Effects of Disposal of a Segment of a Business, Extraordinary, Unusual and Infrequently Occurring Events and Transactions*, requires that certain assets to be disposed of be measured at the lower of carrying amount or net realizable value. The disposals covered by this Opinion are business segments as defined by this Opinion.

² FAR 31.205-17, Idle facilities and idle capacity costs, ¶ (c), "Costs of idle capacity are costs of doing business and are a factor in the normal fluctuations of usage or overhead rates from period to period. Such costs are allowable provided the capacity is necessary or was originally reasonable"

³ FAR 31.205-11, Depreciation, ¶ (a), "Depreciation is a charge to current operations which distributes the cost of a tangible capital asset, less estimated residual value, over the estimated useful life of the asset in a systematic and logical manner. It does not involve a process of valuation. Useful life refers to the prospective period of economic usefulness in a particular contractor's operations as distinguished from physical life; it is evidenced by the actual or estimated retirement and replacement practice of the contractor." 48 CFR 9904.409-50 Cost accounting standard—depreciation of tangible capital assets, Techniques for application, ¶ (1), "Estimates of service life, consumption of services, and residual value shall be reexamined for tangible capital assets (or groups of assets) whenever circumstances change significantly. Where changes are made to the estimated service life, residual value, or method of depreciation during the life of a tangible capital asset, the remaining depreciable cost for cost accounting purposes shall be limited to the undepreciated cost of the assets and shall be assigned only to the cost accounting period in which the change is made and to subsequent periods."

⁴ FAR 31.205-17, Idle facilities and idle capacity costs, ¶ (b) "The cost of idle facilities are unallowable unless the facilities— (2) Were necessary when acquired and are now idle because of changes in requirements, production economics, reorganization, termination, or other causes which could not have been reasonably foreseen."

⁵ FAR 31.205-16, Gains and losses on disposition or impairment of depreciable property or other capital assets, ¶ (a), "Gains and losses from the sale, retirement, or other disposition (but see 31.205-19) of depreciable property shall be included in the year in which they occur as credits or charges to the cost grouping(s) in which the depreciation or amortization applicable to those assets was included."

⁶ FAR 31.205-42, Termination costs, ¶ (d) Loss of useful value, "Loss of useful value of special tooling, or special machinery and equipment is generally allowable" FAR 17.103-1(d), Cancellation, ¶ (2), "In determining cancellation ceilings, the contracting officer must estimate reasonable . . . nonrecurring costs Nonrecurring costs include such costs, where applicable, as plant or equipment relocation or rearrangement, special tooling or special test equipment . . . allocable portions of the costs of facilities to be acquired or established for the conduct of the work"

⁷ DCAA contract Audit Manual (DCAM 7640.1, January 1996) 7-407.4a.



The Implications of FAS 121 and the Interim FAR Rule For Government Contractors: A Sensible Approach to the Determination of Impaired Assets

*Howard N. Kenyon Jr. and Gregory L. Fordham**

Introduction

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Since the decision to characterize an asset as impaired under GAAP is a decision founded in market-based pricing, the issue for government contractors is whether impairment can occur for contractors doing business in a cost-based environment. The FAR cost principles provide several avenues for recovering the undepreciated carrying value of assets that otherwise would not exist for commercial enterprises. But these cost recovery potentials can be used fully only if there has been no write-down of the asset to recognize an impairment loss for financial statement purposes. Once an impairment loss has been recognized, the interim rule and existing cost principles operate to preclude recovery of the write-down.

Consequently, a government contractor must carefully assess the status of underutilized facilities in order to avoid their unwarranted characterization as "impaired" and the associated potential loss of cost recovery. The following explains the requirements of the new accounting principle and interim FAR rule, and how those contractors that would be affected most can legitimately avoid, or at least minimize, their effect.

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Reacting to the possibility that many contractors may be subject to the requirement to write down assets and then attempt to recover the costs of the write-down under cost-based contracts, the FAR Councils issued an interim rule in Federal Acquisition Circular (FAC) 90-35, dated Dec. 14, 1995, which prohibits recovery of the write-down in the period in which it was taken. The interim rule reaffirms the existing requirement that losses on disposition of capital assets be recognized only in the period of disposition in accordance with FAR 31.205-16.

FAR 31.205-16, Gains and losses on disposition of depreciable property or other capital assets, has been changed to "Gains and losses on disposition *or impairment* of depreciable property or other capital assets." [Emphasis added.] And paragraph (g) has been added to deal specifically with impairment losses:

With respect to long-lived tangible and identifiable intangible assets held for use, no loss shall be recognized for a write-down from carrying value to fair value as a result of impairments caused by events or changes in circumstances (e.g., environmental damage, idle facilities arising from a declining business base, etc.). Depreciation or amortization on pre-write-down carrying value of impaired assets not yet disposed of shall continue to be recoverable under established depreciation or amortization schedules to the extent it is not otherwise unallowable under other provisions of the FAR.

On the surface it may appear that the cost of such impaired assets can eventually be recovered through normal pre-write-down depreciation practice. But look out! For contracts not fully CAS covered, what does "to the extent it is not otherwise unallowable under other provisions of the FAR" mean, especially to a government auditor? FAR 31.205-11, Depreciation, requires that in order to be allowable, depreciation cannot exceed that which is used for book or financial statement purposes and shall be determined in a manner consistent with policies and procedures used in the same cost center for non-government business. If on the financial statements an impairment loss has been recognized, wouldn't the carrying value of the asset be less and, consequently, the depreciation less? How, then, would pre-write-down depreciation be fully allowable?

If the contracts were subject to CAS 409, the limitations based on financial statement depreciation amounts would not apply, since requirements of CAS take precedence over cost principles with respect to measurement and allocation of allowable costs.

There are other hurdles. FAR 31.205-11, Depreciation, was also changed by FAC 90-35. Paragraph (o) was added:

In the event of a write-down from carrying value to fair value as a result of impairments caused by events or changes in circumstances, depreciation of the impaired assets shall not exceed the amounts established on depreciation schedules in use prior to the write-down (see 31.205-16(g)).

On the surface this too may be misleading. It does not say pre-write-down depreciation is recoverable; it only says that depreciation cannot exceed pre-write-down amounts. This language thwarts any attempt to circumvent the prohibition on recoverability of impairment loss by shortening the life of the asset to accelerate depreciation. If an impairment loss has already been recognized for financial

statement purposes, the contractor is not only precluded from recovery of asset cost through a shortened life consistent with a new estimate of life, but is in danger of not recovering pre-write-down amounts for the reason discussed above.

The Dilemma

The net result of the interim rule could very well be that an impairment loss is forever lost to the contractor. It is clear that it cannot be an allowable cost in the period in which it is recognized for financial statements; it most likely would not be allowed as normal pre-write-down depreciation charges being in excess of financial statement depreciation. And at the time of disposition, the asset's book value would be determined by "applicable" depreciation, not "allowable" depreciation. Thus, at the time of disposition, when the loss could be recognized as allowable, the loss would not be based on the unrecovered costs with respect to government contracts but rather on the lesser undepreciated book value.

Is There a Way Out?

However, there are ways to avoid potential loss of cost recovery in some circumstances. Recognition of an impairment loss pursuant to FAS 121 could create a problem when none should exist. The new paragraph (o) of FAR 31.205-11 starts with, "In the event of a write-down from carrying value to fair value as a result of impairments . . ." And the new paragraph (g) of FAR 31.205-16 states, "Depreciation or amortization on pre-write-down carrying value of impaired assets . . ." Both of these statements make it clear that the new provisions promulgated by FAC 90-35 address only assets that have been written down as a result of impairment. If no impairment loss is recognized, the new provisions of FAR 31.205-11 and 31.205-16 are not invoked and business is carried on as usual. Depreciation can be continued as before, asset lives can be shortened to reflect prospective economic usefulness, cost of idle facilities may be allowed, and loss on disposition would be allowable at the actual loss amount.

But is there really a dilemma? Maybe there is only the paradox of the self-extinguishing cost principle in the interim rule. First, contractors that do only or mostly sealed bid contracting or whose pricing is market driven—not cost driven—need not be concerned with the interim rule. Their pricing structures will not be affected by unallowable costs. Second, contractors that do all or a substantial amount of cost-based pricing have available several means of recovering costs of underutilized assets. Consequently, if they can recover the costs of the questionable assets, those assets can pass the test for future cash flows and avoid the characterization as impaired. And if the assets are not characterized as impaired, the interim rule does not apply.

For the contractor doing substantial cost-based contracting (negotiated contracts), the necessary course of action is to convince its certified public accountant (CPA) that it can pass the expected cash flow test of FAS 121 and thereby avoid the requirement for an asset write-down. While the CPA will argue a need to invoke FAS 121 because of changes in business climate, etc., the contractor must be ready to counter this argument with projections of full cost recovery. To demonstrate that the depreciation (or other characterization of the asset's cost) will generate the required cash flow, the contractor would have to demonstrate that the total indirect cost pool will be recovered. Recovery would be accomplished by pricing contracts using the full indirect cost rate generated by the pool to which the depreciation is charged. If the rate is being accepted in current negotiations for new contracts or for actuals on cost reimbursement contracts, the contractor would have proved its case of expected future cash flow being a likely occurrence. Arguably, some amount of profit could be imputed to the depreciation cost, further assuring recoverability.

This argument, however, would have to be based on realistic projections that are well supported. The CPA is bound by the FASB accounting principles and will not be able to overlook a write-down requirement on weak evidence. A mere potential for recovery is not by itself enough. It must be linked to a likely realization of future cash flow.

Available Options for Cost Recovery

Recovery potential is inherent in several FAR cost principles but the application of these principles can be quite different among contractors. Thus, the realization of cash flow from the assets would not necessarily be the same for all contractors. Consequently, all contractors could not necessarily avoid the write-down required by FAS 121 and the loss of cost recovery under the interim rule.

Suppose the asset in question was associated with a program that was canceled and there was absolutely no further use for the asset or its use could be projected for only a part of its originally estimated life. Would the CPA have to invoke FAS 121? Not necessarily. When the contractor became aware of a reduced economic service value, it could:

1. Continue normal depreciation if the economic life of the asset has not changed but capacity utilization has;²
2. Adjust the depreciation to reflect the reduced service life and recover the cost within the remaining life of the program;³
3. In the following period, assuming the asset is not being used, recover depreciation as idle facilities cost;⁴
4. Recover the loss on disposition as an allowable cost;⁵ or
5. In the special circumstances of a contract termination for convenience or the cancellation of a multiyear contract, recover the loss of useful value of assets acquired specifically for the contract.⁶

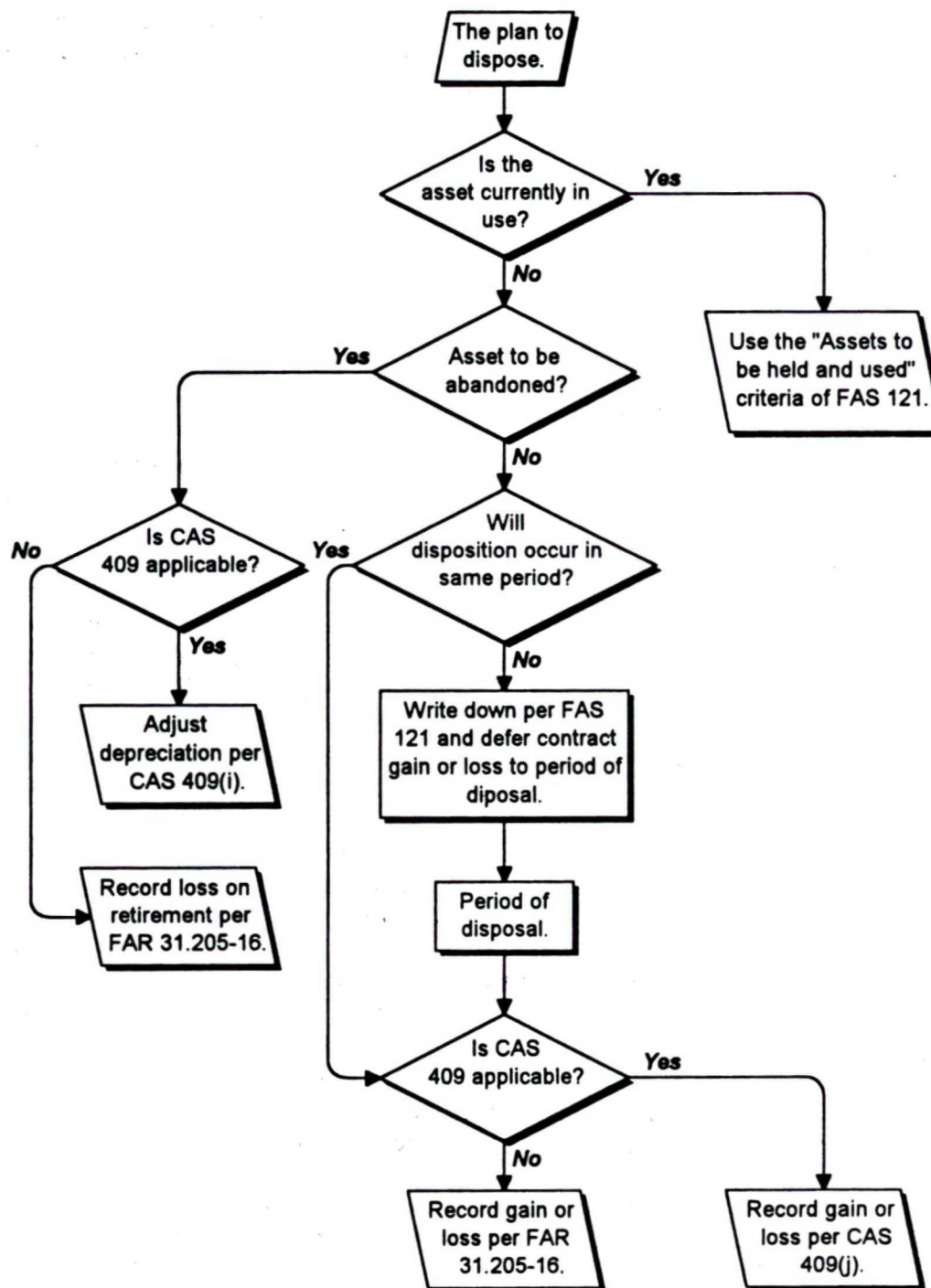
While all the above potentials for cost recovery are in the FAR, the actual results may vary depending upon the circumstances in which they are applied. For example, Contractor A has all cost reimbursement contracts while Contractor B has only sealed bid type contracts. Both have facilities used almost exclusively for certain government work. As a result of budget cuts neither contractor gets anticipated follow-on work. Thus, both have assets that are underutilized and are candidates for impairment write-down under FAS 121. Contractor A can take advantage of the several cost principles discussed above to recover the cost of the subject assets charged as depreciation, etc., since its indirect costs will be redetermined each year. Contractor B has no such opportunity with its sealed bid firm-fixed-price contracts.

But conditions may not be just black or white. For example, Contractor A is performing only cost reimbursement work and has its indirect costs adjusted annually based on actual cost experience. Contractor B is performing only negotiated firm-fixed-price work and projects its rates at the time of negotiating the contract. Obviously, Contractor A has an opportunity to recover costs on ongoing contracts that Contractor B does not have. In the current period Contractor A can shorten the life of an asset and recover more depreciation. Contractor B is locked into rates projected earlier.

As another example, Contractor A has one large government contract and some commercial business. Contractor B has many government contracts and some commercial business. Contractor A does not get expected follow-on contracts when its current contract is completed in the current year. Contractor B does not get follow-on work when one of its several government contracts is completed in the current year. Both contractors had facilities that were used primarily for their completed government contracts. Contractor A is now no longer a government contractor and cannot recover the cost of the impaired assets from the government under any circumstances. Contractor B still has substantial government work so it has a potential to recover under several of the FAR provisions mentioned earlier. But suppose Contractor A's contract was a multiyear contract canceled after the first year and the contract had cancellation ceilings established that would provide full recovery of the undepreciated cost of the facilities. In that case Contractor A would have no impairment loss.

So far, the discussion has concerned assets which have a diminished or terminated service potential which could have been caused by government downsizing or obsolescence due to technology changes.

ASSET DISPOSITION UNDER FAS 121 AND FAC 90-35



But a government contractor could be exposed to other circumstances or events which appear more daunting in trying to avoid the impairment write-down. Such might be the case when laws are enacted making the operation of certain contractor facilities illegal for safety or environmental reasons. This type of sudden, and perhaps sovereign, act could instantly reduce the asset's future cash flows to its expected salvage value, zero, or a negative amount resulting from the cost of disposal. Certainly it would appear to be a candidate for impairment write-down. But it is not necessarily one.

Again, so long as the contractor has not designated the asset as impaired, there may be a chance to generate sufficient cash flow from the useless asset and avoid the impairment loss. The decision by others to make the asset useless is not the same as a decision by management to dispose of the asset. So if management avoids the initial impulse to make a decision, it has cleared one hurdle posed by FAS 121. The next hurdle is to elect the manner in which the unrecovered cost will be made allowable. It appears that some of the potential recovery means mentioned above are also applicable in this situation. But maybe the best solution would be to *retire* the asset immediately without necessarily disposing of it. An asset is treated as retired when it is permanently withdrawn from use in the business.⁷ FAR 31.205-16 provides for the allowability of losses from retirement. Being a retired asset, it is no longer an asset held for use, but rather one being held for non-use. Since the prohibition on allowability of write-downs in new paragraph (g) of FAR 31.205-16 applies only to assets held for use, the loss on retirement would be allowable as it always has been. For contracts covered by CAS 409, the contractor may use the provisions of 48 CFR 9904.409-50(i) or (j) for the necessary adjustment to depreciation.

Regarding the sovereign acts aspect of such an impairment, it should pose no problem. The contractor's actions of ceasing to operate the assets are merely those of compliance with the law, the cost of which is ordinary and necessary for doing business.

With these options available for cost recovery under various circumstances, many cost-based contractors should be able to project full cost recovery and, therefore, adequate cash flow to avoid the write-down criterion.

The Decision to Dispose of an Asset

FAS 121 also requires that assets that are subject to a plan for disposition be written down to fair value less cost to sell, if fair value is less than carrying value. Under the interim rule the write-down would not be an allowable cost. The interim rule maintains that losses on disposition still be recorded in the period of disposition. Thus, the impact of the interim rule is to defer the loss, not to make it totally unallowable as it would be with regard to assets held for use. Furthermore, if the decision or plan to dispose were made in the same accounting period as the actual disposition, the actual disposition would obviate any FAS 121 write-down. (See decision tree, opposite, for asset dispositions in accordance with FAS 121 and FAC 90-35.)

A contractor that had redundant assets all in use at some level may consider immediate retirement (permanent withdrawal of the asset from use in the business) of the excess assets. This would result in the remaining carrying value being written off as a loss on disposal, recoverable under FAR 31.205-16 or under 48 CFR 9904.409-50(i) or (j). By doing this, a contractor could avoid the recognition of an "impairment loss" or the need to establish that there would be no impairment loss. Further, this approach may ease the burden of establishing that the remaining assets held for use are not impaired.

Strategy to Avoid Loss

The crucial and first step in a strategy for maximum cost recovery by a government contractor using cost-based pricing and having a suspected "impaired" asset should be to avoid the fatal mistake of unnecessarily writing down the value of the asset. To make the write-down is to forfeit the many options otherwise available for cost recovery. Designating the asset as impaired is generally the only impairment it can suffer. Only a careful analysis of the circumstances causing the appearance of impairment can lead to selection of the best option to avoid actual loss of some part of the carrying value of the asset. Professional advice should be sought to ensure the best means of recovery are selected.

In situations where impairment cannot be avoided by full cost recovery, its effects may be minimized by projecting a large partial cost recovery. FAS 121, ¶ 7, requires that an impaired asset be written down from its carrying value to its fair value. The usual means of establishing fair value—the amount at which the asset could be bought or sold in a current transaction between willing parties—might not be available for highly specialized facilities of government contractors in a shrinking market. Therefore, as an alternative, the present value of estimated expected cash flows could be used. Obviously, the greater the expected cash flow, the greater the fair value and the smaller the write-down that would ensue.

Other Considerations

If a write-down were made to depreciable assets in recognition of an impairment loss, it may appear that the asset book value and, therefore, the base for computing cost of money and for computing fee potential using the weighted guidelines would be reduced. But such is not the case. CAS 414—cost of money as an element of facilities capital, techniques for application, ¶ (a), states, “The investment base used in computing the cost of money for facilities capital shall be computed from accounting data used for contract cost purposes.” Since the write-down of an impaired asset is not recognized by the interim rule and pre-write-down depreciation schedules must be used for contract costing, the proper base for computing cost of money and the weighted guideline fee potential is the net book value before write-down.

What, then, of a nondepreciable asset that has been written down as impaired, such as contaminated land? Its net book value may be zero while it is still being used to support contract activity. Appendix A to CAS 414, under Basis, states, “. . . land which is integral to the regular operation of the business unit *shall* be included.” [Emphasis added.] And since any write-down would not have been recognized by the interim rule, the full value of the land should be included for computing cost of money.

Conclusion

The interim FAR rule was intended to avoid a surge in write-down losses that otherwise would have resulted from FAS 121, and thus maintain the existing means for a contractor to recover the cost of depreciable assets. While it should not be viewed as a new means to disallow yet another cost, the contractor's own actions of mistakenly recognizing impairment losses could trigger the provisions of the interim rule which could then result in an actual loss of write-downs, not only in the current period but irrevocably.

There is no concise formula to determine whether a government contractor has impaired assets. There are variables in circumstances and contract provisions, as well as differences between CAS and the cost principles, all of which have a bearing on impairment. Each situation requires careful analysis to determine the factors and their effects on cost recovery.

New regulations always come as bad news, but the good news here is that there are sound strategies for avoiding, or at least minimizing, the potential loss created by the interim rule.

Endnotes

¹ Accounting Principles Board (APB) Opinion No. 30, *Reporting the Results of Operations—Reporting the Effects of Disposal of a Segment of a Business, Extraordinary, Unusual and Infrequently Occurring Events and Transactions*, requires that certain assets to be disposed of be measured at the lower of carrying amount or net realizable value. The disposals covered by this Opinion are business segments as defined by this Opinion.

² FAR 31.205-17, Idle facilities and idle capacity costs, ¶ (c), "Costs of idle capacity are costs of doing business and are a factor in the normal fluctuations of usage or overhead rates from period to period. Such costs are allowable provided the capacity is necessary or was originally reasonable"

³ FAR 31.205-11, Depreciation, ¶ (a), "Depreciation is a charge to current operations which distributes the cost of a tangible capital asset, less estimated residual value, over the estimated useful life of the asset in a systematic and logical manner. It does not involve a process of valuation. Useful life refers to the prospective period of economic usefulness in a particular contractor's operations as distinguished from physical life; it is evidenced by the actual or estimated retirement and replacement practice of the contractor." 48 CFR 9904.409-50 Cost accounting standard—depreciation of tangible capital assets, Techniques for application, ¶ (I), "Estimates of service life, consumption of services, and residual value shall be reexamined for tangible capital assets (or groups of assets) whenever circumstances change significantly. Where changes are made to the estimated service life, residual value, or method of depreciation during the life of a tangible capital asset, the remaining depreciable cost for cost accounting purposes shall be limited to the undepreciated cost of the assets and shall be assigned only to the cost accounting period in which the change is made and to subsequent periods."

⁴ FAR 31.205-17, Idle facilities and idle capacity costs, ¶ (b) "The cost of idle facilities are unallowable unless the facilities— (2) Were necessary when acquired and are now idle because of changes in requirements, production economies, reorganization, termination, or other causes which could not have been reasonably foreseen."

⁵ FAR 31.205-16, Gains and losses on disposition or impairment of depreciable property or other capital assets, ¶ (a), "Gains and losses from the sale, retirement, or other disposition (but see 31.205-19) of depreciable property shall be included in the year in which they occur as credits or charges to the cost grouping(s) in which the depreciation or amortization applicable to those assets was included."

⁶ FAR 31.205-42, Termination costs, ¶ (d) Loss of useful value, "Loss of useful value of special tooling, or special machinery and equipment is generally allowable" FAR 17.103-1(d), Cancellation, ¶ (2), "In determining cancellation ceilings, the contracting officer must estimate reasonable . . . nonrecurring costs Nonrecurring costs include such costs, where applicable, as plant or equipment relocation or rearrangement, special tooling or special test equipment . . . allocable portions of the costs of facilities to be acquired or established for the conduct of the work"

⁷ DCAA contract Audit Manual (DCAM 7640.1, January 1996) 7-407.4a.

INFO



ACQUISITION AND
TECHNOLOGY

DP (DAR)

OFFICE OF THE UNDER SECRETARY OF DEFENSE

3000 DEFENSE PENTAGON
WASHINGTON DC 20301-3000

May 6, 1996



In reply refer to
FAR Case: 95-003

MEMORANDUM FOR MR. EDWARD C. LOEB, CHAIRMAN,
CIVILIAN AGENCY ACQUISITION COUNCIL

SUBJECT: Impairment of Long-Lived Assets

We have agreed to a draft final rule (Atch 1) revising Federal Acquisition Regulation (FAR) Part 31. The rule clarifies the cost allowability rules concerning the recognition of gains and losses related to long-lived assets.

If you agree with our final rule, please forward it to the FAR Secretariat for publication in a future Federal Acquisition Circular (FAC). We have attached a draft Federal Register notice and FAC Introductory Item (Atch 2).

The Regulatory Flexibility applies but the draft final rule is not expected to have a significant economic impact on a substantial number of small entities because most contracts awarded to small entities are awarded on a competitive fixed-price basis and do not require application of the cost principles contained in this rule. The Paperwork Reduction Act does not apply because the rule does not impose any reporting or recordkeeping requirements. Our case manager is Ms. Sandra Haberlin, (703)602-0131.

D. S. Parry
CAPT, SC, USN
Director, Defense Acquisition
Regulations Council

Attachments



MAY 08 1996

FAR CASE 95-003
IMPAIRMENT OF LONG-LIVED ASSETS

The baseline is the FAR through FAC 38. Changes are represented by **[bold print in brackets]** for new language and ~~strikethrough~~ for deleted language.

31.205-11 Depreciation.

* * * * *

(o) In the event of a write-down from carrying value to fair value as a result of impairments caused by events or changes in circumstances, **[allowable]** depreciation of the impaired assets shall ~~not exceed~~ **[be limited to]** the amounts **[that would have been allowed had the assets not been]** ~~established on depreciation schedules in use prior to the write-down~~ **[written down]** (see 31.205-16(g)). **[However, this does not preclude a change in depreciation resulting from other causes such as permissible changes in estimates of service life, consumption of services or residual value.]**

* * * * *

31.205-16 Gains and losses on disposition or impairment of depreciable property or other capital assets.

* * * * *

(g) With respect to long-lived tangible and identifiable intangible assets held for use, no loss shall be ~~recognized~~ **[allowed]** for a write-down from carrying value to fair value as a result of impairments caused by events or changes in circumstances (e.g., environmental damage, idle facilities arising from a declining business base, etc.). **[If depreciable property or other capital assets have been written down from carrying value to fair value due to impairments, gains or losses upon disposition shall be the amounts that would have been allowed had the assets not been written down.]** ~~Depreciation or amortization on pre-write-down carrying value of impaired assets not yet disposed of shall continue to be recoverable under established depreciation or amortization schedules to the extent it is not otherwise unallowable under other provisions of the FAR.~~

Draft Federal Register Notice

**DEPARTMENT OF DEFENSE
GENERAL SERVICES ADMINISTRATION
NATIONAL AERONAUTICS AND SPACE ADMINISTRATION**

**48 CFR Part 31
[FAR Case 95-003]**

**Federal Acquisition Regulation;
Impairment of Long-Lived Assets**

AGENCIES: Department of Defense (DoD), General Services Administration (GSA), and National Aeronautics and Space Administration (NASA).

ACTION: Final rule.

SUMMARY: The Civilian Agency Acquisition Council and the Defense Acquisition Regulations Council have agreed on a final rule to amend the Federal Acquisition Regulation (FAR) to clarify the cost allowability rules concerning the recognition of losses when carrying values of impaired assets are written down for financial reporting purposes.

DATES: This rule is effective _____.

FOR FURTHER INFORMATION CONTACT: Mr. Jeremy Olson at (202) 501-3221 in reference to this FAR case. For general information, contact the FAR Secretariat, Room 4037, GS Building, Washington, DC 20405 (202) 501-4755. Please cite FAR Case 95-003.

SUPPLEMENTARY INFORMATION:

A. Background

This final rule clarifies that impairment losses recognized for financial accounting purposes under the Financial Accounting Standards Board Statement of Financial Accounting Standards (SFAS), No. 121, Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to be Disposed Of, dated March 1995, are not allowable for Government contract costing.

The SFAS applies to long-lived assets (such as land, buildings, and equipment), certain identifiable intangibles, and related goodwill. If impaired assets are to be held for use, the SFAS requires a write-down to fair value when events or circumstances (e.g., environmental damage, idle facilities arising from declining business, etc.) indicate that carrying values may not be fully recoverable. Once written down, the previous carrying amount of an impaired asset could not be restored if the impairment was subsequently removed.

In contrast to the SFAS provisions, Cost Accounting Standard (CAS) 9904.409, Depreciation of Tangible Capital Assets, provides quite different criteria and guidance to recognize gains and losses for Government contract purposes. The language at CAS 9904.409-40(a)(4) and (b)(4), CAS 9904.409-50(j), and related Promulgation Comment 10, Gain or Loss, makes it clear that gains and losses are recognized only upon asset disposal; no other circumstances trigger such recognition. The language at CAS 9904.409-50(i) makes it clear that changes in depreciation may result from other permissible causes, e.g., changes in estimated service life, consumption of services, and residual value.

The final rule amends Subsections 31.205-11, Depreciation, and 31.205-16, Gains and Losses on Disposition or Impairment of Depreciable Property or Other Capital Assets, to clarify that these subsections reflect the CAS provisions that an asset be disposed of in order to recognize a gain or loss. Consequently, for Government contract purposes, (1) an impairment loss is recognized only upon disposal of the impaired asset and is measured, like other losses, as the difference between the net amount realized and the impaired asset's undepreciated balance; (2) Government contractors recover the carrying values of impaired assets held for use by retaining pre-write-down depreciation or amortization schedules as though no impairment had occurred; and (3) changes in depreciation are allowable from other permissible causes.

An interim rule was published in the Federal Register on December 14, 1995 (60 FR 64254). Four sources submitted public comments. All comments were considered in developing the final rule.

B. Regulatory Flexibility Act

The Department of Defense, the General Services Administration and the National Aeronautics and Space Administration certify that this final rule does not have a significant economic impact on a substantial number of small entities within the meaning of the Regulatory Flexibility Act, 5 U.S.C. 601, et seq., because most contracts awarded to small

entities are awarded on a competitive fixed-price basis and do not require application of the cost principles contained in this rule.

C. Paperwork Reduction Act

The Paperwork Reduction Act of 1995 (Pub. L. 104-13) does not apply because the changes to the FAR do not impose any new reporting or recordkeeping requirements which require Office of Management and Budget approval under 44 U.S.C. 3501, et seq.

FAC Introductory Item

ITEM XX--

This final rule amends FAR 31.205-11 and 31.205-16 to clarify the cost allowability rules concerning the recognition of losses when carrying values of impaired assets are written down for financial reporting purposes.



ACQUISITION AND
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* * * * *

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* * * * *

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The SFAS applies to long-lived assets (such as land, buildings, and equipment), certain identifiable intangibles, and related goodwill. If impaired assets are to be held for use, the SFAS requires a write-down to fair value when events or circumstances (e.g., environmental damage, idle facilities arising from declining business, etc.) indicate that carrying values may not be fully recoverable. Once written down, the previous carrying amount of an impaired asset could not be restored if the impairment was subsequently removed.

In contrast to the SFAS provisions, Cost Accounting Standard (CAS) 9904.409, Depreciation of Tangible Capital Assets, provides quite different criteria and guidance to recognize gains and losses for Government contract purposes. The language at CAS 9904.409-40(a)(4) and (b)(4), CAS 9904.409-50(j), and related Promulgation Comment 10, Gain or Loss, makes it clear that gains and losses are recognized only upon asset disposal; no other circumstances trigger such recognition. The language at CAS 9904.409-50(i) makes it clear that changes in depreciation may result from other permissible causes, e.g., changes in estimated service life, consumption of services, and residual value.

The final rule amends Subsections 31.205-11, Depreciation, and 31.205-16, Gains and Losses on Disposition or Impairment of Depreciable Property or Other Capital Assets, to clarify that these subsections reflect the CAS provisions that an asset be disposed of in order to recognize a gain or loss. Consequently, for Government contract purposes, (1) an impairment loss is recognized only upon disposal of the impaired asset and is measured, like other losses, as the difference between the net amount realized and the impaired asset's undepreciated balance; (2) Government contractors recover the carrying values of impaired assets held for use by retaining pre-write-down depreciation or amortization schedules as though no impairment had occurred; and (3) changes in depreciation are allowable from other permissible causes.

An interim rule was published in the Federal Register on December 14, 1995 (60 FR 64254). Four sources submitted public comments. All comments were considered in developing the final rule.

B. Regulatory Flexibility Act

The Department of Defense, the General Services Administration and the National Aeronautics and Space Administration certify that this final rule does not have a significant economic impact on a substantial number of small entities within the meaning of the Regulatory Flexibility Act, 5 U.S.C. 601, et seq., because most contracts awarded to small

entities are awarded on a competitive fixed-price basis and do not require application of the cost principles contained in this rule.

C. Paperwork Reduction Act

The Paperwork Reduction Act of 1995 (Pub. L. 104-13) does not apply because the changes to the FAR do not impose any new reporting or recordkeeping requirements which require Office of Management and Budget approval under 44 U.S.C. 3501, et seq.

FAC Introductory Item

ITEM XX--

This final rule amends FAR 31.205-11 and 31.205-16 to clarify the cost allowability rules concerning the recognition of losses when carrying values of impaired assets are written down for financial reporting purposes.

Sandy

Defense Acquisition Regulations Directorate

Memo

APR 26 1996

To: Ms. Carol Covey (CPF)


Subject: Impairment of Long-Lived Assets (FAR Case 95-003)

The Cost Principles Committee has analyzed the public comments submitted in response to the FAR interim rule (Atch 1) published in the Federal Register on December 14, 1995 (60 FR 64254), and has drafted a final rule (Atch 2) with appropriate revisions. The rule revises the cost principles at FAR 31.205-11, Depreciation, and FAR 31.205-16, Gains and losses on disposition or impairment of depreciable property or other capital assets, to clarify that any loss (including an impairment loss) is recognized only upon disposal of the asset. Until an impaired asset is disposed of, depreciation is limited to the amounts that would have been allowed before any impairment loss occurred.

The committee's recommended revisions clarify that (1) the cost principle is an "allowability" rule and not a "measurement or allocability" rule which is within the exclusive statutory authority of the Cost Accounting Standards Board (CAS); and (2) changes in depreciation may result from other permissible causes to ensure there is no conflict with CAS 409.50(i).

The DAR Council will discuss this case on May 1, 1996. We invite any comments you may have. Our case manager is Sandra Haberlin, 602-0131.

Please note that DAR Council Committee reports under open cases are generally considered pre-decisional and deliberative and may, if released, cause harm. Therefore, please do not release the committee report outside your office, and refer any requests for the document to our staff.



D. S. Parry
Captain, SC, USN
Director, Defense Acquisition
Regulations Council

Attachments

DEPARTMENT OF DEFENSE**GENERAL SERVICES
ADMINISTRATION****NATIONAL AERONAUTICS AND
SPACE ADMINISTRATION****48 CFR Part 31****[FAC 90-35; FAR Case 95-003]****RIN 9000-AG73****Federal Acquisition Regulation;
Impairment of Long-Lived Assets**

AGENCIES: Department of Defense (DOD), General Services Administration (GSA), and National Aeronautics and Space Administration (NASA).

ACTION: Interim rule, with request for comments.

SUMMARY: The Civilian Agency Acquisition Council and the Defense Acquisition Regulations Council have agreed to an interim rule to clarify the allowability of losses recognized when carrying values of impaired assets are written down for financial reporting purposes. This regulatory action was not subject to Office of Management and Budget review under Executive Order 12866, dated September 30, 1993.

DATES: *Effective Date:* December 14, 1995.

Comment Due Date: To be considered in the formulation of a final rule, comments should be submitted to the address given below on or before February 12, 1996.

ADDRESSES: Comments should be submitted to: General Services Administration, FAR Secretariat, 18th & F Streets NW., Room 4037, Washington, DC 20405.

FOR FURTHER INFORMATION CONTACT: Mr. Jeremy F. Olson at (202) 501-3775 in reference to this FAR case. For general information, contact the FAR Secretariat, Room 4037, GS Building, Washington, DC 20405 (202) 501-4755. Please cite FAC 90-35, FAR Case 95-003.

SUPPLEMENTARY INFORMATION:**A. Background**

This interim rule is intended to clarify cost allowability rules concerning the recognition of gains and losses related to long-lived assets. The rule addresses a cost category which is the subject of a Financial Accounting Standards Board Statement of Financial Accounting Standards (SFAS), No. 121, dated March 1995, entitled "Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets To Be Disposed Of."

The SFAS applies to long-lived assets (such as land, buildings, and equipment), identifiable intangibles, and related goodwill, and establishes guidance to recognize and measure impairment losses. If impaired assets are to be held for use, the SFAS requires a write-down to fair value when events or circumstances (e.g., environmental damage, idle facilities arising from declining business, etc.) indicate that carrying values may not be fully recoverable.

Impaired assets that are to be disposed of, however, would be reported (with certain exceptions) at the lower of cost or fair value less cost to sell. Once written down, the previous carrying amount of an impaired asset could not be restored if the impairment was subsequently removed.

In contrast to the SFAS provisions, Cost Accounting Standard (CAS) 9904.409, "Depreciation of Tangible Capital Assets", provides quite different criteria and guidance to recognize gains and losses for Government contract purposes. The language at 9904.409-40 (a)(4) and (b)(4), 9904.409-50(j), and related Promulgation Comment 10, "Gain or Loss," makes it clear that gains and losses are recognized only upon asset disposal; no other circumstances trigger such recognition.

FAR 31.205-16 reflects the CAS provisions that an asset be disposed of in order to recognize a gain or loss. The FAR rule applies to both CAS and non-CAS covered contracts. Consequently, for Government contract purposes, an impairment loss is recognized only upon disposal of the impaired asset. Like other losses, it is measured as the difference between the net amount realized and the impaired asset's undepreciated balance. Government contractors, therefore, recover the carrying values of impaired assets held for use by retaining pre-write-down depreciation or amortization schedules as though no impairment had occurred. The rule addresses the treatment of losses for impaired assets by adding a new paragraph (o) at 31.205-11, and revising the title and adding a new paragraph (g) at 31.205.16.

B. Regulatory Flexibility Act

The interim rule is not expected to have significant economic impact on a substantial number of small entities within the meaning of the Regulatory Flexibility Act, 5 U.S.C. 601 *et seq.* because most contracts awarded to small entities are awarded on a competitive fixed-price basis and the cost principles do not apply. An Initial Regulatory Flexibility Analysis has, therefore, not been performed.

Comments are invited from small businesses and other interested parties. Comments from small entities concerning the affected FAR parts will also be considered in accordance with 5 U.S.C. 610. Such comments must be submitted separately and cite 5 U.S.C. 601, *et seq.* (FAC 90-35, Far case 95-003) in correspondence.

C. Paperwork Reduction Act

The Paperwork Reduction Act does not apply because the rule does not impose any reporting or record keeping requirements which require the approval of the Office of Management and Budget under 44 U.S.C. 3501, *et seq.*

D. Determination To Issue an Interim Rule

A determination has been made under authority of the Secretary of Defense (DOD), the Administrator of General Services (GSA), and the Administrator of the National Aeronautics and Space Administration (NASA) that, pursuant to 41 U.S.C. 418b, urgent and compelling reasons exist to publish an interim rule prior to affording the public an opportunity to comment. This action is necessary because the Statement of Financial Accounting Standards No. 121, Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to be Disposed Of, dated March 1995, requires all publicly owned firms to recognize impairment losses in their financial statements for fiscal years beginning after December 15, 1995. It is likely that Government contractors whose 1996 fiscal year begins after December 15, 1995, will recognize impairment losses for financial reporting and claim a portion of such losses either on current contracts or on those awarded after December 15, 1995. In order to ensure that contractors' impairment losses are not paid by the Federal Government, it is necessary to issue this clarification of existing cost principles expeditiously. However, pursuant to Public Law 98-577 and FAR 1.501, public comments received in response to this interim rule will be considered in formulating the final rule.

List of Subjects in 48 CFR Part 31

Government procurement.

Dated: December 8, 1995.

Edward C. Loeb,

Acting Director, Office of Federal Acquisition Policy.

Federal Acquisition Circular
Number 90-35

Federal Acquisition Circular (FAC) 90-35 is issued under the authority of the Secretary of Defense, the Administrator of General

Services, and the Administrator for the National Aeronautics and Space Administration.

Unless otherwise specified, all Federal Acquisition Regulation (FAR) and other directive material contained in FAC 90-35 is effective December 14, 1995.

Dated: December 1, 1995.

Eleanor R. Spector,
Director, Defense Procurement.

Dated: December 6, 1995.

Ida M. Ustad,
Associate Administrator, for Acquisition Policy.

Dated: December 7, 1995.

Tom Luedtke,
Deputy Associate Administrator for Procurement, NASA.

Therefore, 48 CFR Part 31 is amended as set forth below:

PART 31—CONTRACT COST PRINCIPLES AND PROCEDURES

1. The authority citation for 48 CFR Part 31 continues to read as follows:

Authority: 40 U.S.C. 486(c); 10 U.S.C. chapter 137; and 42 U.S.C. 2473(c).

2. Section 31.205-11 is amended at the end of paragraph (e) by adding the parenthetical "(but see paragraph (o) of this subsection)."; and by adding paragraph (o) to read as follows:

31.205-11 Depreciation.

* * * * *

(o) In the event of a write-down from carrying value to fair value as a result of impairments caused by events or changes in circumstances, depreciation of the impaired assets shall not exceed the amounts established on depreciation

schedules in use prior to the write-down (see 31.205-16(g)).

3. Section 31.205-16 is amended by revising the section heading and adding paragraph (g) to read as follows:

31.205-16 Gains and losses on disposition or impairment of depreciable property or other capital assets.

* * * * *

(g) With respect to long-lived tangible and identifiable intangible assets held for use, no loss shall be recognized for a write-down from carrying value to fair value as a result of impairments caused by events or changes in circumstances (e.g., environmental damage, idle facilities arising from a declining business base, etc.). Depreciation or amortization on pre-write-down carrying value of impaired assets not yet disposed of shall continue to be recoverable under established depreciation or amortization schedules to the extent it is not otherwise unallowable under other provisions of the FAR.

[FR Doc. 95-30442 Filed 12-13-95; 8:45 am]

BILLING CODE 6820-EP-M

48 CFR Part 31

[Federal Acquisition Circular 90-35]

Federal Acquisition Regulation; Rates of Inflation

AGENCIES: Department of Defense (DOD), General Services Administration (GSA), and National Aeronautics and Space Administration (NASA).

ACTION: Annual notice of rates of inflation.

The Civilian Agency Acquisition Council and the Defense Acquisition Regulations Council have agreed to publish as an information item, the rates of inflation which are used in conjunction with other factors to determine the allowability of IR&D/B&P costs for major contractors under 31.205-18(c)(2)(i)(C)(2) during the first three contractor fiscal years beginning on or after October 1, 1992. The following rates of inflation are effective immediately, and shall remain in effect until superseded by the next publication, which is anticipated in January 1996:

Fiscal year	Annual percent-age rate
1994	2.5
1995	2.9
1996	3.0
1997	3.0

The above rates are the Price Escalation Indices for the Research, Development, Test & Evaluation (RDT&E) Account, Total Obligation Authority (TOA), issued by the Principal Deputy Under Secretary of Defense (Comptroller) on January 10, 1995. These rates of inflation supersede those published in FAC 90-23, Item XL—Annual Notice of Rates of Inflation, in the Federal Register on December 28, 1994.

Dated: December 8, 1995.

Edward C. Loeb,
Acting Director, Office of Federal Acquisition Policy.

[FR Doc. 95-30443 Filed 12-13-95; 8:45 am]

BILLING CODE 6820-EP-M



DEPARTMENT OF THE NAVY
OFFICE OF THE ASSISTANT SECRETARY
RESEARCH, DEVELOPMENT AND ACQUISITION
1000 NAVY PENTAGON
WASHINGTON DC 20350-1000

23 April 1996

FAR Case 95-003

MEMORANDUM FOR DIRECTOR, DEFENSE ACQUISITION REGULATIONS COUNCIL

SUBJECT: FAR Case 95-003, Impairment of Long-Lived Assets

I. PROBLEM

The Cost Principles Committee was tasked to review public comments received in response to the subject interim rule published in the *Federal Register* on 14 December 1995 and to draft a final rule.

II. RECOMMENDATION

That the interim rule be amended as shown in TAB A and adopted as a final rule.

III. BACKGROUND

The interim rule was intended to clarify that impairment losses recognized for financial accounting purposes under the Financial Accounting Standards Board's Statement of Financial Accounting Standards (SFAS), No. 121, *"Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets To Be Disposed Of,"* are not allowable for Government contract costing. The interim rule revised the existing language at FAR 31.205-11 and 31.205-16 to expressly state that for Government contracting purposes, any loss (including an impairment loss) is recognized only upon disposal of the asset. Until an impaired asset is disposed of, depreciation is limited to the amounts that would have been allowed before any impairment loss occurred.

SFAS No. 121, effective for company fiscal years beginning after 15 December 1995, addresses the impairment of long-lived assets (such as land, buildings, and equipment), certain identifiable intangibles, and related goodwill. The SFAS "requires that long-lived assets and certain identifiable intangibles to be held and used by an entity be reviewed for impairment whenever events or changes in circumstances indicate the carrying amount of an asset may not be recoverable." Such events include a significant decrease in the market value of an asset, change in the extent or manner in which an asset is used, and adverse change in legal factors or business climate. If the company believes that the expected future cash flows from the use of the asset and eventual disposition are less than the carrying amount (usually net book value) of the asset, an impairment loss must be recognized.

For impaired assets expected to be held and used, the net book value is reduced to fair value (i.e., the current amount the asset could be bought or sold for between willing parties). Once an asset is written down due to an impairment loss, the asset cannot be written back up, even if the impairment is subsequently removed. Impaired assets to be disposed of are generally reported at the lower of the carrying amount or fair value less cost to sell.

IV. EVALUATION OF COMMENTS

Responses were received from the following four commentors: Sundstrand Aerospace, National Security Industrial Association (NSIA), Aerospace Industries Association (AIA), and the American Bar Association (ABA). All commentors oppose the rule and believe it is unnecessary. Essentially, they contend that the rule should be withdrawn because it (1) is contrary to Generally Accepted Accounting Principles (GAAP), (2) involves a subject matter beyond the authority of the Councils, and (3) is administratively burdensome. The Committee's analysis of the substantive issues raised by the commentors follows.

A. Contrary to GAAP

NSIA asserts that Government contract accounting should not depart from GAAP unless public policy or other special circumstances warrant deviation. AIA states that the interim rule is unwarranted and contrary to sound accounting theory. The commentors also state that the interim rule does not address why SFAS No. 121 should not be used for Government accounting.

Committee Comments

The interim rule does depart from GAAP, because in this instance, it is inadequate for Government contract costing. GAAP is required to be followed in the absence of contract rules to the contrary. However, when GAAP produces an inequitable result, the Government has the right and fiduciary responsibility to the U.S. taxpayers to prescribe another arrangement. The Committee continues to believe that the interim rule protects the Government's interests and provides for equitable treatment.

The relevance of GAAP for Government contracting purposes is perhaps best summarized by the American Institute of Certified Public Accountants (AICPA). The AICPA makes the following statement in Section 2.46 of the *Audit and Accounting Guide for Audits of Federal Government Contractors*:

"Generally accepted accounting principles (GAAP) are established for financial accounting purposes and provide little guidance for cost accounting purposes in the Government contracting industry. Consequently, GAAP is applied only when no guidance in FAR or CAS exists."

To illustrate the inequity of SFAS No. 121, consider assets such as land and buildings and how their values can change over time. If these types of assets become impaired, an estimated loss will be recognized under GAAP. The estimated one-time period loss could then be charged to Government contracts even though the assets are still being used by the company. Since the Government intends to reimburse the contractor its historical costs and the assets have not actually been disposed of, the contractor has not experienced a real out-of-pocket loss. The loss, if any, will be realized when the assets are ultimately disposed of at some future point. Also, the Government would not receive a credit if the impairment is subsequently removed because GAAP prohibits the restoration of a previously recognized impairment loss.

B. Involves a Subject Matter Beyond the Authority of the Councils

The commentators believe that the interim rule addresses the measurement or allocation of cost which is within the exclusive statutory authority of the CAS Board (CASB). The commentators quote 41 U.S.C. 422(j)(4) which gives the CASB exclusive authority with respect to the measurement, assignment, or allocation of costs subject to CAS. The basic concern is summarized in the following ABA comment:

"Although the Section acknowledges the role of the Defense Acquisition Regulations Council and the Civilian Agency Acquisition Council with respect to cost allowability matters, matters of public policy, it is clear from both the nature of the Interim Rule, as well as the Background discussion, that the Councils have chosen to address a matter involving a government contract cost accounting practice--a matter beyond their authority. Rulemaking and regulatory guidance in this area should appropriately be issued by the CAS Board."

Committee Comments

This issue is fundamental to the case. The Committee agrees that the CASB has sole authority over the measurement, assignment, and allocation of costs for CAS-covered contracts. However, not all Government contracts are subject to CAS. Further, CAS 404 and 409 do not address the measurement, assignment, or allocation associated with intangible capital assets.

The CASB acknowledges that cost allowability is a contract administration matter. The CASB makes the following comments in its Statement of Objectives, Policies and Concepts:

"While the Board has exclusive authority for establishing Standards governing the measurement, assignment and allocation of costs, it does not determine the allowability of categories of individual items of costs.

* * * * *

The use of Cost Accounting Standards has no direct bearing on the allowability of those individual items of cost which are subject to limitations or exclusions set forth in the contract or which are otherwise specified as unallowable by the Government."

In addition, recognition of the concept of "allowability" is found in the following quote from the Boeing SERP Case Appeal (Court of Appeals for the Federal Circuit (CAFC) Case No. 86-927, October 1, 1986):

"Since the allowability of a cost remains the province of the procuring agencies, the DOD may limit costs based upon rational procurement policies and not all costs are deemed reasonable just because they have been incurred and measured, allocated and assigned in accordance with CAS requirements."

While the CAS could be similarly amended or interpreted in a way that would conclude that recognition of asset impairments for Government contracting is inappropriate, it is not likely this will occur in the near future. In the meantime, U.S. taxpayers could end up paying for estimated losses recognized for financial accounting purposes that will not actually be realized for years, if at all - a clearly inequitable result. However, to further clarify that the cost principle is an "allowability", and not a "measurement or allocability" rule with respect to CAS-covered contracts, we have rephrased the interim rule. In addition, we have added a sentence to 31.205-11(o) to ensure there is no conflict with CAS 409.50(i) by clarifying that changes in depreciation may result from other permissible causes.

C. Administratively Burdensome

The commentators allege that the rule is administratively burdensome because it will necessitate keeping an extra set of fixed asset records.

Committee Comments

We disagree. Contractors are already required to segregate unallowable costs for Government contracting purposes (e.g., treatment of gains or losses subsequent to mergers or business combinations) and to maintain fixed asset records. Moreover, contractors may already have to keep more than one set of fixed assets records, regardless of the cost principle, because of differences in depreciation methods required by GAAP, state, and/or Federal tax returns.

V. COLLATERALS

A. Regulatory Flexibility Act

This final rule is not expected to have a significant impact on a substantial number of small entities within the meaning of the Regulatory Flexibility Act, 5 U.S.C. 601 et seq., because most contracts awarded to small entities are awarded on a competitive, fixed price basis and the cost principles do not apply.

B. Paperwork Reduction Act

The Paperwork Reduction Act does not apply because the changes to the FAR do not impose record keeping or information collection requirements, or collections of information from offerors, contractors, or members of the public which require the approval of the Office of Management and Budget under 44 U.S.C. 3501 et seq.

VI. SUMMARY

All Committee members below concur in the contents of this report.



Clarence M. Belton
Chairman, Cost Principles Committee

DOD Members

Paul A. Schill, Air Force
James Bozzard, Army
Stephen T. Larkin, DCAA
Glenn Gulden, DLA
Chris Werner, OSD

Non-DOD Members

Bill Childs, NASA
Bill Dunn, EPA
Jerry Olson, GSA
Terry Sheppard, DOE

TAB A--Committee Recommended Final Rule

TAB A
RECOMMENDED COMMITTEE LANGUAGE

The baseline language is the interim rule published in the *Federal Register* on December 14, 1995. Changes are represented by **[bold print in brackets]** for new language and ~~strikeout~~ for deleted language.

31.205-11 Depreciation

* * * * *

(o) In the event of a write-down from carrying value to fair value as a result of impairments caused by events or changes in circumstances, **[allowable]** depreciation of the impaired assets shall ~~not exceed~~ **[be limited to]** the amounts **[that would have been allowed had the assets not been]** ~~established on depreciation schedules in use prior to the write-down~~ **[written down]** (see 31.205-16(g)). **[However, this does not preclude a change in depreciation resulting from other causes such as permissible changes in estimates of service life, consumption of services or residual value.]**

31.205-16 Gains and losses on disposition or impairment of depreciable property or other capital assets

* * * * *

(g) With respect to long-lived tangible and identifiable intangible assets held for use, no loss shall be ~~recognized~~ **[allowed]** for a write-down from carrying value to fair value as a result of impairments caused by events or changes in circumstances (e.g., environmental damage, idle facilities arising from a declining business base, etc.). **[If depreciable property or other capital assets have been written down from carrying value to fair value due to impairments, gains or losses upon disposition shall be the amounts that would have been allowed had the assets not been written down.]** ~~Depreciation or amortization on pre-write down carrying value of impaired assets not yet disposed of shall continue to be recoverable under established depreciation or amortization schedules to the extent it is not otherwise unallowable under other provisions of the FAR.~~

**CLEAN VERSION OF
RECOMMENDED COMMITTEE LANGUAGE**

31.205-11 Depreciation

* * * * *

(o) In the event of a write-down from carrying value to fair value as a result of impairments caused by events or changes in circumstances, allowable depreciation of the impaired assets shall be the amounts that would have been allowed had the assets not been written-down (see 31.205-16(g)). However, this does not preclude a change in depreciation resulting from other causes such as permissible changes in estimates of service life, consumption of services or residual value.

31.205-16 Gains and losses on disposition or impairment of depreciable property or other capital assets

* * * * *

(g) With respect to long-lived tangible and identifiable intangible assets held for use, no loss shall be allowed for a write-down from carrying value to fair value as a result of impairments caused by events or changes in circumstances (e.g., environmental damage, idle facilities arising from a declining business base, etc.). If depreciable property or other capital assets have been written down from carrying value to fair value due to impairments, gains or losses upon disposition shall be the amounts that would have been allowed had the assets not been written down.



General Services Administration
Office of Acquisition Policy
Washington, DC 20405

DARC
INFO

OCT 25 1995

MEMORANDUM FOR FAR SECRETARIAT

FROM:

C. Allen Olson
C. ALLEN OLSON
CHAIRMAN
CIVILIAN AGENCY ACQUISITION COUNCIL

SUBJECT: FAR Case 95-003, Impairment of Long-lived Assets

Please take appropriate action to publish the attached interim rule. The CAAC approved the case on July 25, 1995 and the DARC approved the rule on August 22, 1995. On October 2, 1995, the DARC requested that the rule be converted to an interim rule because it is critical to incorporate it into the FAR before December 15, 1995. Subsequent editorial corrections as described in the September 8, 1995 FAR Staff telefax were discussed on October 25, 1995 and agreed to between Jeremy Olson and (FAR Staff) and Rick Layser and Sandra Haberlin (DARC Staff).

This document shall not be sent to the Federal Register until specific approval is obtained from the Director or Acting Director.

Please contact Mr. Jeremy F. Olson if there are any questions.

Enclosures

Draft interim rule

DARC memorandum 10/2/95 w/draft determination to issue an interim rule

cc: Director, DARC



PROPOSED FEDERAL REGISTER NOTICE

DEPARTMENT OF DEFENSE
GENERAL SERVICES ADMINISTRATION
NATIONAL AERONAUTICS AND SPACE ADMINISTRATION

48 CFR Part 31
[FAR Case 95-003]

Federal Acquisition Regulation;
Impairment of Long-Lived Assets

AGENCIES: Department of Defense (DoD); General Services Administration (GSA); and National Aeronautics and Space Administration (NASA).

Interim
ACTION: ~~Proposed~~ rule with request for comments.

SUMMARY: The Civilian Agency Acquisition Council and the Defense Acquisition Regulations Council are ~~considering revisions to~~ clarify the allowability of losses recognized when carrying values of impaired assets are written down for financial reporting purposes.

COMMENTS: Comments should be submitted to the FAR Secretariat at the address shown below on or before (60 days from publication), to be considered in the formulation of a final rule.

ADDRESS: Interested parties should submit written comments to: General Services Administration, FAR Secretariat (VRS), 18th & F Streets, NW, Room 4041, Washington, D.C. 20405. Please cite FAR Case 95-003 in all correspondence related to these issues.

FOR FURTHER INFORMATION CONTACT: Ms. Beverly Fayson, FAR Secretariat, telephone (202) 501-4786. Please cite FAR Case 95-003.

SUPPLEMENTARY INFORMATION:

A. Background

The ~~proposed~~ *interim* rule is intended to clarify cost allowability rules concerning the recognition of gains and losses related to long-lived assets. The ~~proposed~~ rule addresses a cost category which is the subject of a Financial Accounting Standards Board proposed Statement of Financial Accounting Standards (SFAS), No.

132-B, dated November 29, 1993, entitled "Accounting for the Impairment of Long-Lived Assets."

The SFAS applies to long-lived assets (such as land, buildings, and equipment), identifiable intangibles, and related goodwill, and established guidance to recognize and measure impairment losses. If impaired assets are to be held for use, the SFAS requires a write-down to fair value when events or circumstances (e.g., environmental damage, idle facilities arising from declining business, etc.) indicate that carrying values may not be fully recoverable.

Impaired assets that are to be disposed of, however, would be reported (with certain exceptions) at the lower of cost or fair value less cost to sell. Once written down, the previous carrying amount of an impaired asset could not be restored if the impairment was subsequently removed.

In contrast to the SFAS provisions, Cost Accounting Standard (CAS) 9904.409, "Depreciation of Tangible Capital Assets," provides quite different criteria and guidance to recognize gains and losses for Government contract purposes. The language at 9904.409-40(a)(4) and (b)(4), 9904.409-50(j), and related Promulgation Comment 10, "Gain or Loss," makes it clear that gains and losses are recognized only upon asset disposal; no other circumstances trigger such recognition.

FAR 31.205-16 reflects the CAS provisions that an asset be disposed of in order to recognize a gain or loss. The FAR rule applies to both CAS and non-CAS covered contracts. Consequently, for Government contract purposes, an impairment loss is recognized only upon disposal of the impaired asset. Like other losses, it is measured as the difference between the net amount realized and the impaired asset's undepreciated balance. Government contractors, therefore, recover the carrying values of impaired assets held for use by retaining pre-write-down depreciation or amortization schedules as though no impairment had occurred. This ~~proposed~~ ^{interim} rule address the treatment of losses for impaired assets by ~~revising~~ ^{adding a new paragraph} 31.205-11(e), and revising the title and adding a new paragraph (g) at 31.205-16.

B. Regulatory Flexibility Act

This ~~proposed~~ ^{interim} rule is not expected to have a significant economic impact on a substantial number of small entities within the meaning of the Regulatory Flexibility Act, 5 U.S.C. 601, et seq., because most contracts awarded to small entities are awarded on a competitive fixed-price basis and the cost principles do not apply. An Initial Regulatory Flexibility Analysis has, therefore, not been performed. Comments from small entities concerning the affected FAR subpart will be considered in accordance with 5 U.S.C. 610. Such comments must be submitted separately and should cite 5 U.S.C. 601, et seq., (FAR Case 95-003), in correspondence.

C. Paperwork Reduction Act

The Paperwork Reduction Act does not apply because the proposed change to the FAR does not impose record keeping or information collection requirements, or collections of information from offerors, contractors, or members of the public which require the approval of the Office of Management and Budget under 44 U.S.C. 3501, et seq.

**EDITORIAL CHANGES TO THE
PROPOSED RULE APPROVED BY DARC & CAAC
FAR CASE 95-003, IMPAIRMENT OF LONG-LIVED ASSETS**

Changes in bold inside brackets [like this] are changes approved by the DARC and CAAC. Text shown in bold italics inside brackets [*like this*] are additional necessary editorial changes. Because these are editorial and do not change the intended and approved impact of the rule, the rule need not be resubmitted to the councils.

31.205-11 Depreciation.

(a) Depreciation is a charge to current operations which distributes the cost of a tangible capital asset, less estimated residual value, over the estimated useful life of the asset in a systematic and logical manner. It does not involve a process of valuation. Useful life refers to the prospective period of economic usefulness in a particular contractor's operations as distinguished from physical life; it is evidenced by the actual or estimated retirement and replacement practice of the contractor.

(b) Contractors having contracts subject to 48 CFR 9904.409, Depreciation of Tangible Capital Assets, must adhere to the requirement of that standard for all fully CAS-covered contracts and may elect to adopt the standard for all other contracts. All requirements of 48 CFR 9904.409 are applicable if the election is made, and its requirements supersede any conflicting requirements of this cost principle. Once electing to adopt 48 CFR 9904.409 for all contracts, contractors must continue to follow it until notification of final acceptance of all deliverable items on all open negotiated Government contracts. Paragraphs (c) through (e) below apply to contracts to which 48 CFR 9904.409 is not applied.

(c) Normal depreciation on a contractor's plant, equipment, and other capital facilities is an allowable contract cost, if the contractor is able to demonstrate that it is reasonable and allocable (but see paragraph (i) below).

(d) Depreciation shall be considered reasonable if the contractor follows policies and procedures that are—

(1) Consistent with those followed in the same cost center for business other than Government;

(2) Reflected in the contractor's books of accounts and financial statements; and

(3) Both used and acceptable for Federal income tax purposes.

(e) When the depreciation reflected on a contractor's books of accounts and financial statements differs from that used and acceptable for Federal income tax purposes, reimbursement shall be based on the asset cost amortized over the estimated useful life of the property using depreciation methods (straight line, sum of the years' digits, etc.) acceptable for income tax purposes. Allowable depreciation shall not exceed the amounts used for book and statement purposes and shall be determined in a manner consistent with the depreciation policies and procedures followed in the same cost center on non-Government business [*(but see paragraph (o).)*¹ ~~except that, in the event of a write-down from carrying value to fair value as a result of impairments caused by events or changes in circumstances, depreciation of the impaired assets shall not exceed the amounts established on depreciation schedules in use prior to the write-down (see 31.205-16(g)).~~]

(f) Depreciation for reimbursement purposes in the case of tax-exempt organizations shall be determined on the basis described in paragraph (e) immediately above.

¹ Make editorial change to rule approved by DARC and CAAC by moving the approved language to a new paragraph (o) and inserting a cross reference. The editorial change is necessary because the cost allowability rule was to have applied to both CAS and non CAS contracts. However, paragraph (b) states that the paragraph with the new allowability criteria were inserted applies only to non-CAS. Creating a new paragraph (o) will correct this editorial error.

(g) Special considerations are required for assets acquired before the effective date of this cost principle if, on that date, the undepreciated balance of these assets resulting from depreciation policies and procedures used previously for Government contracts and subcontracts is different from the undepreciated balance on the books and financial statements. The undepreciated balance for contract cost purposes shall be depreciated over the remaining life using the methods and lives followed for book purposes. The aggregate depreciation of any asset allowable after the effective date of this 31.205-11 shall not exceed the cost basis of the asset less any depreciation allowed or allowable under prior acquisition regulations.

(h) Depreciation should usually be allocated to the contract and other work as an indirect cost. The amount of depreciation allowed in any accounting period may, consistent with the basic objectives in paragraph (a) above, vary with volume of production or use of multishift operations.

(i) In the case of emergency facilities covered by certificates of necessity, a contractor may elect to use normal depreciation without requesting a determination of "true depreciation," or may elect to use either normal or "true depreciation" after a determination of "true depreciation" has been made by an Emergency Facilities Depreciation Board (EFDB). The method elected must be followed consistently throughout the life of the emergency facility. When an election is made to use normal depreciation, the criteria in paragraphs (c), (d), (e), and (f) above shall apply for both the emergency period and the post-emergency period. When an election is made to use "true depreciation", the amount allowable as depreciation—

(1) With respect to the emergency period (five years), shall be computed in accordance with the determination of the EFDB and allocated rateably over the full five year emergency period; *provided* no other allowance is made which would duplicate the factors, such as extraordinary obsolescence, covered by the Board's determination; and

(2) After the end of the emergency period, shall be computed by distributing the remaining undepreciated portion of the cost of the emergency facility over the balance of its useful life provided the remaining undepreciated portion of such cost shall not include any amount of unrecovered "true depreciation."

(j) No depreciation, rental, or use charge shall be allowed on property acquired at no cost from the Government by the contractor or by any division, subsidiary, or affiliate of the contractor under common control.

(k) The depreciation on any item which meets the criteria for allowance at a "price" under 31.205-26(e) may be based on that price, provided the same policies and procedures are used for costing all business of the using division, subsidiary, or organization under common control.

(l) No depreciation or rental shall be allowed on property fully depreciated by the contractor or by any division, subsidiary, or affiliate of the contractor under common control. However, a reasonable charge for using fully depreciated property may be agreed upon and allowed (but see 31.109(h)(2)). In determining the charge, consideration shall be given to cost, total estimated useful life at the time of negotiations, effect of any increased maintenance charges or decreased efficiency due to age, and the amount of depreciation previously charged to Government contracts or subcontracts.

(m) 48 CFR 9904.404, Capitalization of Tangible Assets, applies to assets acquired by a "capital lease" as defined in Statement of Financial Accounting Standard No. 13 (FAS-13), Accounting for Leases, issued by the Financial Accounting Standards Board (FASB). Compliance with 48 CFR 9904.404 and FAS-13 requires that such leased assets (capital leases) be treated as purchased assets; i.e., be capitalized and the capitalized value of such assets be distributed over their useful lives as depreciation charges, or over the leased life as amortization charges as appropriate. Assets whose leases are classified as capital leases under FAS-13 are subject to the requirements of 31.205-11 while assets acquired under leases classified as operating leases are subject to the requirements on rental costs in 31.205-36. The standards of financial accounting and reporting prescribed by FAS-13 are incorporated into this principle and shall govern its application, except as provided in subparagraphs (1), (2), and (3) below.

(1) Rental costs under a ~~sale and leaseback~~ arrangement shall be allowable up to the amount that would have been allowed had the ~~contractor~~ retained title to the property.

(2) Capital leases, as defined in FAS-13, for all real and personal property, between any related parties are subject to the requirements of this subparagraph 31.205-11(m). If it is determined that the terms of the lease have been significantly affected by the fact that the lessee and lessor are related, depreciation charges shall not be allowed in excess of those which would have occurred if the lease contained terms consistent with those found in a lease between unrelated parties.

(3) Assets acquired under leases that the contractor must capitalize under FAS-13 shall not be treated as purchased assets for contract purposes if the leases are covered by 31.205-36(b)(4).

(n) Whether or not the contract is otherwise subject to CAS, the requirements of 31.205-52, which limit the allowability of depreciation, shall be observed.

[(o) In the event of a write-down from carrying value to fair value as a result of impairments caused by events or changes in circumstances, depreciation of the impaired assets shall not exceed the amounts established on depreciation schedules in use prior to the write-down (see 31.205-16(g)).]

* * * * *

31.205-16 Gains and losses on disposition [or impairment] of depreciable property or other capital assets.

(a) Gains and losses from the sale, retirement, or other disposition (but see 31.205-19) of depreciable property shall be included in the year in which they occur as credits or charges to the cost grouping(s) in which the depreciation or amortization applicable to those assets was included (but see paragraph (d) of this subsection). However, no gain or loss shall be recognized as a result of the transfer of assets in a business combination (see 31.205-52).

(b) Gains and losses on disposition of tangible capital assets, including those acquired under capital leases (see 31.205-11(m)), shall be considered as adjustments of depreciation costs previously recognized. The gain or loss for each asset disposed of is the difference between the net amount realized, including insurance proceeds from involuntary conversions, and its undepreciated balance. The gain recognized for contract costing purposes shall be limited to the difference between the acquisition cost (or for assets acquired under a capital lease, the value at which the leased asset is capitalized) of the asset and its undepreciated balance (except see subdivisions (c)(2)(i) or (ii) of this section).

(c) Special considerations apply to an involuntary conversion which occurs when a contractor's property is destroyed by events over which the owner has no control, such as fire, windstorm, flood, accident, theft, etc., and an insurance award is recovered. The following govern involuntary conversions:

(1) When there is a cash award and the converted asset is not replaced, gain or loss shall be recognized in the period of disposition. The gain recognized for contract costing purposes shall be limited to the difference between the acquisition cost of the asset and its undepreciated balance.

(2) When the converted asset is replaced, the contractor shall either—

(i) Adjust the depreciable basis of the new asset by the amount of the total realized gain or loss; or

(ii) Recognize the gain or loss in the period of disposition, in which case the Government shall participate to the same extent as outlined in subparagraph (c)(1) above.

(d) Gains and losses on the disposition of depreciable property shall not be recognized as a separate charge or credit when—

(1) Gains and losses are processed through the depreciation reserve account and reflected in the depreciation allowable under 31.205-11; or

(2) The property is exchanged as part of the purchase price of a similar item, and the gain or loss is taken into consideration in the depreciation cost basis of the new item.

(e) Gains and losses arising from mass or extraordinary sales, retirements, or other disposition other than through business combinations shall be considered on a case-by-case basis.

(f) Gains and losses of any nature arising from the sale or exchange of capital assets other than depreciable property shall be excluded in computing contract costs.

[(g) With respect to long-lived tangible and identifiable intangible assets held for use, no loss shall be recognized for a write-down from carrying value to fair value as a result of impairments caused by events or changes in circumstances (e.g., environmental damage, idle facilities arising from a declining business base, etc.). Depreciation or amortization on pre-write-down carrying value of impaired assets not yet disposed of shall continue to be recoverable under established depreciation or amortization schedules to the extent it is not otherwise unallowable under other provisions of the FAR.]

ACQUISITION AND
TECHNOLOGY

DP(DAR)

OFFICE OF THE UNDER SECRETARY OF DEFENSE

3000 DEFENSE PENTAGON
WASHINGTON DC 20301-3000

October 2, 1995

In reply refer to
FAR Case: 95-003MEMORANDUM FOR MR. C. ALLEN OLSON, CHAIRMAN
CIVILIAN AGENCY ACQUISITION COUNCIL

SUBJECT: Impairment of Long-lived Assets

We sent you a memorandum on August 22, 1995, agreeing to the changes to the proposed FAR rule forwarded by your letter of July 25, 1995. The rule revises FAR 31.205-11 and 31.205-16 to clarify the allowability of losses recognized when carrying values of impaired assets are written down for financial reporting purposes.

We have determined, after conversations with Jerry Olsen of your office, that compelling reasons exist to issue these FAR revisions as an interim rule. The rationale for this determination is set forth in the attached draft Determination to Issue an Interim Rule.

If you agree, please forward the rule to the FAR Secretariat for inclusion in the next FAC. Our case manager is Ms. Sandra Haberlin, (703)602-0131.

D. S. Parry
Captain, SC, USN
Director, Defense Acquisition
Regulations Council

Attachment



Draft Determination to Issue an Interim Rule
for
FAR Case 95-003, Impairment of Long-Lived Assets

A determination has been made under the authority of the Secretary of Defense (DOD), the Administrator of General Services (GSA), and the Administrator of the National Aeronautics and Space Administration (NASA) that compelling reasons exist to promulgate this interim rule without prior opportunity for public comment. This action is necessary because Statement of Financial Accounting Standards No. 121, Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of, dated March 1995, requires all publicly owned firms to recognize impairment losses in their financial statements for fiscal years beginning after December 15, 1995. It is likely that Government contractors whose 1996 fiscal year begins on or shortly after January 1, 1996, will recognize impairment losses for financial reporting and claim a portion of such losses either on current contracts or on those awarded after December 31, 1995. In order to ensure that contractors' impairment losses are not paid by the Federal Government, it is necessary to issue this clarification of existing cost principles expeditiously. However, pursuant to Public Law 98-577 and FAR 1.501, public comments received in response to this interim rule will be considered in the formation of the final rule.

INFO



ACQUISITION AND
TECHNOLOGY

DP (DAR)

OFFICE OF THE UNDER SECRETARY OF DEFENSE

3000 DEFENSE PENTAGON
WASHINGTON DC 20301-3000

October 2, 1995



In reply refer to
FAR Case: 95-003

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SUBJECT: Impairment of Long-lived Assets

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D. S. Parry
Captain, SC, USN
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Attachment



OCT 04 1995

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FAR Case 95-003, Impairment of Long-Lived Assets

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STATUS OF CASES LISTED IN PARAGRAPH (1) OF COUNCIL OF DEFENSE AND SPACE INDUSTRY ASSOCIATIONS' LETTER OF SEPTEMBER 29, 1995

FAR Cases:

- 91-056** **Environmental Cost Principles** - Tasked Contract Cost Principles Committee on Feb 8, 1995, to review recommendations resulting from DCAA/DCMC Pilot Environmental Cost Program, and revise draft proposed FAR rule as appropriate. Committee is nearing completion of the tasking.
- 93-022** **Travel Costs** - Proposed FAR rule published on Sept 16, 1994 (TAB A). Final FAR rule sent to FAR Secretariat for publication on May 22, 1995. Awaiting FAC.
- 93-026** **Business Meals** - Proposed FAR rule published August 21, 1995 (TAB B). Public comments due October 20, 1995
- 95-003** **Impairment of Long Lived Assest** - Sent draft interim FAR rule to CAAC on October 2, 1995.
- 95-021** **Allowability of Foreign Selling Costs** - DAR Council agreed to draft proposed FAR rule on August 30, 1995. Preparing package to send to CAAC (Paperwork Reduction Act impact).

DFARS Cases:

- 94-D007** **Internal Restructuring Costs** - Proposed rule published on Jan 12, 1995, is being withdrawn as a result of review and analysis of public comments. Proposed rule is at TAB C.
- 94-D316** **Restructuring Costs Under Defense Contracts** - Interim rule published via Departmental Letter 94-020 on December 29, 1994 (TAB D), and in the Federal Register on January 5, 1995. Analysis of public comments nearing completion.

TELEFAX

September 8, 1995

TO: RICK LAYSER

FROM: JERRY OLSON

SUBJECT: FAR Case 95-003, Impairment of Long-Lived Assets

Per conversations between Rick Layser, Don Sawyer and Jerry Olson, it appears there may be an editorial error in the proposed rule approved by the councils. Attached is a correction that would take care of the problem. If you agree, I will substitute the corrected rule (as attached) for the approved version of the rule when I send it to the FAR Secretariat for publication. Because this is an editorial matter which does not impact the intended effect of the rule, I do not believe it needs to be reviewed by the councils

**EDITORIAL CHANGES TO THE
PROPOSED RULE APPROVED BY DARC & CAAC
FAR CASE 95-003, IMPAIRMENT OF LONG-LIVED ASSETS**

Changes in bold inside brackets [like this] are changes approved by the DARC and CAAC. Text shown in bold italics inside brackets [like this] are additional necessary editorial changes. Because these are editorial and do not change the intended and approved impact of the rule, the rule need not be resubmitted to the councils.

31.205-11 Depreciation.

(a) Depreciation is a charge to current operations which distributes the cost of a tangible capital asset, less estimated residual value, over the estimated useful life of the asset in a systematic and logical manner. It does not involve a process of valuation. Useful life refers to the prospective period of economic usefulness in a particular contractor's operations as distinguished from physical life; it is evidenced by the actual or estimated retirement and replacement practice of the contractor.

(b) Contractors having contracts subject to 48 CFR 9904.409, Depreciation of Tangible Capital Assets, must adhere to the requirement of that standard for all fully CAS-covered contracts and may elect to adopt the standard for all other contracts. All requirements of 48 CFR 9904.409 are applicable if the election is made, and its requirements supersede any conflicting requirements of this cost principle. Once electing to adopt 48 CFR 9904.409 for all contracts, contractors must continue to follow it until notification of final acceptance of all deliverable items on all open negotiated Government contracts. Paragraphs (c) through (e) below apply to contracts to which 48 CFR 9904.409 is not applied.

(c) Normal depreciation on a contractor's plant, equipment, and other capital facilities is an allowable contract cost, if the contractor is able to demonstrate that it is reasonable and allocable (but see paragraph (i) below).

(d) Depreciation shall be considered reasonable if the contractor follows policies and procedures that are—

(1) Consistent with those followed in the same cost center for business other than Government;

(2) Reflected in the contractor's books of accounts and financial statements; and

(3) Both used and acceptable for Federal income tax purposes.

(e) When the depreciation reflected on a contractor's books of accounts and financial statements differs from that used and acceptable for Federal income tax purposes, reimbursement shall be based on the asset cost amortized over the estimated useful life of the property using depreciation methods (straight line, sum of the years' digits, etc.) acceptable for income tax purposes. Allowable depreciation shall not exceed the amounts used for book and statement purposes and shall be determined in a manner consistent with the depreciation policies and procedures followed in the same cost center on non-Government business [(but see paragraph (o).) ¹ ~~except that, in the event of a write-down from carrying value to fair value as a result of impairments caused by events or changes in circumstances, depreciation of the impaired assets shall not exceed the amounts established on depreciation schedules in use prior to the write-down (see 31.205-16(g)).~~]

(f) Depreciation for reimbursement purposes in the case of tax-exempt organizations shall be determined on the basis described in paragraph (e) immediately above.

(g) Special considerations are required for assets acquired before the effective date of this cost principle if, on that date, the undepreciated balance of these assets resulting from depreciation

¹ Make editorial change to rule approved by DARC and CAAC by moving the approved language to a new paragraph (o) and inserting a cross reference. The editorial change is necessary because the cost allowability rule was to have applied to both CAS and non CAS contracts. However, paragraph (b) states that the paragraph with the new allowability criteria were inserted applies ~~only~~ to non-CAS. Creating a new paragraph (o) will correct this editorial error.

policies and procedures used previously for Government contracts and subcontracts is different from the undepreciated balance on the books and financial statements. The undepreciated balance for contract cost purposes shall be depreciated over the remaining life using the methods and lives followed for book purposes. The aggregate depreciation of any asset allowable after the effective date of this 31.205-11 shall not exceed the cost basis of the asset less any depreciation allowed or allowable under prior acquisition regulations.

(h) Depreciation should usually be allocated to the contract and other work as an indirect cost. The amount of depreciation allowed in any accounting period may, consistent with the basic objectives in paragraph (a) above, vary with volume of production or use of multishift operations.

(i) In the case of emergency facilities covered by certificates of necessity, a contractor may elect to use normal depreciation without requesting a determination of "true depreciation," or may elect to use either normal or "true depreciation" after a determination of "true depreciation" has been made by an Emergency Facilities Depreciation Board (EFDB). The method elected must be followed consistently throughout the life of the emergency facility. When an election is made to use normal depreciation, the criteria in paragraphs (c), (d), (e), and (f) above shall apply for both the emergency period and the post-emergency period. When an election is made to use "true depreciation", the amount allowable as depreciation—

(1) With respect to the emergency period (five years), shall be computed in accordance with the determination of the EFDB and allocated rateably over the full five year emergency period; *provided* no other allowance is made which would duplicate the factors, such as extraordinary obsolescence, covered by the Board's determination; and

(2) After the end of the emergency period, shall be computed by distributing the remaining undepreciated portion of the cost of the emergency facility over the balance of its useful life provided the remaining undepreciated portion of such cost shall not include any amount of unrecovered "true depreciation."

(j) No depreciation, rental, or use charge shall be allowed on property acquired at no cost from the Government by the contractor or by any division, subsidiary, or affiliate of the contractor under common control.

(k) The depreciation on any item which meets the criteria for allowance at a "price" under 31.205-26(e) may be based on that price, provided the same policies and procedures are used for costing all business of the using division, subsidiary, or organization under common control.

(l) No depreciation or rental shall be allowed on property fully depreciated by the contractor or by any division, subsidiary, or affiliate of the contractor under common control. However, a reasonable charge for using fully depreciated property may be agreed upon and allowed (but see 31.109(h)(2)). In determining the charge, consideration shall be given to cost, total estimated useful life at the time of negotiations, effect of any increased maintenance charges or decreased efficiency due to age, and the amount of depreciation previously charged to Government contracts or subcontracts.

(m) 48 CFR 9904.404, Capitalization of Tangible Assets, applies to assets acquired by a "capital lease" as defined in Statement of Financial Accounting Standard No. 13 (FAS-13), Accounting for Leases, issued by the Financial Accounting Standards Board (FASB). Compliance with 48 CFR 9904.404 and FAS-13 requires that such leased assets (capital leases) be treated as purchased assets; i.e., be capitalized and the capitalized value of such assets be distributed over their useful lives as depreciation charges, or over the leased life as amortization charges as appropriate. Assets whose leases are classified as capital leases under FAS-13 are subject to the requirements of 31.205-11 while assets acquired under leases classified as operating leases are subject to the requirements on rental costs in 31.205-36. The standards of financial accounting and reporting prescribed by FAS-13 are incorporated into this principle and shall govern its application, except as provided in subparagraphs (1), (2), and (3) below.

(1) Rental costs under a sale and leaseback arrangement shall be allowable up to the amount that would have been allowed had the contractor retained title to the property.

(2) Capital leases, as defined in FAS-13, for all real and personal property, between any related parties are subject to the requirements of this subparagraph 31.205-11(m). If it is determined that the terms of the lease have been significantly affected by the fact that the lessee and

lessor are related, depreciation charges shall not be allowed in excess of those which would have occurred if the lease contained terms consistent with those found in a lease between unrelated parties.

(3) Assets acquired under leases that the contractor must capitalize under FAS-13 shall not be treated as purchased assets for contract purposes if the leases are covered by 31.205-36(b)(4).

(n) Whether or not the contract is otherwise subject to CAS, the requirements of 31.205-52, which limit the allowability of depreciation, shall be observed.

[(o) In the event of a write-down from carrying value to fair value as a result of impairments caused by events or changes in circumstances, depreciation of the impaired assets shall not exceed the amounts established on depreciation schedules in use prior to the write-down (see 31.205-16(g)).]

* * * * *

31.205-16 Gains and losses on disposition [or impairment] of depreciable property or other capital assets.

(a) Gains and losses from the sale, retirement, or other disposition (but see 31.205-19) of depreciable property shall be included in the year in which they occur as credits or charges to the cost grouping(s) in which the depreciation or amortization applicable to those assets was included (but see paragraph (d) of this subsection). However, no gain or loss shall be recognized as a result of the transfer of assets in a business combination (see 31.205-52).

(b) Gains and losses on disposition of tangible capital assets, including those acquired under capital leases (see 31.205-11(m)), shall be considered as adjustments of depreciation costs previously recognized. The gain or loss for each asset disposed of is the difference between the net amount realized, including insurance proceeds from involuntary conversions, and its undepreciated balance. The gain recognized for contract costing purposes shall be limited to the difference between the acquisition cost (or for assets acquired under a capital lease, the value at which the leased asset is capitalized) of the asset and its undepreciated balance (except see subdivisions (c)(2)(i) or (ii) of this section).

(c) Special considerations apply to an involuntary conversion which occurs when a contractor's property is destroyed by events over which the owner has no control, such as fire, windstorm, flood, accident, theft, etc., and an insurance award is recovered. The following govern involuntary conversions:

(1) When there is a cash award and the converted asset is not replaced, gain or loss shall be recognized in the period of disposition. The gain recognized for contract costing purposes shall be limited to the difference between the acquisition cost of the asset and its undepreciated balance.

(2) When the converted asset is replaced, the contractor shall either—

(i) Adjust the depreciable basis of the new asset by the amount of the total realized gain or loss; or

(ii) Recognize the gain or loss in the period of disposition, in which case the Government shall participate to the same extent as outlined in subparagraph (c)(1) above.

(d) Gains and losses on the disposition of depreciable property shall not be recognized as a separate charge or credit when—

(1) Gains and losses are processed through the depreciation reserve account and reflected in the depreciation allowable under 31.205-11; or

(2) The property is exchanged as part of the purchase price of a similar item, and the gain or loss is taken into consideration in the depreciation cost basis of the new item.

(e) Gains and losses arising from mass or extraordinary sales, retirements, or other disposition other than through business combinations shall be considered on a case-by-case basis.

(f) Gains and losses of any nature arising from the sale or exchange of capital assets other than depreciable property shall be excluded in computing contract costs.

[(g) With respect to long-lived tangible and identifiable intangible assets held for use, no loss shall be recognized for a write-down from carrying value to fair value as a result of impairments caused by events or changes in circumstances]

(e.g., environmental damage, idle facilities arising from a declining business base, etc.). Depreciation or amortization on pre-write-down carrying value of impaired assets not yet disposed of shall continue to be recoverable under established depreciation or amortization schedules to the extent it is not otherwise unallowable under other provisions of the FAR.]



ACQUISITION AND
TECHNOLOGY
DP (DAR)

OFFICE OF THE UNDER SECRETARY OF DEFENSE

3000 DEFENSE PENTAGON
WASHINGTON DC 20301-3000

August 22, 1995



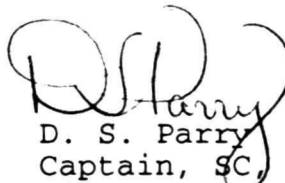
In reply refer to
FAR Case: 95-003

MEMORANDUM FOR MR. C. ALLEN OLSON, CHAIRMAN
CIVILIAN AGENCY ACQUISITION COUNCIL

SUBJECT: Impairment of Long-lived Assets

We have agreed to the changes to the proposed FAR rule forwarded by your letter of July 25, 1995. The rule revises FAR 31.205-11 and 31.205-16 to clarify the allowability of losses recognized when carrying values of impaired assets are written down for financial reporting purposes.

Please forward the revised proposed rule to the FAR Secretariat for publication. We have attached a revised draft Federal Register notice. The Regulatory Flexibility Act applies but the proposed rule is not expected to have a significant impact on a substantial number of small entities because most contracts awarded to small entities are awarded on a competitive fixed-price basis, and the cost principles do not apply. The Paperwork Reduction Act does not apply because the proposed rule does not impose any reporting or record keeping requirements. Our case manager is Mr. Rick Layser, (703)602-0131.


D. S. Parry

Captain, SC, USN
Director, Defense Acquisition
Regulations Council

Attachment

Telecon. Rick Layser/Terry Olson
Terry wanted to confirm that DAR Council
agreed that proposed language should be located
at a new paragraph (c) at the end of 31.205-11.
I told him that that is what the Council agreed to.
10/25 Again confirmed w/ J. Olson that the change
should be made.



PROPOSED FEDERAL REGISTER NOTICE

**DEPARTMENT OF DEFENSE
GENERAL SERVICES ADMINISTRATION
NATIONAL AERONAUTICS AND SPACE ADMINISTRATION**

**48 CFR Part 31
[FAR Case 95-003]**

**Federal Acquisition Regulation;
Impairment of Long-Lived Assets**

AGENCIES: Department of Defense (DoD); General Services Administration (GSA); and National Aeronautics and Space Administration (NASA).

ACTION: Proposed rule with request for comments.

SUMMARY: The Civilian Agency Acquisition Council and the Defense Acquisition Regulations Council are considering revisions to clarify the allowability of losses recognized when carrying values of impaired assets are written down for financial reporting purposes.

COMMENTS: Comments should be submitted to the FAR Secretariat at the address shown below on or before (60 days from publication), to be considered in the formulation of a final rule.

ADDRESS: Interested parties should submit written comments to: General Services Administration, FAR Secretariat (VRS), 18th & F Streets, NW, Room 4041, Washington, D.C. 20405. Please cite FAR Case 95-003 in all correspondence related to these issues.

FOR FURTHER INFORMATION CONTACT: Ms. Beverly Fayson, FAR Secretariat, telephone (202) 501-4786. Please cite FAR Case 95-003.

SUPPLEMENTARY INFORMATION:

A. Background

The proposed rule is intended to clarify cost allowability rules concerning the recognition of gains and losses related to long-lived assets. The proposed rule addresses a cost category which is the subject of a Financial Accounting Standards Board proposed Statement of Financial Accounting Standards (SFAS), No.

132-B, dated November 29, 1993, entitled "Accounting for the Impairment of Long-Lived Assets."

The SFAS applies to long-lived assets (such as land, buildings, and equipment), identifiable intangibles, and related goodwill, and established guidance to recognize and measure impairment losses. If impaired assets are to be held for use, the SFAS requires a write-down to fair value when events or circumstances (e.g., environmental damage, idle facilities arising from declining business, etc.) indicate that carrying values may not be fully recoverable.

Impaired assets that are to be disposed of, however, would be reported (with certain exceptions) at the lower of cost or fair value less cost to sell. Once written down, the previous carrying amount of an impaired asset could not be restored if the impairment was subsequently removed.

In contrast to the SFAS provisions, Cost Accounting Standard (CAS) 9904.409, "Depreciation of Tangible Capital Assets," provides quite different criteria and guidance to recognize gains and losses for Government contract purposes. The language at 9904.409-40(a)(4) and (b)(4), 9904.409-50(j), and related Promulgation Comment 10, "Gain or Loss," makes it clear that gains and losses are recognized only upon asset disposal; no other circumstances trigger such recognition.

FAR 31.205-16 reflects the CAS provisions that an asset be disposed of in order to recognize a gain or loss. The FAR rule applies to both CAS and non-CAS covered contracts. Consequently, for Government contract purposes, an impairment loss is recognized only upon disposal of the impaired asset. Like other losses, it is measured as the difference between the net amount realized and the impaired asset's undepreciated balance. Government contractors, therefore, recover the carrying values of impaired assets held for use by retaining pre-write-down depreciation or amortization schedules as though no impairment had occurred. This proposed rule address the treatment of losses for impaired assets by revising 31.205-11(e), and revising the title and adding a new paragraph (g) at 31.205-16.

B. Regulatory Flexibility Act

This proposed rule is not expected to have a significant economic impact on a substantial number of small entities within the meaning of the Regulatory Flexibility Act, 5 U.S.C. 601, et seq., because most contracts awarded to small entities are awarded on a competitive fixed-price basis and the cost principles do not apply. An Initial Regulatory Flexibility Analysis has, therefore, not been performed. Comments from small entities concerning the affected FAR subpart will be considered in accordance with 5 U.S.C. 610. Such comments must be submitted separately and should cite 5 U.S.C. 601, et seq., (FAR Case 95-003), in correspondence.

C. Paperwork Reduction Act

The Paperwork Reduction Act does not apply because the proposed change to the FAR does not impose record keeping or information collection requirements, or collections of information from offerors, contractors, or members of the public which require the approval of the Office of Management and Budget under 44 U.S.C. 3501, et seq.



General Services Administration
Office of Acquisition Policy
Washington, DC 20405

JUL 25 1995

D.S. Parry
CAPT, SC, USN
Director, Defense Acquisition
Regulations Council
ATTN: IMD 3D139
OUSD(A&T)
3062 Defense, Pentagon
Washington, DC 20301-3062

Re: FAR Case 95-003, Impairment of long-lived Assets

Dear CAPT Parry:

The DARC approved a proposed rule to add allowable cost criteria to the cost principle at FAR 31.205-16 concerning the recognition of gains and losses related to long-lived assets. The CAAC concurs with the proposed rule approved by the DARC except that the CAAC also believes additional changes are necessary in the cost principle covering depreciation expense, 31.205-11. The further changes approved by the CAAC are shown in the attached amended proposed rule.

This further change in the proposed rule is necessary because, if a contractor writes down the value of an asset per the new SFAS, the depreciation expense charged for that asset will necessarily be reduced to reflect the lower value of the asset. That reduced depreciation schedule will be reflected on the contractor's books and records. However, FAR 31.205-11(e) states that depreciation expenses charged to a contract cannot exceed the depreciation expense on the contractor's books and records. This means that, if the change to 31.205-16 recommended by the DARC is made and if FAR 31.205-11(e) is left unchanged, contractors would be unable to recoup the write down amount under Government contracts. Accordingly, the depreciation cost criteria must be changed to permit a contractor to use the old depreciation schedule if the value of an asset is written down per the new SFAS in order to let contractors continue to make full recovery.

If the DARC agrees with these further changes, we will publish the rule in the Federal Register for public comment.

Sincerely,

C. ALLEN OLSON
Chairman
Civilian Agency
Acquisition Council



**PROPOSED RULE APPROVED BY CAAC
FAR CASE 95-003, IMPAIRMENT OF LONG-LIVED ASSETS**

Changes in bold inside brackets [**like this**] are changes recommended by the DARC and concurred in by the CAAC. Text shown in bold italics inside brackets [***like this***] are the additional changes approved by the CAAC.

31.205-11 Depreciation.

(a) Depreciation is a charge to current operations which distributes the cost of a tangible capital asset, less estimated residual value, over the estimated useful life of the asset in a systematic and logical manner. It does not involve a process of valuation. Useful life refers to the prospective period of economic usefulness in a particular contractor's operations as distinguished from physical life; it is evidenced by the actual or estimated retirement and replacement practice of the contractor.

(b) Contractors having contracts subject to 48 CFR 9904.409, Depreciation of Tangible Capital Assets, must adhere to the requirement of that standard for all fully CAS-covered contracts and may elect to adopt the standard for all other contracts. All requirements of 48 CFR 9904.409 are applicable if the election is made, and its requirements supersede any conflicting requirements of this cost principle. Once electing to adopt 48 CFR 9904.409 for all contracts, contractors must continue to follow it until notification of final acceptance of all deliverable items on all open negotiated Government contracts. Paragraphs (c) through (e) below apply to contracts to which 48 CFR 9904.409 is not applied.

(c) Normal depreciation on a contractor's plant, equipment, and other capital facilities is an allowable contract cost, if the contractor is able to demonstrate that it is reasonable and allocable (but see paragraph (i) below).

(d) Depreciation shall be considered reasonable if the contractor follows policies and procedures that are—

(1) Consistent with those followed in the same cost center for business other than Government;

(2) Reflected in the contractor's books of accounts and financial statements; and

(3) Both used and acceptable for Federal income tax purposes.

(e) When the depreciation reflected on a contractor's books of accounts and financial statements differs from that used and acceptable for Federal income tax purposes, reimbursement shall be based on the asset cost amortized over the estimated useful life of the property using depreciation methods (straight line, sum of the years' digits, etc.) acceptable for income tax purposes. Allowable depreciation shall not exceed the amounts used for book and statement purposes and shall be determined in a manner consistent with the depreciation policies and procedures followed in the same cost center on non-Government business[, ***except that, in the event of a write-down from carrying value to fair value as a result of impairments caused by events or changes in circumstances, depreciation of the impaired assets shall not exceed the amounts established on depreciation schedules in use prior to the write-down (see 31.205-16(g)).***]

(f) Depreciation for reimbursement purposes in the case of tax-exempt organizations shall be determined on the basis described in paragraph (e) immediately above.

(g) Special considerations are required for assets acquired before the effective date of this cost principle if, on that date, the undepreciated balance of these assets resulting from depreciation policies and procedures used previously for Government contracts and subcontracts is different from the undepreciated balance on the books and financial statements. The undepreciated balance for contract cost purposes shall be depreciated over the remaining life using the methods and lives followed for book purposes. The aggregate depreciation of any asset allowable after the effective date of this 31.205-11 shall not exceed the cost basis of the asset less any depreciation allowed or allowable under prior acquisition regulations.

(h) Depreciation should usually be allocated to the contract and other work as an indirect cost. The amount of depreciation allowed in any accounting period may, consistent with the basic objectives in paragraph (a) above, vary with volume of production or use of multishift operations.

(i) In the case of emergency facilities covered by certificates of necessity, a contractor may elect to use normal depreciation without requesting a determination of "true depreciation," or may elect to use either normal or "true depreciation" after a determination of "true depreciation" has been made by an Emergency Facilities Depreciation Board (EFDB). The method elected must be followed consistently throughout the life of the emergency facility. When an election is made to use normal depreciation, the criteria in paragraphs (c), (d), (e), and (f) above shall apply for both the emergency period and the post-emergency period. When an election is made to use "true depreciation", the amount allowable as depreciation—

(1) With respect to the emergency period (five years), shall be computed in accordance with the determination of the EFDB and allocated rateably over the full five year emergency period; *provided* no other allowance is made which would duplicate the factors, such as extraordinary obsolescence, covered by the Board's determination; and

(2) After the end of the emergency period, shall be computed by distributing the remaining undepreciated portion of the cost of the emergency facility over the balance of its useful life provided the remaining undepreciated portion of such cost shall not include any amount of unrecovered "true depreciation."

(j) No depreciation, rental, or use charge shall be allowed on property acquired at no cost from the Government by the contractor or by any division, subsidiary, or affiliate of the contractor under common control.

(k) The depreciation on any item which meets the criteria for allowance at a "price" under 31.205-26(e) may be based on that price, provided the same policies and procedures are used for costing all business of the using division, subsidiary, or organization under common control.

(l) No depreciation or rental shall be allowed on property fully depreciated by the contractor or by any division, subsidiary, or affiliate of the contractor under common control. However, a reasonable charge for using fully depreciated property may be agreed upon and allowed (but see 31.109(h)(2)). In determining the charge, consideration shall be given to cost, total estimated useful life at the time of negotiations, effect of any increased maintenance charges or decreased efficiency due to age, and the amount of depreciation previously charged to Government contracts or subcontracts.

(m) 48 CFR 9904.404, Capitalization of Tangible Assets, applies to assets acquired by a "capital lease" as defined in Statement of Financial Accounting Standard No. 13 (FAS-13), Accounting for Leases, issued by the Financial Accounting Standards Board (FASB). Compliance with 48 CFR 9904.404 and FAS-13 requires that such leased assets (capital leases) be treated as purchased assets; i.e., be capitalized and the capitalized value of such assets be distributed over their useful lives as depreciation charges, or over the leased life as amortization charges as appropriate. Assets whose leases are classified as capital leases under FAS-13 are subject to the requirements of 31.205-11 while assets acquired under leases classified as operating leases are subject to the requirements on rental costs in 31.205-36. The standards of financial accounting and reporting prescribed by FAS-13 are incorporated into this principle and shall govern its application, except as provided in subparagraphs (1), (2), and (3) below.

(1) Rental costs under a sale and leaseback arrangement shall be allowable up to the amount that would have been allowed had the contractor retained title to the property.

(2) Capital leases, as defined in FAS-13, for all real and personal property, between any related parties are subject to the requirements of this subparagraph 31.205-11(m). If it is determined that the terms of the lease have been significantly affected by the fact that the lessee and lessor are related, depreciation charges shall not be allowed in excess of those which would have occurred if the lease contained terms consistent with those found in a lease between unrelated parties.

(3) Assets acquired under leases that the contractor must capitalize under FAS-13 shall not be treated as purchased assets for contract purposes if the leases are covered by 31.205-36(b)(4).

(n) Whether or not the contract is otherwise subject to CAS, the requirements of 31.205-52, which limit the allowability of depreciation, shall be observed.

* * * * *

31.205-16 Gains and losses on disposition [or impairment] of depreciable property or other capital assets.

(a) Gains and losses from the sale, retirement, or other disposition (but see 31.205-19) of depreciable property shall be included in the year in which they occur as credits or charges to the cost grouping(s) in which the depreciation or amortization applicable to those assets was included (but see paragraph (d) of this subsection). However, no gain or loss shall be recognized as a result of the transfer of assets in a business combination (see 31.205-52).

(b) Gains and losses on disposition of tangible capital assets, including those acquired under capital leases (see 31.205-11(m)), shall be considered as adjustments of depreciation costs previously recognized. The gain or loss for each asset disposed of is the difference between the net amount realized, including insurance proceeds from involuntary conversions, and its undepreciated balance. The gain recognized for contract costing purposes shall be limited to the difference between the acquisition cost (or for assets acquired under a capital lease, the value at which the leased asset is capitalized) of the asset and its undepreciated balance (except see subdivisions (c)(2)(i) or (ii) of this section).

(c) Special considerations apply to an involuntary conversion which occurs when a contractor's property is destroyed by events over which the owner has no control, such as fire, windstorm, flood, accident, theft, etc., and an insurance award is recovered. The following govern involuntary conversions:

(1) When there is a cash award and the converted asset is not replaced, gain or loss shall be recognized in the period of disposition. The gain recognized for contract costing purposes shall be limited to the difference between the acquisition cost of the asset and its undepreciated balance.

(2) When the converted asset is replaced, the contractor shall either—

(i) Adjust the depreciable basis of the new asset by the amount of the total realized gain or loss; or

(ii) Recognize the gain or loss in the period of disposition, in which case the Government shall participate to the same extent as outlined in subparagraph (c)(1) above.

(d) Gains and losses on the disposition of depreciable property shall not be recognized as a separate charge or credit when—

(1) Gains and losses are processed through the depreciation reserve account and reflected in the depreciation allowable under 31.205-11; or

(2) The property is exchanged as part of the purchase price of a similar item, and the gain or loss is taken into consideration in the depreciation cost basis of the new item.

(e) Gains and losses arising from mass or extraordinary sales, retirements, or other disposition other than through business combinations shall be considered on a case-by-case basis.

(f) Gains and losses of any nature arising from the sale or exchange of capital assets other than depreciable property shall be excluded in computing contract costs.

[(g) With respect to long-lived tangible and identifiable intangible assets held for use, no loss shall be recognized for a write-down from carrying value to fair value as a result of impairments caused by events or changes in circumstances (e.g., environmental damage, idle facilities arising from a declining business base, etc.). Depreciation or amortization on pre-write-down carrying value of impaired assets not yet disposed of shall continue to be recoverable under established depreciation or amortization schedules to the extent it is not otherwise unallowable under other provisions of the FAR.]



JUN 19 1995

General Services Administration
Office of Acquisition Policy
Washington, DC 20405

DARC

MEMORANDUM FOR CAAC MEMBERS

FROM:

C. Allen Olson
C. ALLEN OLSON

CHAIRMAN

CIVILIAN AGENCY ACQUISITION COUNCIL

SUBJECT: FAR Case 95-003, Impairment of Long-lived Assets

The DARC approved a proposed rule to add allowable cost criteria to the cost principle at FAR 31.205-16 concerning the recognition of gains and losses related to long-lived assets. We recommend that the CAAC approve issuance of the proposed rule, as amended in the attached FAR Staff recommendation.

The FAR change is necessary because the Financial Accounting Standards Board issued Statement of Financial Accounting Standards (SFAS) Number 121, Accounting for the Impairment of long-lived Assets and for Long-lived Assets to be Disposed Of. That SFAS permits a contractor to write down the value of an asset that becomes impaired, such as through environmental damage, and charge the write down to the current year as a cost. While such an accounting treatment may be appropriate for financial accounting because it provides information necessary for sound investment decisions, it is not appropriate to use that accounting as the cost of performing a contract for cost reimbursement purposes. The change proposed by the DARC would make the write down cost unallowable under government contracts.

We concur with the DARC's recommendation, except that we also believe additional changes are necessary in the cost principle covering depreciation expense, 31.205-11. This further change is necessary because, if a contractor writes down the value of an asset per the new SFAS, the depreciation expense charged for that asset will necessarily be reduced to reflect the lower value of the asset. That reduced depreciation schedule will be reflected on the contractor's books and records. However, FAR 31.205-11(e) states that depreciation expenses changed to a contract cannot exceed the depreciation expense on the contractors books and records. This means that, if the change to 31.205-16 recommended by the DARC is made and if FAR 31.205-11(e) is left unchanged, contractors would be unable to recoup the write down amount under Government contracts. Accordingly, the depreciation cost criteria must be changed to permit a contractor to use the old depreciation schedule if the value of an asset is written down per the new SFAS in order to let contractors continue to make full recovery.

Questions may be directed to Mr. Jeremy F. Olson at 202-501-3221.

Enclosures





OFFICE OF THE UNDER SECRETARY OF DEFENSE

3000 DEFENSE PENTAGON
WASHINGTON DC 20301-3000

March 8, 1995



ACQUISITION AND
TECHNOLOGY
DP (DAR)

In reply refer to
FAR Case: 95-003

MEMORANDUM FOR MR. C. ALLEN OLSON, CHAIRMAN
CIVILIAN AGENCY ACQUISITION COUNCIL

SUBJECT: Impairment of Long-Lived Assets

We have agreed to a proposed FAR rule revising 31.205-16 to add paragraph (g) to clarify cost allowability rules concerning the recognition of gains and losses related to long-lived assets. The proposed rule addresses a cost category which is the subject of a Financial Accounting Standards Board proposed Statement of Financial Accounting Standards (SFAS), No. 132-B, dated November 29, 1993, entitled "Accounting for the Impairment of Long-Lived Assets."

If you agree with our proposed rule, please forward it to the FAR Secretariat. We will seek DoD approvals to publish as soon as you advise that we have agreement on a rule. We have attached the proposed revisions to the FAR and a draft Federal Register notice. The Regulatory Flexibility Act applies but the proposed rule is not expected to have a significant impact on a substantial number of small entities because most contracts awarded to small entities are awarded on a competitive fixed-price basis, and the cost principles do not apply. The Paperwork Reduction Act does not apply because the proposed rule does not impose any reporting or record keeping requirements. Our case manager is Ms. Linda Holcombe, (703) 602-0131.

Nancy Ladd
Nancy L. Ladd
Director, Defense Acquisition
Regulations Council

Attachments



MAR 14 1995

FAR Case 95-003, Impairment of Long-Lived Assets

Baseline: FAR posted through FAC 94-20

Proposed change shown in **bold** and [brackets].

PART 31--CONTRACT COST PRINCIPLES AND PROCEDURES

* * *

31.205-16 Gains and losses on disposition [or impairment] of depreciable property or other capital assets.

(a) - (f) --No change--

[(g) With respect to long-lived tangible and identifiable intangible assets held for use, no loss shall be recognized for a write-down from carrying value to fair value as a result of impairments caused by events or changes in circumstances (e.g., environmental damage, idle facilities arising from a declining business base, etc.). Depreciation or amortization on pre-write-down carrying values of impaired assets not yet disposed of shall continue to be recoverable under established depreciation or amortization schedules to the extent it is not otherwise unallowable under other provisions of the FAR.]

(Hand written changes recommended
by the FAR staff)

PROPOSED FEDERAL REGISTER NOTICE

**DEPARTMENT OF DEFENSE
GENERAL SERVICES ADMINISTRATION
NATIONAL AERONAUTICS AND SPACE ADMINISTRATION**

**48 CFR Part 31
[FAR Case 95-003]**

**Federal Acquisition Regulation;
Impairment of Long-Lived Assets**

AGENCIES: Department of Defense (DoD); General Services Administration (GSA); and National Aeronautics and Space Administration (NASA).

ACTION: Proposed rule with request for comments.

SUMMARY: The Civilian Agency Acquisition Council and the Defense Acquisition Regulations Council are considering revisions to clarify FAR 31.205-16 concerning the allowability of losses recognized when carrying values of impaired assets are written down for financial reporting purposes.

COMMENTS: Comments should be submitted to the FAR Secretariat at the address shown below on or before (60 days from publication), to be considered in the formulation of a final rule.

ADDRESS: Interested parties should submit written comments to: General Services Administration, FAR Secretariat (VRS), 18th & F Streets, N.W., Room 4041, Washington, DC 20405. Please cite FAR Case 95-003 in all correspondence related to these issues.

FOR FURTHER INFORMATION CONTACT: Ms. Beverly Fayson, FAR Secretariat, telephone (202) 501-4786. Please cite FAR Case 95-003.

SUPPLEMENTARY INFORMATION:

A. Background

The proposed rule is intended to clarify cost allowability rules concerning the recognition of gains and losses related to long-lived assets. The proposed rule addresses a cost category which is the subject of a Financial Accounting Standards Board ~~proposed~~ Statement of Financial Accounting Standards (SFAS),

March 1995.

No. ~~132-B~~, dated ~~November 29, 1993~~, entitled "Accounting for the Impairment of Long-Lived Assets," *and for Long Lived Assets to be Disposed of.*

The SFAS applies to long-lived assets (such as land, buildings, and equipment), identifiable intangibles, and related goodwill, and establishes guidance to recognize and measure impairment losses. If impaired assets are to be held for use, the SFAS requires a write-down to fair value when events or circumstances (e.g., environmental damage, idle facilities arising from declining business, etc.) indicate that carrying values may not be fully recoverable.

Impaired assets that are to be disposed of, however, would be reported (with certain exceptions) at the lower of cost or fair value less cost to sell. Once written down, the previous carrying amount of an impaired asset could not be restored if the impairment was subsequently removed. The final SFAS, which is virtually unchanged from the proposed rule (except for certain utility company provisions), is scheduled to be issued on February 15, 1995. The SFAS will apply to all financial statements issued for fiscal years beginning after June 15, 1995. *December*

In contrast to the SFAS provisions, Cost Accounting Standard (CAS) 9904.409, "Depreciation of Tangible Capital Assets," provides quite different criteria and guidance to recognize gains and losses for Government contract purposes. The language at 9904.409-40(a)(4) and (b)(4), 9904.409-50(j), and related Promulgation Comment 10, "Gain or Loss," makes it clear that gains and losses are recognized only upon asset disposal; no other circumstances trigger such recognition.

FAR 31.205-16 reflects the CAS provision that an asset be disposed of in order to recognize a gain or loss. The FAR rule applies to both CAS and non-CAS covered contracts. Consequently, for Government contract purposes, an impairment loss is recognized only upon disposal of the impaired asset. Like other losses, it is measured as the difference between the net amount realized and the impaired asset's undepreciated balance. *Through the change*
 * Government contractors, *will be required to* therefore, recover the carrying values of impaired assets held for use by retaining pre-write-down depreciation or amortization schedules as though no impairment had occurred. This proposed rule *revises* the title of the cost principle at 31.205-16 and adds a new paragraph (g) which addresses the treatment of losses for impaired assets.

B. Regulatory Flexibility Act

This proposed rule is not expected to have a significant economic impact on a substantial number of small entities within the meaning of the Regulatory Flexibility Act, 5 U.S.C. 601, et seq., because most contracts awarded to small entities are awarded on a competitive fixed-price basis and the cost principles do not apply. An Initial Regulatory Flexibility Analysis has, therefore, not been performed. Comments from small

entities concerning the affected FAR subpart will be considered in accordance with 5 U.S.C. 610. Such comments must be submitted separately and should cite 5 U.S.C. 601, et seq. (FAR case 95-003), in correspondence.

C. Paperwork Reduction Act

The Paperwork Reduction Act does not apply because the proposed change to the FAR does not impose record keeping or information collection requirements, or collections of information from offerors, contractors, or members of the public which require the approval of the Office of Management and Budget under 44 U.S.C. 3501, et seq.

FAR STAFF ANALYSIS
FAR CASE 95-003
IMPAIRMENT OF LONG-LIVED ASSETS

Relationship to 31.205-11, Depreciation

The concept of the proposed new allowability criteria for impaired assets is that additional cost resulting from an impairment will not be recognized for allowable cost purposes. This is taken care of as an addition to 31.205-16, gains and losses on disposition [or impairment] of depreciable property or other capital assets. However, there is not proposed revision to 31.205-11, depreciation.

Question - Why is 31.205-11, Depreciation, not changed? If a contractor writes down the value of an asset to reflect an impairment, it appears that the allowable cost criteria under 31.205-11, depreciation, would prevent the contractor from recovering the previous depreciation schedule amounts by operation of 31.205-11(e). That paragraph limit the depreciation amount to the amounts that reflect the contractor's books and statements. Thus, a contractor would be prohibited by the new 31.205-16 (g) from recovering the write-off amount at the time the impairment is written off and the contractor would also be prohibited from using the old depreciation schedule amounts by operation of existing 31.205-11(e).

Recommendation - Amend 31.205-11(e) to address appropriate limitations if an asset has been written-down as a result of an impairment. All that is necessary is to state that the pre-write down value may be used in that event.

Status of SFAS rule

Question - Has the final SFAS rule been published?

Answer - Yes. It is effective March 1995.

Recommendation - Amend the proposed Federal Register announcement of the proposed rule to reflect that the SFAS has been published, rather than stating that the SFAS will be published.

**FAR STAFF ALTERNATIVE RECOMMENDATION
FAR CASE 95-003, IMPAIRMENT OF LONG-LIVED ASSETS**

Text shown in bold italics inside brackets *[like this]* are the changes recommended by the FAR Staff. Changes in bold inside brackets **[like this]** are changes recommended by the DARC and concurred in by the FAR Staff.

31.205-11 Depreciation.

(a) Depreciation is a charge to current operations which distributes the cost of a tangible capital asset, less estimated residual value, over the estimated useful life of the asset in a systematic and logical manner. It does not involve a process of valuation. Useful life refers to the prospective period of economic usefulness in a particular contractor's operations as distinguished from physical life; it is evidenced by the actual or estimated retirement and replacement practice of the contractor.

(b) Contractors having contracts subject to 48 CFR 9904.409, Depreciation of Tangible Capital Assets, must adhere to the requirement of that standard for all fully CAS-covered contracts and may elect to adopt the standard for all other contracts. All requirements of 48 CFR 9904.409 are applicable if the election is made, and its requirements supersede any conflicting requirements of this cost principle. Once electing to adopt 48 CFR 9904.409 for all contracts, contractors must continue to follow it until notification of final acceptance of all deliverable items on all open negotiated Government contracts. Paragraphs (c) through (e) below apply to contracts to which 48 CFR 9904.409 is not applied.

(c) Normal depreciation on a contractor's plant, equipment, and other capital facilities is an allowable contract cost, if the contractor is able to demonstrate that it is reasonable and allocable (but see paragraph (i) below).

(d) Depreciation shall be considered reasonable if the contractor follows policies and procedures that are—

(1) Consistent with those followed in the same cost center for business other than Government;

(2) Reflected in the contractor's books of accounts and financial statements; and

(3) Both used and acceptable for Federal income tax purposes.

(e) When the depreciation reflected on a contractor's books of accounts and financial statements differs from that used and acceptable for Federal income tax purposes, reimbursement shall be based on the asset cost amortized over the estimated useful life of the property using depreciation methods (straight line, sum of the years' digits, etc.) acceptable for income tax purposes. Allowable depreciation shall not exceed the amounts used for book and statement purposes and shall be determined in a manner consistent with the depreciation policies and procedures followed in the same cost center on non-Government business, ***[except that, in the event of a write-down from carrying value to fair value as a result of impairments caused by events or changes in circumstances, depreciation of the impaired assets shall not exceed the amounts established on depreciation schedules in use prior to the write-down (see 31.205-16(g)).]***

(f) Depreciation for reimbursement purposes in the case of tax-exempt organizations shall be determined on the basis described in paragraph (e) immediately above.

(g) Special considerations are required for assets acquired before the effective date of this cost principle if, on that date, the undepreciated balance of these assets resulting from depreciation policies and procedures used previously for Government contracts and subcontracts is different from the undepreciated balance on the books and financial statements. The undepreciated balance for contract cost purposes shall be depreciated over the remaining life using the methods and lives followed for book purposes. The aggregate depreciation of any asset allowable after the effective date of this 31.205-11 shall not exceed the cost basis of the asset less any depreciation allowed or allowable under prior acquisition regulations.

(h) Depreciation should usually be allocated to the contract and other work as an indirect cost. The amount of depreciation allowed in any accounting period may, consistent with the basic objectives in paragraph (a) above, vary with volume of production or use of multishift operations.

(i) In the case of emergency facilities covered by certificates of necessity, a contractor may elect to use normal depreciation without requesting a determination of "true depreciation," or may elect to use either normal or "true depreciation" after a determination of "true depreciation" has been made by an Emergency Facilities Depreciation Board (EFDB). The method elected must be followed consistently throughout the life of the emergency facility. When an election is made to use normal depreciation, the criteria in paragraphs (c), (d), (e), and (f) above shall apply for both the emergency period and the post-emergency period. When an election is made to use "true depreciation", the amount allowable as depreciation—

(1) With respect to the emergency period (five years), shall be computed in accordance with the determination of the EFDB and allocated rateably over the full five year emergency period; *provided* no other allowance is made which would duplicate the factors, such as extraordinary obsolescence, covered by the Board's determination; and

(2) After the end of the emergency period, shall be computed by distributing the remaining undepreciated portion of the cost of the emergency facility over the balance of its useful life provided the remaining undepreciated portion of such cost shall not include any amount of unrecovered "true depreciation."

(j) No depreciation, rental, or use charge shall be allowed on property acquired at no cost from the Government by the contractor or by any division, subsidiary, or affiliate of the contractor under common control.

(k) The depreciation on any item which meets the criteria for allowance at a "price" under 31.205-26(e) may be based on that price, provided the same policies and procedures are used for costing all business of the using division, subsidiary, or organization under common control.

(l) No depreciation or rental shall be allowed on property fully depreciated by the contractor or by any division, subsidiary, or affiliate of the contractor under common control. However, a reasonable charge for using fully depreciated property may be agreed upon and allowed (but see 31.109(h)(2)). In determining the charge, consideration shall be given to cost, total estimated useful life at the time of negotiations, effect of any increased maintenance charges or decreased efficiency due to age, and the amount of depreciation previously charged to Government contracts or subcontracts.

(m) 48 CFR 9904.404, Capitalization of Tangible Assets, applies to assets acquired by a "capital lease" as defined in Statement of Financial Accounting Standard No. 13 (FAS-13), Accounting for Leases, issued by the Financial Accounting Standards Board (FASB). Compliance with 48 CFR 9904.404 and FAS-13 requires that such leased assets (capital leases) be treated as purchased assets; i.e., be capitalized and the capitalized value of such assets be distributed over their useful lives as depreciation charges, or over the leased life as amortization charges as appropriate. Assets whose leases are classified as capital leases under FAS-13 are subject to the requirements of 31.205-11 while assets acquired under leases classified as operating leases are subject to the requirements on rental costs in 31.205-36. The standards of financial accounting and reporting prescribed by FAS-13 are incorporated into this principle and shall govern its application, except as provided in subparagraphs (1), (2), and (3) below.

(1) Rental costs under a sale and leaseback arrangement shall be allowable up to the amount that would have been allowed had the contractor retained title to the property.

(2) Capital leases, as defined in FAS-13, for all real and personal property, between any related parties are subject to the requirements of this subparagraph 31.205-11(m). If it is determined that the terms of the lease have been significantly affected by the fact that the lessee and lessor are related, depreciation charges shall not be allowed in excess of those which would have occurred if the lease contained terms consistent with those found in a lease between unrelated parties.

(3) Assets acquired under leases that the contractor must capitalize under FAS-13 shall not be treated as purchased assets for contract purposes if the leases are covered by 31.205-36(b)(4).

(n) Whether or not the contract is otherwise subject to CAS, the requirements of 31.205-52, which limit the allowability of depreciation, shall be observed.

* * * * *

31.205-16 Gains and losses on disposition [or impairment] of depreciable property or other capital assets.

(a) Gains and losses from the sale, retirement, or other disposition (but see 31.205-19) of depreciable property shall be included in the year in which they occur as credits or charges to the cost grouping(s) in which the depreciation or amortization applicable to those assets was included (but see paragraph (d) of this subsection). However, no gain or loss shall be recognized as a result of the transfer of assets in a business combination (see 31.205-52).

(b) Gains and losses on disposition of tangible capital assets, including those acquired under capital leases (see 31.205-11(m)), shall be considered as adjustments of depreciation costs previously recognized. The gain or loss for each asset disposed of is the difference between the net amount realized, including insurance proceeds from involuntary conversions, and its undepreciated balance. The gain recognized for contract costing purposes shall be limited to the difference between the acquisition cost (or for assets acquired under a capital lease, the value at which the leased asset is capitalized) of the asset and its undepreciated balance (except see subdivisions (c)(2)(i) or (ii) below).

(c) Special considerations apply to an involuntary conversion which occurs when a contractor's property is destroyed by events over which the owner has no control, such as fire, windstorm, flood, accident, theft, etc., and an insurance award is recovered. The following govern involuntary conversions:

(1) When there is a cash award and the converted asset is not replaced, gain or loss shall be recognized in the period of disposition. The gain recognized for contract costing purposes shall be limited to the difference between the acquisition cost of the asset and its undepreciated balance.

(2) When the converted asset is replaced, the contractor shall either—

(i) Adjust the depreciable basis of the new asset by the amount of the total realized gain or loss; or

(ii) Recognize the gain or loss in the period of disposition, in which case the Government shall participate to the same extent as outlined in subparagraph (c)(1) above.

(d) Gains and losses on the disposition of depreciable property shall not be recognized as a separate charge or credit when—

(1) Gains and losses are processed through the depreciation reserve account and reflected in the depreciation allowable under 31.205-11; or

(2) The property is exchanged as part of the purchase price of a similar item, and the gain or loss is taken into consideration in the depreciation cost basis of the new item. (e) Gains and losses arising from mass or extraordinary sales, retirements, or other disposition other than through business combinations shall be considered on a case-by-case basis.

(f) Gains and losses of any nature arising from the sale or exchange of capital assets other than depreciable property shall be excluded in computing contract costs.

[(g) With respect to long-lived tangible and identifiable intangible assets held for use, no loss shall be recognized for a write-down from carrying value to fair value as a result of impairments caused by events or changes in circumstances (e.g., environmental damage, idle facilities arising from a declining business base, etc.). Depreciation or amortization on pre-write-down carrying value of impaired assets not yet disposed of shall continue to be recoverable under established depreciation or amortization schedules to the extent it is not otherwise unallowable under other provisions of the FAR.]



ACQUISITION AND
TECHNOLOGY
DP (DAR)

OFFICE OF THE UNDER SECRETARY OF DEFENSE

3000 DEFENSE PENTAGON
WASHINGTON DC 20301-3000

March 8, 1995



In reply refer to
FAR Case: 95-003

MEMORANDUM FOR MR. C. ALLEN OLSON, CHAIRMAN
CIVILIAN AGENCY ACQUISITION COUNCIL

SUBJECT: Impairment of Long-Lived Assets

We have agreed to a proposed FAR rule revising 31.205-16 to add paragraph (g) to clarify cost allowability rules concerning the recognition of gains and losses related to long-lived assets. The proposed rule addresses a cost category which is the subject of a Financial Accounting Standards Board proposed Statement of Financial Accounting Standards (SFAS), No. 132-B, dated November 29, 1993, entitled "Accounting for the Impairment of Long-Lived Assets."

If you agree with our proposed rule, please forward it to the FAR Secretariat. We will seek DoD approvals to publish as soon as you advise that we have agreement on a rule. We have attached the proposed revisions to the FAR and a draft Federal Register notice. The Regulatory Flexibility Act applies but the proposed rule is not expected to have a significant impact on a substantial number of small entities because most contracts awarded to small entities are awarded on a competitive fixed-price basis, and the cost principles do not apply. The Paperwork Reduction Act does not apply because the proposed rule does not impose any reporting or record keeping requirements. Our case manager is Ms. Linda Holcombe, (703) 602-0131.

Nancy Ladd
Nancy L. Ladd
Director, Defense Acquisition
Regulations Council

Attachments



FAR Case 95-003, Impairment of Long-Lived Assets

Baseline: FAR posted through FAC 94-20

Proposed change shown in **bold** and [brackets].

PART 31--CONTRACT COST PRINCIPLES AND PROCEDURES

* * *

31.205-16 Gains and losses on disposition [or impairment] of depreciable property or other capital assets.

(a) - (f) --No change--

[(g) With respect to long-lived tangible and identifiable intangible assets held for use, no loss shall be recognized for a write-down from carrying value to fair value as a result of impairments caused by events or changes in circumstances (e.g., environmental damage, idle facilities arising from a declining business base, etc.). Depreciation or amortization on pre-write-down carrying values of impaired assets not yet disposed of shall continue to be recoverable under established depreciation or amortization schedules to the extent it is not otherwise unallowable under other provisions of the FAR.]

PROPOSED FEDERAL REGISTER NOTICE

**DEPARTMENT OF DEFENSE
GENERAL SERVICES ADMINISTRATION
NATIONAL AERONAUTICS AND SPACE ADMINISTRATION**

**48 CFR Part 31
[FAR Case 95-003]**

**Federal Acquisition Regulation;
Impairment of Long-Lived Assets**

AGENCIES: Department of Defense (DoD); General Services Administration (GSA); and National Aeronautics and Space Administration (NASA).

ACTION: Proposed rule with request for comments.

SUMMARY: The Civilian Agency Acquisition Council and the Defense Acquisition Regulations Council are considering revisions to clarify FAR 31.205-16 concerning the allowability of losses recognized when carrying values of impaired assets are written down for financial reporting purposes.

COMMENTS: Comments should be submitted to the FAR Secretariat at the address shown below on or before (60 days from publication), to be considered in the formulation of a final rule.

ADDRESS: Interested parties should submit written comments to: General Services Administration, FAR Secretariat (VRS), 18th & F Streets, N.W., Room 4041, Washington, DC 20405. Please cite FAR Case 95-003 in all correspondence related to these issues.

FOR FURTHER INFORMATION CONTACT: Ms. Beverly Fayson, FAR Secretariat, telephone (202) 501-4786. Please cite FAR Case 95-003.

SUPPLEMENTARY INFORMATION:

A. Background

The proposed rule is intended to clarify cost allowability rules concerning the recognition of gains and losses related to long-lived assets. The proposed rule addresses a cost category which is the subject of a Financial Accounting Standards Board proposed Statement of Financial Accounting Standards (SFAS),

No. 132-B, dated November 29, 1993, entitled "Accounting for the Impairment of Long-Lived Assets."

The SFAS applies to long-lived assets (such as land, buildings, and equipment), identifiable intangibles, and related goodwill, and establishes guidance to recognize and measure impairment losses. If impaired assets are to be held for use, the SFAS requires a write-down to fair value when events or circumstances (e.g., environmental damage, idle facilities arising from declining business, etc.) indicate that carrying values may not be fully recoverable.

Impaired assets that are to be disposed of, however, would be reported (with certain exceptions) at the lower of cost or fair value less cost to sell. Once written down, the previous carrying amount of an impaired asset could not be restored if the impairment was subsequently removed. The final SFAS, which is virtually unchanged from the proposed rule (except for certain utility company provisions), is scheduled to be issued on February 15, 1995. The SFAS will apply to all financial statements issued for fiscal years beginning after June 15, 1995.

In contrast to the SFAS provisions, Cost Accounting Standard (CAS) 9904.409, "Depreciation of Tangible Capital Assets," provides quite different criteria and guidance to recognize gains and losses for Government contract purposes. The language at 9904.409-40(a)(4) and (b)(4), 9904.409-50(j), and related Promulgation Comment 10, "Gain or Loss," makes it clear that gains and losses are recognized only upon asset disposal; no other circumstances trigger such recognition.

FAR 31.205-16 reflects the CAS provision that an asset be disposed of in order to recognize a gain or loss. The FAR rule applies to both CAS and non-CAS covered contracts. Consequently, for Government contract purposes, an impairment loss is recognized only upon disposal of the impaired asset. Like other losses, it is measured as the difference between the net amount realized and the impaired asset's undepreciated balance. Government contractors, therefore, recover the carrying values of impaired assets held for use by retaining pre-write-down depreciation or amortization schedules as though no impairment had occurred. This proposed rule revises the title of the cost principle at 31.205-16 and adds a new paragraph (g) which addresses the treatment of losses for impaired assets.

B. Regulatory Flexibility Act

This proposed rule is not expected to have a significant economic impact on a substantial number of small entities within the meaning of the Regulatory Flexibility Act, 5 U.S.C. 601, et seq., because most contracts awarded to small entities are awarded on a competitive fixed-price basis and the cost principles do not apply. An Initial Regulatory Flexibility Analysis has, therefore, not been performed. Comments from small

entities concerning the affected FAR subpart will be considered in accordance with 5 U.S.C. 610. Such comments must be submitted separately and should cite 5 U.S.C. 601, et seq. (FAR case 95-003), in correspondence.

C. Paperwork Reduction Act

The Paperwork Reduction Act does not apply because the proposed change to the FAR does not impose record keeping or information collection requirements, or collections of information from offerors, contractors, or members of the public which require the approval of the Office of Management and Budget under 44 U.S.C. 3501, et seq.



To: LINDA HOLCOMBE

Date: 3-7-95

From: Steve Porter

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BY FAX

SAGC

March 7, 1995

MEMORANDUM FOR MR. DON SAWYER, OUSD(A&T), PENTAGON

SUBJECT: DAR Case 95-003, Impairment of Long-Lived Assets

Per our conversation yesterday, I called Linda Holcombe, the case manager for DAR Case 95-003, and told her that I concurred with your position, and indicated we should go ahead and process the case.

I felt that we should go ahead because you and I shared a common thought: that improvements to property would always be a capital cost, not a period expense. That shared thought is now being put to the test in a real live case involving FMC, DCMC and DCAA. Because we have been discussing the FMC problem for some time, I felt it appropriate, and mutually beneficial to include you in our discussions. I have therefore sent copies of this memo to the FMC participants.

It is never good to base a policy judgement on a single case, but here we have a single case that contains policy considerations that I believe will be important to the full understanding of DAR Case 95-003. Succinctly put, the collective judgement of DCMC and DCAA is that we should include FMC environmental remediation costs in overhead pools, and pay these costs as a part of current expense. The expense will not be considered a capital expense, and it is the collective judgement of DCMC and DCAA that it should not be a capital expense.

Background. FMC bought the real estate in question over a period of years; as early as 1910 and as late as 1940. When purchased, the land was farm land, and the book value probably reflects the cost of 1910 farm land (\$4.00 an acre?). Over the years this land was subject to the effects of multiple manufacturing plants, and slowly evolved into what it has become today... somewhat polluted. The State of California has required that FMC take action to correct the environmental damage in regard to the California property, and that work will proceed.

Policy Issues. CAS 404 states:

"Costs incurred subsequent to the acquisition of a tangible capital asset which result in extending the life or increasing the productivity of that asset (e.g., betterments and improvements) and which meet the contractor's established criteria for capitalization shall be capitalized with appropriate accounting for replaced asset accountability units. However, costs incurred for repairs and maintenance to a tangible capital asset which either restore the asset to, or maintain it at, its normal or expected service life or production capacity shall be treated as costs of the current period."¹

The heart of the discussion we are having is that there is a difference of opinion as to the base line to use when determining whether or not we are improving a property, or restoring the property to its original form.

What the Army does not want to do is to pay a large amount to restore the land to the condition it was in 1910, when originally purchased by FMC, and then have FMC sell the property for a substantial gain, all of which will enure to the benefit of FMC.

What we really need is a policy decision that identifies the baseline for purposes of determining whether or not we are improving property or restoring the asset to its original condition. My view is that we are in the business of contracts, so if a restoration is being done, it will focus on the state that existed at the beginning of the contract. If the restoration improves the property beyond that which existed at the beginning of the contract, then it is not a restoration but an improvement. Restorations are current expenses, and improvements are capital costs. We pay current expenses, the contractor pays capital costs.

In an effort to come up with a solution, I suggested that we might enter into some kind of financing arrangement whereby we finance the cost of restoration to a state that existed prior to the contract, but retain some equitable (but tangible) interest in the property. Our interest would be to ensure repayment

¹See 48 CFR 9904.404-40 (d), CAS 404, Capitalization of Tangible Assets.

of the restoration costs, up to the amount of profit on a sale. Evidently this has already been suggested, but rejected by the contractor, which makes me even more sure that we need to do something to protect the taxpayer.

The original DAR Case 95-003 reflected an attempt by the accounting profession to bring reality to this type of situation. The profession attempted to recognize the economic realities of the situation; some property has been so spoiled by misuse, or economic change, that it is not worth the original book value, and a new lesser value should be reflected on the books. By creating this 'write-down' process, the accountants have given properties like this one a new baseline that is more in keeping with reality. Once a write-down occurs, restoration will clearly be a capital expense. That reality is lost in the FMC case.

It is clearly wrong for the Army to pay to bring this property back to the 1910 condition. It is equally clear that the Army should pay some restoration costs.

I believe DCMC and DCAA may have overstated the DoD position. I believe it is unreasonable to use 1910 (or other acquisition date) as the environmental baseline. I also believe that what ever policy we do develop must include a prohibition against a contractor being paid to restore property for the purpose of sale...any sale, even a sale or exchange of property in the distant future.

Request. Could you or your colleagues please determine whether or not DCAA and DCMC are correct in their characterization of the DoD position in regard to these costs?

STEVE PORTER
ARMY LEGAL MEMBER
DAR COUNCIL

Copy to:

MICHAEL D. MERRITT, DCMAO-Chicago (FMC CACO)
FAX 312/825-5851
LARRY RABYNE, ESQ., DCMAO-Chicago (DCMC Legal)
FAX 312/825-5883
FRAN CORNETT, HQ DCAA, FAX 703/617-7452
LINDA HOLCOMBE, DAR CASE MGR FAX 703/602-0350

To: LINDA HOLCOMBE

From: Steve Porter

3-7-95 5:09pm p. 5 of 5

DAR Council Members

To: LINDA HOLCOMBE

From: Steve Porter

3-2-95 5:15pm p. 1 of 4



To: LINDA HOLCOMBE

Date: 3-2-95

From: Steve Porter

Page 1 of 4

March 2, 1995

MEMORANDUM FOR LINDA HOLCOMBE, CASE MANAGER

SUBJECT: DAR Case 95-003, Impairment of Long-Lived Assets

I received your FAX today concerning the use of several terms contained within the case. While these terms are academically interesting, the Council has lost sight of the larger picture. When this case was being discussed I brought up the following points, but to no avail:

1. The charge for impairment of long lived assets will be as an extraordinary expense; it will not be a charge against any cost center, but rather will be a charge after the computation of profit¹. This means the charge will not increase the cost of Government contracts in any way.
2. Financial accounting, and the Cost Accounting Standards require depreciation to be computed the capitalized cost of an asset, less its residual value.²
3. Depreciation is often adjusted because of changes to expected physical usefulness, or changes in expected economic usefulness, two factors which impact the useful life of an asset as well as the residual value.³
4. The new rule promulgated by the Financial Accounting Standards Board requires that "[a]fter an impairment is recognized, the reduced carrying amount of the asset shall be accounted for as its new cost. For depreciable assets, the new cost shall be depreciated over the asset's remaining

¹The rule states: "An impairment loss ... shall be reported as a component of income from continuing operations before income taxes. That amount shall be reported as a separate caption on the income statement ..."

²See 48 CFR 9904.409-40 (a)(1), CAS 401, Cost accounting standard depreciation of tangible capital assets.

³Id. at 9904.409-50 (e)(1)

useful life."⁴

5. The new rule provides that "[r]estoration of previously recognized impairment losses is prohibited."⁵

6. "Costs incurred subsequent to the acquisition of a tangible capital asset which result in extending the life or increasing the productivity of that asset (e.g., betterments and improvements) and which meet the contractor's established criteria for capitalization shall be capitalized..."⁶

These points are important to keep in mind when we are dealing with the cost of environmental damage. Step one with be the contractor's extraordinary charge for the environmental impairment. This charge should not effect contract costs. Step two will be the computation of depreciation costs (where applicable), and will be based on the new reduced base for financial accounting purposes. If the draft FAR rule is promulgated, the depreciation cost will remain at the older higher level.

When there is a charge for environmental cleanup costs, the charge will be for a betterment of the land or buildings that was originally reduced in value. While the rule requires that capital assets not be written back up for economic or other reasons related to the original charge, CAS and GAAP require capitalization of all expense that results in the land and buildings having an increased value. This will result in no environmental clean-up costs for the period, because these costs now become a part of the "cost basis" the contractor reflects on its books for the asset.

This is a very good approach, because we do not want to spend money to increase the value of land, only to have the contractor sell the land and pocket the profit.

⁴EITF Exposure Draft 132-b, 29 November 1993, supplemented by the results of the field test, November 1994.

⁵Id.

⁶48 CFR 9904.404-40 (d), CAS 404 Capitalization of tangible assets.

Terminations for Convenience are not covered by the draft FAR Case, but will provide a source of great expense if this rule is promulgated. What should be an extraordinary expense for the write down of buildings and land involved with Government contracts, will now under the draft language most assuredly be an expense in all cases. This will unnecessarily increase our contract costs by mega-bucks.

Please reconsider this poorly written and poorly reasoned draft before it is too late and you won't be able to afford the price you must pay. My suggestion: Do nothing, let the FASB promulgate their rule, and make our contractors live by it. That will be most cost effective and fair.

STEVE PORTER
ARMY LEGAL MEMBER



DEPARTMENT OF THE NAVY

OFFICE OF THE ASSISTANT SECRETARY
(Research, Development and Acquisition)
WASHINGTON, D.C. 20350-1000

2,
January 9, 1995

MEMORANDUM FOR NAVY POLICY REPRESENTATIVE

Subj: FAR CASE 95-003, IMPAIRMENT OF LONG-LIVED ASSETS

This is in reference to the Case Management Record of January 30, 1995 on the subject FAR case. It is noted that the Cost Principles Committee was not requested to coordinate on the proposed change to the cost principle at FAR 31.205-16. However, the Committee would like to submit the following comments for DAR Council consideration.

The Cost Principles Committee concurs with the conclusion that impairment losses should be unallowable for government contracting purposes. We also do not take exception to the proposed new language which sets forth the Government's policy regarding this issue. However, we believe that the word "impairment" should be added to the heading of the cost principle to highlight that the allowability of asset impairment costs are also being addressed. Also, from a stylistic point of view and for better clarity, we believe that the coverage on asset impairments should not be added to paragraph (a) which addresses disposition (sale, retirement, etc.) of depreciable property. Since impairment is different from disposition, the Cost Principles Committee believes that it is more appropriate to have separate paragraphs addressing the allowability of the two distinct costs. Therefore, we recommend that the cost principle be revised as follows:

31.205-16 Gains or losses on disposition [or impairment] of depreciable property or other capital assets.

* * * * *

[(g) With respect to long-lived tangible and identifiable intangible assets held for use, no loss shall be recognized for a write-down from carrying value to fair value as a result of impairments caused by events or changes in circumstances (e.g. environmental damage, idle facilities arising from a declining business base, etc.). Depreciation or amortization on pre-write-down carrying values of impaired assets not yet disposed of shall continue to be recoverable under established depreciation or amortization schedules to the extent it is not otherwise unallowable under other provisions of the FAR.]

I am available to discuss this issue if you like.

Clarence M. Belton
Chairman, Cost Principles Committee

2/9/95

I spoke with Don Sawyer regarding this approach.
Don indicated that he does not object to our revision.

CTB