Chapter 28 Gains and Losses on Disposition or Impairment of Depreciable Property or Other Capital Assets

Authoritative Sources

FAR 31.205-11 Depreciation

FAR 31.205-16 Gains and Losses on Disposition or Impairment of Depreciable Property or Other Capital Assets

FAR 31.205-36 Rental Costs

48 CFR 9904.409 Depreciation of Tangible Capital Assets

This chapter provides supplemental guidance on auditing costs related to gains and losses on disposition or impairment of depreciable property or other capital assets.

This chapter addresses the following topics:

28-1 General Information

A gain occurs due to an increase in the capital asset’s value, or if the amount realized or the fair market value is greater than the undepreciated amount. Contrary, a capital loss occurs due to the decrease of the capital asset’s value, or if the amount realized or the fair market value is less than the depreciated amount. Both gains and losses are considered to be realized in the cost accounting period when the asset is sold or dispositioned. When a gain or loss is material in amount, it shall be allocated in the same manner as the depreciation cost of the asset has been, or would have been allocated for the cost accounting period in which the disposition occurs. Capital gains and losses may appear in two forms: long-term and short-term. Short-term gains and losses are those on assets that are held for a year or less before being sold or dispositioned. Long-term capital gains and losses result from the sale or disposition of the asset that were held for more than a year.

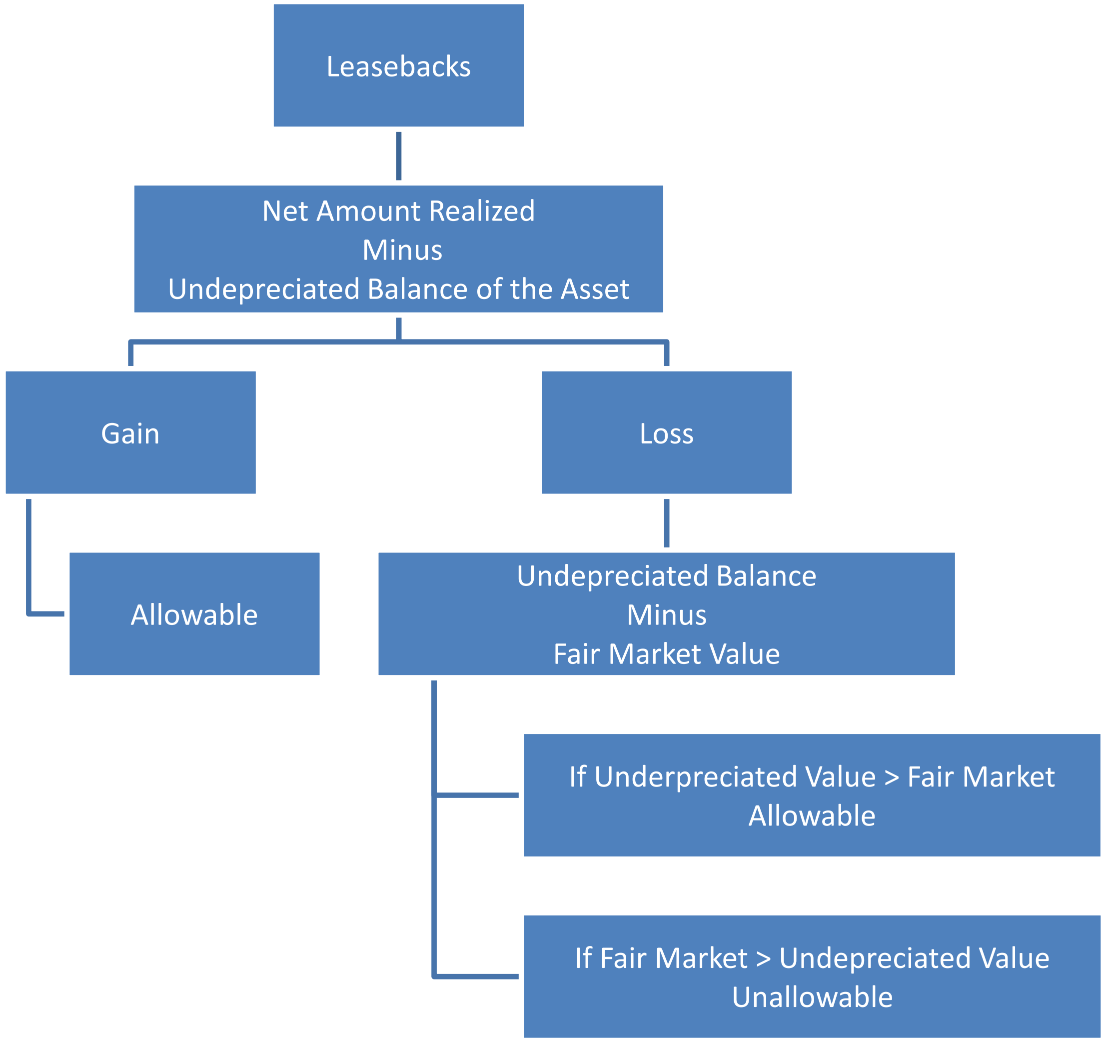
28-2 General Audit Guidelines

Gains and losses from the sale, retirement, or other disposition of depreciable property are allowable per FAR 31.205-16. The allowable gain and loss must be recorded in the year in which the gain or loss occurred. Additionally, the gain or loss must be recorded as a credit or charge to the cost grouping associated with the depreciation or amortization applicable to the assets. Therefore, the audit team should pay close attention to the timing of the sale, retirement or disposition of the property and compare it against when the gain or loss was recorded.

28-2.1 Leaseback Limitations

FAR provides additional sale and leaseback limitations of depreciable property outlined in FAR 31.205-11(h)(1), Depreciation, and FAR 31.205-36(b)(2), Rental Costs. When costs are subject to these limitations, additional requirements exist for gains or losses of assets. The audit team must verify whether leaseback limitations are applicable and obtain the appropriate supporting documentation from the contractor related to the terms of the lease.

The gain or loss is calculated by taking the difference between the net amount realized and the undepreciated balance of the asset on the date the contractor becomes a lessee. When the calculation results in a loss, the allowable loss is zero if the fair market value exceeds the undepreciated balance. If the fair market value is less than the undepreciated balance of the asset on the date the contractor becomes a lessee, the allowable portion of the loss is also limited to the difference between the fair market value and the undepreciated balance of the asset.



28-2.2 Tangible Capital Assets

For the purposes of recognizing gains and losses, tangible capital assets also include assets acquired under capital leases. Therefore, the audit team should be aware that FAR 31.205-11(h), Depreciation, is also applicable. Gains and losses on disposition of tangible capital assets are the difference between the net amount realized, including insurance proceeds from involuntary conversions, and the asset's undepreciated balance. However, gains and losses on disposition of tangible capital assets are considered adjustments against previously recognized depreciation. The audit team must review the depreciation accumulated and the adjustment for the disposition of the tangible capital asset.

28-2.3 Contract Costing

Gains recognized for contract costing purposes are allowable; however, such gains are limited to the difference between the acquisition cost of the asset and its undepreciated balance. On the other hand, for assets acquired under a capital lease, the calculation must use the value at which the leased asset is capitalized instead of the acquisition cost. When reviewing contractor documentation, the audit team must determine if the asset was purchased or acquired under a capital lease to determine the allowable amount. There may be instances where involuntary conversions may impact the allowability per FAR, see involuntary conversion section 16-3.1 below for exceptions.

28-3 Gains and Losses of Special Circumstances

28-3.1 Involuntary Conversion

An involuntary conversion occurs when an asset is involuntarily removed from service due to circumstances outside the control of the contractor, such as fire, flood, theft, etc. In these instances, the contractor may receive an insurance award. If there is a cash award and the converted asset is not replaced, the gain or loss recognized for contract costing purposes is the difference between the proceeds and its undepreciated balance. For example, a contractor has an asset acquired for $100,000. At the time of the involuntary conversion, the asset had an undepreciated value of $80,000, and the contractor received a cash award from the insurance of $70,000. In this example, the loss would be $10,000 ($80,000-$70,000). The gain or loss must be recognized in the period of disposition and shall be allocated in the same manner as the depreciation cost of the asset (CAS 409.40(B)(4)).

Converted assets may also result in gains. Assume the same facts as above, but the cash award from the insurance is $120,000. The total gain is $40,000 ($120,000 - $80,000). However, the recognized gain for government contract costing purposes is limited to the difference between the original acquisition cost of the asset and the undepreciated balance, or $20,000 ($100,000 - $80,000). Again, the gain or loss must be recognized in the period of disposition (FAR 31.205-16(e)(1)).

When an asset is used as a trade-in on the purchase of similar items, the total realized gain or loss may be used to adjust the basis of the new asset's depreciable basis. The contractor can also elect to recognize the gain or loss in the same period of disposition. In this case, the calculation is the same as if the cash was awarded; the gain or loss is the difference between the proceeds and its undepreciated balance. If the contractor adjusts the new asset’s basis, that basis would be increased by the value of the loss or decreased by the value of the gain. Using the examples above, that would mean either an increase to the depreciable base of $10,000 (for the loss) or a decrease of $20,000 (for the recognized gain).

28-3.2 Depreciable Property

The contractor may recognize gains and losses on the disposition of depreciable property; however, FAR does not allow for the recognition as a separate charge or credit under the following circumstances:

- When the gains and losses are processed through the depreciation reserve account and reflected in the depreciation allowable under FAR 31.205-11: Depreciation.
- When 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.

28-3.3 Mass or Extraordinary Sales, Retirements, or Other Disposition

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 as determined by the ACO. Because these are considered on a case-by-case basis, the audit team must coordinate with the ACO prior to designing audit procedures, as the ACO may have established agreements with the contractor on the amount and timing of the recognition of the gain or loss.

28-3.4 Other Exchanges

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.

28-3.5 Long-Lived Tangible and Identifiable Intangible Assets

A loss from a write-down from carrying value to fair value resulting from impairments caused by events or changes in circumstances are unallowable. These events or changes in circumstances may include environmental damage, idle facilities arising from a declining business base, among others.

Gains and losses upon disposition are allowable, if depreciable property or other capital asset has been written-down from carrying value to fair value due to impairments. The allowable gain or loss shall be the amount that would have been allowed had the assets not been written-down.