SELECTED AREAS OF COST

Chapter 19 – Depreciation Costs

Authoritative Sources

FASB ASC 360 Property, Plant, and Equipment

FASB ASC 840 Leases

FAR 31.205-11 Depreciation

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

FAR 31.205-52 Asset Valuations Resulting from Business Combinations

Internal Revenue Code Section 167

48 CFR 9904.404 (CAS 404) Capitalization of Tangible Assets

48 CFR 9904.409 (CAS 409) Cost Accounting Standard Depreciation of Tangible Capital Assets

A contractor typically owns tangible personal property, such as a plant, equipment, and other capital facilities. These assets provide a service for a number of years. Because such assets are expected to provide service for many years, the tangible personal property is recorded as an asset, rather than an expense, in the year the asset is acquired. According to the matching principle, a portion of the asset should be reported as an expense during each period of the asset's useful life. Deprecation is the process of achieving this principle, by assigning the cost of the asset to expense over the asset's useful life in a rational and systematic manner.

General Audit Guidelines

A proper determination of periodic depreciation costs depends largely on the effectiveness and consistency of the contractor's depreciation policies and procedures and on the sufficiency of the related property/depreciation records. Because an interrelationship exists between the amount of depreciation cost chargeable to any fiscal period as compared with prior and/or future fiscal periods, completeness of such records for the entire retention period of the asset(s) is essential.

This chapter addresses the following topics:

19-1 Allowability

19-2 Depreciation Methods

19-3 Estimated Useful Life

19-4 Salvage Value

19-5 Consistency

19-6 Special Areas of Concern

19-1 Allowability

19-1.1 Regulations

Normal depreciation is generally considered allowable contract costs if reasonable and allocable. In general, in computing depreciation any rational and systematic method that is consistently applied may be used. Regardless of the method used, deductions for depreciation shall not exceed such amounts as may be necessary to recover the unrecovered cost or other basis less salvage, during the remaining life of the property.

The provisions of FAR 31.205-11 govern the allowability of depreciation costs. Contractors with contracts subject to cost accounting standards (CAS) must comply with the provisions of CAS 404, Capitalization of Tangible Assets, and CAS 409, Depreciation of Tangible Capital Assets. CAS 404 concepts relative to capital leases and CAS 409 are incorporated into FAR Part 31. Refer to CAM Chapter 8 Section 404 and 409 for CAS provisions dealing with the cost accounting practices associated with capitalization and depreciation of tangible capital assets.

For non-CAS covered contracts, costs are reasonable if the contractor follows policies and procedures that are (a) consistent with those followed in the same cost center for business other than Government, and (b) reflected in the contractor's books of accounts and financial statements.

A proper determination of periodic depreciation costs depends largely on the effectiveness and consistency of the contractor's depreciation policies and procedures and on the sufficiency of the related property/depreciation records. Because an interrelationship exists between the amount of depreciation cost chargeable to any fiscal period as compared with prior and/or future fiscal periods, completeness of such records for the entire retention period of the asset(s) is essential.

If the costs are considered material and/or significant risk is identified, the auditor should:

- Review the contractor's depreciation policies and procedures and/or established practice and perform selective tests to determine whether the contractor’s policies and procedures have been followed to calculate depreciation for the accounting period being audited.
- Determine if the contractor’s accounting records support the capitalized asset cost, including any cost of making the asset ready for use.

- Review of Schedule M of the contractor's Federal income tax return and the results of any review of the tax returns made by the Internal Revenue Service. In the event the IRS has made any changes, the auditor should evaluate the amounts and circumstances and make whatever adjustments are appropriate to determine allowable depreciation costs of the current or prior years. The review of Schedule M will indicate whether the contractor's method of computing depreciation for tax purposes differs from that used for book and statement purposes. This is important since the criteria in FAR 31.205-11(c), which applies to contracts that are not covered by 48 CFR 9904.409 (CAS 409), states that if the amounts differ, allowable depreciation shall not exceed the amounts used for accounting books and financial statement purposes.
- Review the contractor's financial statements, which should reflect the amount of depreciation charged to operations on the contractor's books. Since such statements generally cover company-wide operations, the FAO responsible for the audit of the home office should serve as the focal point for assistance to other field audit cognizance.

19-1.2 Relationship Between FASB ASC and IRS Regulations

In 1986, the Internal Revenue Code and implementing regulations changed to permit the use of accelerated methods of depreciation in determining taxable income. Since that time many companies have adopted these methods for income tax purposes in order to defer payment of taxes and to improve cash flow, while for book and financial statement purposes they continue to use the traditional straight-line method of depreciation. Thus, the amount of depreciation charged to operations under the contractor's established depreciation policies and procedures may often differ from the amount claimed for Federal income tax purposes. Where the book and tax methods differ, the amount allowable for the fiscal period for contract cost purposes is determined on the basis outlined in FAR 31.205-11(c) and may not exceed the book/statement amount.

19-2 Depreciation Methods

The methods for computing depreciation described in this subparagraph do not apply to the “class life asset depreciation range (ADR) system.” When the ADR system is used, the rules are subject to certain modifications as covered in 19-6.2.

19-2.1 Straight-Line Method

Under this method, the cost or other basis of the property less its salvage value is deducted in equal annual amounts over the period of its estimated useful life. If the depreciation period is less than three years, only the straight-line method is acceptable. This method considers the use (or productivity) of the asset is consistent throughout its useful life, thus matching the cost of the asset evenly with the use of the asset. Shown below is this method of computation using an asset with an original cost of $450,000 with a salvage value of $50,000 and a useful life of 5 years.

Straight-Line Depreciation Schedule

Year	Depreciation Base	Depreciation Expense	Balance Accumulated Depreciation	Book Value, End of Year
1	$450,000	$80,000	$80,000	$370,000
2	450,000	80,000	160,000	290,000
3	450,000	80,000	240,000	210,000
4	450,000	80,000	320,000	130,000
5	450,000	80,000	400,000	50,000

19-2.2 Declining-Balance Method

Under this method, the cost or other basis of the property is deducted at a higher depreciation amount in the earlier periods and a lower amount in the later periods. This method utilizes a depreciation rate (expressed as a percentage) that is some multiple of the straight-line method. The rate remains constant and is applied to the reducing book value each year. Shown below is the double-declining-balance method using an asset with an original cost of $450,000 with a salvage value of $50,000 and a useful life of 5 years.

Double-Declining Depreciation Schedule

Year	Book Value of Asset First of Year	Rate of Declining Balance	Depreciation Expense	Balance Accumulated Depreciation	Book Value, End of Year
1	$450,000	40%	$180,000	$180,000	$270,000
2	$270,000	40%	108,000	288,000	162,000
3	162,000	40%	64,800	352,800	97,200
4	97,200	40%	38,880	391,680	58,320
5	58,320	40%	8,320*	400,000	50,000

* Limited to $8,320 because book value should not be less than salvage value.

While salvage value is not deducted from the cost or other basis of the property in determining the annual depreciation allowance, an asset may not be reduced below its reasonable salvage value after taking into account the reduction permitted under the 10 percent rule (see 19-4). This method considers the use (or productivity) of the asset declines as the asset gets older, thus matching the cost of the asset with the deceasing use of the asset.

19-2.3 Sum-of-Years'-Digits Method

Under this method, the cost or other basis of the property less its salvage value is deducted at a higher depreciation cost in the earlier periods and a lower cost in the later periods. This method utilizes a decreasing fraction (the numerator is the number of years of estimated life remaining as of the beginning of the year, with the denominator being the sum of the years) applied to the depreciation base to determine the period costs. At the end of the asset's useful life, the balance remaining will equal the salvage value. This method considers the use (or productivity) of the asset declines as the asset gets older, thus matching the cost of the asset with the decreasing use of the asset. Shown below is the sum-of-the years'-digits method using an asset with an original cost of $450,000 with a salvage value of $50,000 and a useful life of 5 years.

Sum-of-the-Years'-Digits Depreciation Schedule

Year	Depreciation Base	Remaining Life in Years	Depreciation Fraction	Depreciation Expense	Book Value, End of Year
1	$400,000	5	5/15	$133,333	$316,667
2	400,000	4	4/15	106,667	210,000
3	400,000	3	3/15	80,000	130,000
4	400,000	2	2/15	53,333	76,667
5	400,000	1	1/15	26,667	50,000
		15	15/15	400,000	

19-2.4 Other Methods

Any consistent method of computing depreciation may be used provided that during the first two-thirds of the useful life of the property, the depreciation deductions under any such method do not result in accumulated allowances at the end of any accounting period that are greater than the total that could have been deducted under the declining-balance method. Under appropriate circumstances, "other consistent methods" include the sinking-fund method, the unit-of-production method, and the machine-hour method.

19-3 Estimated Useful Life

The estimated useful life of an asset should represent the prospective period of economic usefulness to the contractor as presented in the "depreciation" definition under FAR 2.101. If the auditor concludes that depreciable lives used by the contractor for book purposes do not represent "economic usefulness", the auditor should contemplate questioning costs.

19-4 Salvage Value

Salvage value is the amount the contractor expects to receive in cash or trade-in allowance upon disposing of the asset at the end of its useful life. There is no fixed basis for determining salvage value. If the full inherent life of an asset is used, salvage value may be no more than junk value.

If salvage value is less than 10 percent of the basis of the property, then salvage value can be ignored when calculating depreciation. Salvage value can never be less than book value or zero.

Under Straight-Line and Sum of Years-Digits Methods, the contractor may use either gross salvage or net salvage value in determining depreciation, and the treatment of the costs of removal must be consistent with the practice adopted. Under the straight-line and sum of the years digits methods, salvage value is subtracted from the cost or other basis before applying the annual depreciation rate.

Under the Declining-Balance Method, there is no deduction for the salvage value in computing the depreciation base. However, for this method, and any other method that does not consider the salvage value in determining the asset's depreciation base, the **allowable** depreciation costs for the last year of the useful life would be the calculated depreciation amount less the salvage value. This will result in the book value of the asset to equal the salvage value.

19-5 Consistency

Any method otherwise permissible may be applied to a particular depreciable property "account" (which may represent an individual item or a group of related items). However, once a method is adopted for any specific "account," it must be applied consistently thereafter.

AUDIT GUIDELINES

Although the method used must be applied consistently to an account, it need not necessarily be used for acquisitions of similar property in the same or subsequent years, provided such acquisitions are set up in separate accounts. A contractor may establish as many accounts for depreciable property as desired. It is apparent from the foregoing that although the contractor must be consistent in depreciation methods, this consistency relates only to the application of a particular method to a particular asset account from year to year. It does not mean that all assets must use the same method.

It should also be noted that the method used for each asset account in computing incurred costs should be consistent with that used by the contractor in estimating costs for pricing purposes.

19-6 Special Areas of Concern

19-6.1 Asset Valuations Resulting from Business Combinations

FAR 31.205-52 Asset Valuations Resulting from Business Combinations

(a) For tangible capital assets, when the purchase method of accounting for a business combination is used, whether or not the contract or subcontract is subject to CAS, the allowable depreciation and cost of money shall be based on the capitalized asset values measured and assigned in accordance with 48 CFR 9904.404-50(d), if allocable, reasonable, and not otherwise unallowable.

(b) For intangible capital assets, when the purchase method of accounting for a business combination is used, allowable amortization and cost of money shall be limited to the total of the amounts that would have been allowed had the combination not taken place.

AUDIT GUIDELINES

When determining the capitalization value of the assets acquired in a business combination using the purchase method of accounting, CAS 404-50(d) recognizes that there are two categories of assets, which require different treatment when determining the net book value of the assets. In applying CAS 404-50(d), the contractor must categorize each acquired asset between:

(1) Assets that have generated either depreciation expense or cost of money (COM) charges in the prior year to the business combination and the costs were allocated to Government contracts negotiated on the basis of cost; or

(2) Assets that did not generate either depreciation expense or COM charges allocated to Government contracts negotiated on the basis of cost in the prior year to the business combination.

The standard requires that for assets in the first category, the capitalized value is the net book value of the asset as reported by the seller at the time of the acquisition. For assets in the second category, the capitalized value is a portion of the cost of the acquired company attributable to the asset not to exceed the asset's fair value at the date of the acquisition. However, when the fair value of identifiable acquired assets, less liabilities assumed, exceeds the purchase price of the acquired company, the value otherwise assignable to tangible capital assets shall be reduced by a proportionate part of the excess.

19-6.2 Class Life Asset Depreciation Range (ADR) System

The Revenue Act of 1971 authorized the "class life asset depreciation range (ADR) system." At the taxpayer's election, it may apply the class life ADR system for assigning asset lives to income-producing real or tangible personal property placed in service after 1970. The taxpayer is permitted to use only the straight-line, declining-balance, or sum-of-the-years-digits methods under the class life ADR system.

The regulations provide for exclusion of certain types of property from the ADR system. The principal exclusions permissible are for assets that are:

(1) subject to special rapid amortization or depreciation provisions,

(2) received from related parties in a transfer that does not trigger an investment credit recapture,

(3) without an ADR class, or

(4) excludable property under the 10 percent used property rule.

All assets for any year, for which the contractor uses the class life ADR system, must be accounted for in either item or multiple-asset accounts by the year placed in service. These accounts are called "vintage accounts."

Salvage value is not used to reduce the basis for computing depreciation. However, allowable depreciation for any vintage account may not exceed the cost or other basis of the account less the sum of (1) the reserve for depreciation, and (2) the salvage value. Thus, salvage value functions only as an overall limitation on the total depreciation allowable for property in a vintage account. Gross salvage value must be estimated for each vintage account at the time of electing to use the class life ADR and may be reduced under the percent rule. If the taxpayer consistently follows a practice of understating salvage values, IRS will increase the salvage value to what it finds is a reasonable amount.

The allowance for first-year depreciation of a vintage account is determined by applying the "modified half-year convention" or the "half-year convention." The same convention must be adopted for all vintage accounts of a tax year, but not necessarily for those of another tax year. The original basis of the account changes only if there is an extraordinary retirement. An asset is treated as retired when it is permanently withdrawn from use in the business.

AUDIT GUIDELINES

The depreciation cost principle provides that depreciation costs for contracts not subject to 48 CFR 9904.409 shall not exceed the amounts used for financial reporting purposes. Asset lives and methods of depreciation established by the contractor in agreement with the class life ADR system are considered to be compatible with FAR 31.205-11(c). However, due to unusual circumstances affecting defense contracts, use of the class life ADR system may result in inequitable charges to the Government. If any inequities are found, the issue should be brought to Headquarters attention through the Region.

19-6.3 Depreciation of Leased Property

FASB ASC 840, Leases, provides guidance for the treatment of capitalized lease assets. ASC 840 is applicable for any costs incurred during a contractor's financial statement period ending after September 15, 2009. Previously, FASB Statement No. 13 (FASB 13), Accounting for Leases, addressed capitalized leased assets. FASB 13 became mandatory for contractor fiscal years beginning on or after January 1, 1981. The provision of ASC 840 (formerly FASB 13) is incorporated in FAR 31.205-11, Depreciation, and FAR 31.205-36, Rental Costs. Refer to Chapter 40, Lease Costs for additional discussion of leases.

From the standpoint of the lessee, the lease shall be classified as a capital lease if any of the following criteria are met:

(1) The lease transfers ownership of the property to the lessee by the end of the lease term.

(2) The lease contains a bargain purchase option.

(3) The lease term is equal to 75 percent or more of the estimated economic life of the lease property. However, where the lease term begins in the last 25 percent of estimated economic life, this criterion shall not be used for purposes of classifying the lease.

(4) The present value at the beginning of the lease term of the minimum lease payments equals or exceeds 90 percent of the excess of the fair value of the lease property over any related investment tax credit retained by the lessor. However, where the lease term begins in the last 25 percent of estimated economic life, this criterion shall not be used for purposes of classifying the lease.

If the asset is capitalized using either of the first two criteria, the asset is amortized over the estimated economic life of the asset. If the asset is capitalized under either of the last two criteria, it is amortized over the lease term.

The lease term defined by the FASB ASC includes the basic term plus option periods under certain conditions. The conditions which must be part of the lease for the option period(s) to be included in the lease term are:

(1) lease contains bargain renewal options,

(2) the lessee would have to pay a penalty so large as to assure renewal,

(3) the lessee guarantees lessor's debt for the option period(s),

(4) the lease contains a bargain purchase option, and

(5) the lessor has the option to renew the lessee's lease.

19-6.4 Depreciation on Assets Acquired from the Government and Depreciation of Fully Depreciated Assets

Usage charges for fully depreciated assets are allowable under certain circumstances. FAR 31.205-11(f) states, "... a reasonable charge for using fully depreciated property may be agreed upon and allowed." A usage charge may be appropriate when the actual useful life of an asset exceeds its estimated useful life and there has been a significant change in Government participation after the asset was fully depreciated. In such cases, the allocation of the cost of the asset usage between Government and commercial contracts may be adjusted by applying a usage charge.

When the continued use of a fully depreciated asset is appropriate under the circumstances, FAR 31.205-11(f) provides that the allowability of a usage charge is subject to the approval of the contracting officer. While usage charges are permitted under the FAR, there is no requirement that the contracting officer allow the charges.

AUDIT GUIDELINES

In reviewing contractor claims for usage charges, it is imperative that the auditor determine if the actual useful life of the asset exceeds the estimated useful life due to a betterment, an error in estimate, or a patchwork repair, as this will have a bearing on if a usage charge is appropriate, the amount, and when to claim the charges.

Betterment. CAS 404-40(d) 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..." Accordingly, in those cases where the useful life of the asset extends beyond its estimated life as a result of a betterment, CAS requires that the contractor adjust the estimated life of the asset. If the contractor has failed to make such an adjustment, then the asset is not fully depreciated and the usage charge should be disallowed until the adjusted estimated life is exhausted. Review of the circumstances at the time the adjusted estimated life is exhausted would give a better representation if a usage charge is appropriate.

Error in Estimate. On a few occasions, the contractor may have an asset that lasts longer than its estimated useful life as a result of an error in the contractor's original estimate. In these cases, the contractor may be entitled to a usage charge. However, when the actual useful lives of the contractor's assets exceed the estimated useful lives on a recurring basis, the auditor should review the contractor's estimating procedures to assure that they are taking into account history when determining the estimated useful life of the assets. If the assets are fully depreciated as a result of a noncompliance with CAS 409, the usage charge should be disallowed until the adjusted estimated life is exhausted. Review of the circumstances at the time the adjusted estimated life is exhausted would give a better representation if a usage charge is appropriate.

Patchwork Repair. On rare occasions, a contractor may decide to continue to utilize an asset beyond its useful life through continual patchwork repairs. In these cases, the contractor may be entitled to a usage charge. However, the auditor should review the contractor's rationale for continually repairing the asset rather than overhauling the asset (a betterment), trading in the asset, or scrapping the asset in favor of a new one. The auditor should consider factors such as the cost of patchwork repairs, the utilization of contractor personnel in performing these repairs, the cost of an overhaul, the trade-in value of the old asset, and the cost of a new asset when evaluating the amount of the usage charge.

When a usage charge is appropriate/allowed, the amount of the charge should be determined on a case-by-case basis. In determining a reasonable usage charge, the auditor should make sure that the contractor has properly considered each of the factors listed in FAR 31.205-11(f), including:

- the cost,
- 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.

To demonstrate how a reasonable usage charge may be calculated, an example is shown below:

Description	Formula	Value
Cost of asset		$100,000
Original Estimated Useful Life		3 years
Actual Useful Life		5 years
Total estimated decrease in efficiency for Years 4 and 5 ($2,000 per year)		$4,000
Total estimated increase in maintenance (patchwork repairs) for Years 4 and 5 ($2,500 per year)		$5,000
Average Government Participation for Years 1 through 3		50%
Average Government Participation for Years 4 and 5		90%
Calculation of Recommended Usage Charge:		
Depreciation expense charged to the Government if the estimated useful life had been 5 years:		
Years 1 thru 3 ($20,000 per year X 3 years X 50%)		$30,000
Years 4 and 5 ($20,000 per year X 2 years X 90%)		$36,000
Amount of Years 1 thru 3 plus Years 4 and 5	(a)	$66,000
Less: Actual Depreciation Expense charged to Government contracts ($100,000 X 50%)	(b)	$50,000
Additional depreciation due to extended useful life	(c) = (a) - (b)	$16,000
Less: Efficiency Reduction ($4,000 X 90%)	(d)	$3,600
Increased Maintenance ($5,000 X 90%)	(e)	$4,500
Allowable Usage Charge	(c) – ((d) + (e))	$7,900

19-6.5 Depreciation on Idle Facilities or Idle Capacity

The auditor should ascertain whether any of the depreciation costs charged to Government contracts are generated by idle facilities or idle capacity as these terms are defined in FAR 31.205-17. If this is determined to be the case, treat the applicable depreciation cost as part of the total idle facility or idle capacity cost. Refer to Chapter 32 for further discussion on idle facilities.

19-6.6 Depreciation on Intracompany Transfers of Assets

The auditor should refer to FAR 31.205-11(e) for property that is acquired from a division, subsidiary, or affiliate of the contractor. The provision provides that the depreciation on any such item which meets the criteria for allowance at a "price" under FAR 31.205-26(e) may be based on such price (rather than cost to the contractor), provided the same depreciation policies and procedures are used for costing purposes for all business of the using division, subsidiary, or organization under common control.

19-6.7 Depreciation or Amortization of Leasehold Improvements

Improvements by the lessee are ordinarily subject to an allowance for depreciation or amortization. The auditor should review the basis for writing off the cost of leasehold improvements.

Whether the lease is with a commercial concern or with the Government, the cost of the improvement may be depreciated over the useful life of the improvement or amortized over the remaining term of the lease, whichever is shorter. The distinction between depreciation and amortization has some significance; the language of the regulations is generally interpreted to mean that when amortizing, the declining-balance or the sum of the years digits may not be used. When depreciating, there is no such limitation.

The term of the lease will include any period for which the lease may be renewed, extended, or continued pursuant to either:

(1) an option exercisable by the lessee or

(2) in the absence of an option, reasonable interpretation of past acts of the lessee and lessor such as with respect to renewal, unless the lessee clearly establishes, past acts notwithstanding, that is improbable that the lease will be renewed, extended, or continued.

19-6.8 Depreciation Under Novation Agreements

For contracts being performed under novation agreements, depreciation allowed to the successor contractor should not exceed the amount that would have been allowed to the predecessor contractor to which the contract was originally awarded. Refer to Chapter 8 for additional discussion on business combinations.

19-6.9 Gain or Loss on Disposition of Assets

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 (but see paragraph (f) 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) Notwithstanding the provisions in paragraph (c) of this subsection, when costs of depreciable property are subject to the sale and leaseback limitations in 31.205-11(h)(1) or 31.205-36(b)(2)—

(1) The gain or loss is the difference between the net amount realized and the undepreciated balance of the asset on the date the contractor becomes a lessee; and

(2) When the application of (b)(1) of this subsection results in a loss—

(i) The allowable portion of the loss is zero if the fair market value exceeds the undepreciated balance of the asset on the date the contractor becomes a lessee; and

(ii) The allowable portion of the loss is limited to the difference between the fair market value and the undepreciated balance of the asset on the date the contractor becomes a lessee if the fair market value is less than the undepreciated balance of the asset on the date the contractor becomes a lessee.

(c) Gains and losses on disposition of tangible capital assets, including those acquired under capital leases (see 31.205-11(h)), 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.

(d) 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 paragraphs (e)(2)(i) or (ii) of this subsection).

(e) 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 (e)(1) of this subsection.

(f) 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.

(g) 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.

(h) 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.

(i) 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.

AUDIT GUIDELINES

Except for ordinary retirements under the class life ADR system (see 19-6.2), the contractor will realize a gain or loss at the time a depreciable asset is disposed of. The gain or loss will represent the difference between the asset's book value and the amount realized upon its disposal. However, that will not always be the amount recognized for contract cost purposes. CAS 409 and FAR 31.205-16 provide several bases for determining the amount of gain or loss to be recognized, as well as certain elections open to the contractor regarding cost treatment of the gain or loss. Audits at a contractor location with a significant amount of assets disposed of in an accounting period should include appropriate audit steps to assure that contract costs for gains and losses are determined in accordance with the requirements of CAS 409 and FAR 31.205-16.

ASC 360-10-35-17, Property, Plant, and Equipment, Overall, Subsequent Measurement (formerly FASB Statement No. 144, “Accounting for the Impairment or Disposal of Long-Lived Assets”) requires the carrying amount of long-lived assets, such as land, buildings, and equipment, be reduced to fair value when events or circumstances indicate that their carrying amount may not be fully recoverable.

For contract costing purposes, however, contractors are required to follow the provisions of CAS 409, FAR 31.205-11, and FAR 31.205-16 regarding asset valuation and depreciation. Consequently, contractors should only recognize an impairment loss upon disposal of the impaired asset. Until an impaired asset is disposed of, contractors should calculate depreciation based on the asset value before any impairment loss recognized for financial reporting.

Frequently Asked Question

Question 1: What are examples of assets that may be transferred at price as discussed under 19-6.6 Depreciation on Intracompany Transfers of Assets?

Answer: FAR 31.205-26(e) allows for any assets to be transferred at price as long as it is the established practice of the transferring organization to price interorganizational transfers at other than cost for commercial work of the contractor or any division, subsidiary, or affiliate of the contractor under common control and the item being transferred qualifies for an exception under FAR 15-403-1(b) and the contracting officer has not determined the price to be unreasonable.

Exceptions under FAR 15-403-1(b) are:

(1) When the contracting officer determines that prices agreed upon are based on adequate price competition;

(2) When the contracting officer determines that prices agreed upon are based on prices set by law or regulation;

(3) When a commercial item is being acquired;

(4) When a waiver has been granted; or

(5) When modifying a contract or subcontract for commercial items.

Callout

Consistent with those followed in the same cost center for business other than Government - Due to unusual circumstances affecting defense contracts, the contractor's policies and procedures may result in inequitable charges to the Government. If any inequities are found, Headquarters should be advised. (Return)

Capitalized asset cost - The depreciable cost of an asset is different than the capitalized asset cost. The depreciable cost of an asset is its capitalized costs less its estimated salvage (residual) value. See 19.4 for more information on salvage value. (Return)

Schedule M - Schedule M-1, Reconciliation of Income (Loss) per Books with Income per Return has a line item to reconcile the Depreciation expense between the books and the tax return. (Return)

Internal Revenue Code - The IRS regulations which implement Section 167 of the IRC of 1954, as amended, prescribe detailed criteria for determining depreciation costs. Auditors should acquire and maintain a working knowledge of the IRS code and regulations on depreciation. (Return)

mix of work - The auditor should take into account commercial versus government work and the type of contracts (i.e., cost, T&M, fixed). (Return)

capitalized lease assets - The method of accounting for a capital lease differs from that of an operating lease. In an operating lease the lessee assigns rent to the periods benefiting from the use of the asset and ignores, in the accounting, any commitments to make future payments. (Return)

actual useful life of an asset exceeds its estimated useful life and there has been a significant change in Government participation after the asset was fully depreciated - This could result in the Government not incurring its fair share of the cost of the tangible asset in comparison to the use since there is no more depreciation cost being charged/claimed. (Return)

assets disposed - Contractor's property/depreciation records should reveal if a significant amount of assets has been disposed of in a specific accounting period. (Return)

FASB Statement No. 144 - FASB Statement No. 144 (previously FASB Statement No. 121) was effective for fiscal years beginning after December 15, 2001. FASB Statement No. 144 was incorporated into ASC 360-10 for financial statements issued after September 15, 2009. (Return)

Definition

Financial statements - Financial statements are considered to be those statements which are annually certified and distributed to stockholders and others. For companies that are not publicly traded, thus requiring public disclosure of their Financial Statements, the company might need to prepare Financial Statements in accordance with GAAP for the use by prospective investors and/or financial institutions (banks and other lending companies). In the case of small business, it is possible that the company does not have a financial statement or is required to produce such statement. Therefore the company might only keep its accounting records for the purpose of government cost accounting and tax accounting. (Return)

salvage value - The estimated residual value of the owned property at the end of the property's useful life. This can be affected by how the property is used. This should be estimated when the property is first purchased. (Return)

useful life - FAR: 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. (Return)

modified half-year convention - The first-year depreciation allowance for a vintage account is determined by treating: (1) all vintage account property placed in service during the first half of the tax year as placed in service on the first day of the tax year, and (2) all vintage account property placed in service during the second half of the tax year as placed in service on the first day of the succeeding tax year. (Return)

half-year convention - The first year depreciation allowance for a vintage account is determined by treating all property in the account as placed in service on the first day of the second half of the tax year. (Return)

extraordinary retirement - Extraordinary retirements occur when assets are destroyed by fire, storm, or other casualty, or when assets amounting to more than 20 percent of the unadjusted cost or other basis of the entire account are disposed of because business activities are terminated, curtailed, or disposed of. Recognition of gain or loss is in the year of retirement. (Return)

retired - With respect to ordinary retirements (all others), gain or loss is generally not recognized at the time of retirement. The sales proceeds, if any, are added to the depreciation reserve of the vintage account from which the asset is retired, and the depreciation deduction is continued as if all the assets survived for as long as the life assigned to the remaining assets in the group. (Return)

idle facilities - FAR: "Idle facilities" means completely unused facilities that are excess to the contractor's current needs. "Facilities" means plant or any portion thereof (including land integral to the operation), equipment, individually or collectively, or any other tangible capital asset, wherever located, whether owned or leased by the contractor. (Return)

idle capacity - FAR: “Idle capacity” means the unused capacity of partially used facilities. It is the difference between that which a facility could achieve under 100 percent operating time on a one-shift basis, less operating interruptions resulting from time lost for repairs, setups, unsatisfactory materials, and other normal delays, and the extent to which the facility was actually used to meet demands during the accounting period. A multiple-shift basis may be used in the calculation instead of a one-shift basis if it can be shown that this amount of usage could normally be expected for the type of facility involved. (Return)

novation agreements - The transferor guarantees performance of the contract, the transferee assumes all obligations under the contract and the government recognizes the transfer of the contract and related assets. (Return)