



# **MILITARY EQUIPMENT VALUATION & ACCOUNTABILITY**

KNOWLEDGE. CONFIDENCE. TRUST.

## **Military Equipment Valuation and Accountability**

### **Capitalization Threshold for Military Equipment Task 1: “Literature Research and Coordination Efforts”**

**Department of Defense  
Office of the Under Secretary of Defense (OUSD)  
Acquisition, Technology & Logistics (AT&L)**

**December 30, 2008**

## Executive Summary

The Office of the Under Secretary of Defense (Acquisition, Technology and Logistics) (OUSD(AT&L)) Property and Equipment (P&E) Policy Office has engaged in efforts to determine whether the current \$100,000 capitalization threshold for general property, plant, and equipment (GPP&E) should be applied to military equipment (ME) and whether a separate threshold(s) for ME should be implemented. When the \$100,000 capitalization threshold was validated in 1999, ME was not included within the analysis. Accounting standards at that time required ME to be expensed. Since ME was excluded from prior analysis, additional work specific to ME is required to determine an appropriate threshold(s).

Task 1 of the Capitalization Threshold Study involved the following tasks related to provide the P&E Policy Office with the necessary background to develop an approach to analyze ME data and determine an appropriate threshold(s):

1. researching accounting standards,
2. reviewing prior capitalization threshold studies,
3. researching prior performance audits on PP&E Capitalization thresholds,
4. researching management requirements and objectives,
5. researching audit objectives, procedures, and requirements, and
6. discussions with other Federal financial reporting entities.

In summary, we found the following from our literature search and discussions with other agencies:

**Research of accounting standards.** Our research found that accounting standards do not provide specific guidance to assess whether a capitalization threshold is appropriate. Standards require each Federal entity to determine its own appropriate capitalization threshold based on individual financial and operating conditions. The standards do reference that each Federal entity must consider matching and materiality in its determination. Matching requires capitalized assets to be systematically allocated to the periods of benefit through depreciation, amortization, or depletion. Materiality is dependent upon the degree to which omitting an item is likely to change the judgment or a reasonable person relying on the information. Finally, accounting standards state that financial statements should meet the objectives of operating performance and stewardship.

**Review of prior capitalization threshold studies.** Our research into prior capitalization threshold studies validated our research into accounting standards. The prior studies focused on materiality, management information requirements, and cost benefit. They did not identify specific guidelines for establishing capitalization threshold(s) or assessing the reasonableness of established thresholds.

**Research of prior performance audits on PP&E capitalization thresholds.** Similar to our research on capitalization threshold studies, our research of performance audits did not provide direction to evaluate capitalization thresholds. The prior performance audits of capitalization thresholds have been very limited. Government Accountability Office (GAO) and DoD Inspector General (DoDIG) audits of capitalization thresholds do not provide any specific guidance on how to assess the appropriateness of capitalization thresholds for Federal agencies. The basis of prior audit procedures for DoDIG was to test compliance with threshold policies set by each entity.

**Research of management requirements and objectives.** As well as considering the principles of materiality, matching, operating performance, and stewardship, our research on management requirements and objectives determined that entities must also consider cost versus benefit of implementing a threshold. When ME items are capitalized, data must be recorded in fixed asset accounting systems and documentation must be maintained to support audit requirements. In accordance with the cost versus benefit principle, management should consider whether the benefit of capturing low cost items exceeds the costs required to capture the additional data. The cost of the proposed capitalization must be justified prior to implementation.

**Research of audit objectives, procedures, and requirements.** Our review of audit objectives and requirements for capitalization thresholds corroborated the materiality requirements delineated by Federal accounting standards. Requests for change in the capitalization threshold must be supported by an analysis of the underlying data. Capitalization thresholds should consider the impact in changes to the threshold over time. In order to confirm continued relevance, capitalization thresholds should be reevaluated annually. Auditors determine the reasonableness of capitalization thresholds by performing materiality assessments related to the percentage impact change on the Statement of Net Cost if the threshold is adjusted.

**Discussions with other Federal financial reporting entities.** In addition to the research conducted, the P&E Policy Office contacted Federal agencies to document techniques employed, risks identified, and the outcome of their capitalization threshold determination efforts. The discussions with Federal agencies revealed how agencies analyze capitalization thresholds. Agencies that perform analyses on their capitalization thresholds focus on factors such as percentage of assets capitalized based on historical cost, the impact of the proposed threshold on subsequent financial statements based on prior purchasing trends, and statistical extrapolations on the disbursement values and quantities that would be capitalized at various threshold levels. Capitalization threshold analyses performed by other agencies is an ongoing effort that is re-evaluated periodically to confirm that the financial statements are not materially misstated based on the current threshold(s), and the analysis includes all transactional data relating to GPP&E expenditures. Bulk purchase thresholds are implemented in some organizations to prevent the distortion of costs reported in a given period.

The research into the accounting and auditing standards and procedures, as well as the findings from discussions with other Federal agencies, will be considered and factored when developing the approach for the analysis of the ME capitalization threshold(s).

The following document summarizes the research of available literature, studies, audit procedures, and the discussions with other Federal agencies about their capitalization threshold efforts. The findings will be used when developing the approach for performing the analysis (Task 3) to determine a supportable threshold(s) for the ME universe (Task 2).

## Table of Contents

<b>I. Capitalization Threshold Study Overview .....</b>	<b>5</b>
<i>i. Purpose of Task 1 .....</i>	<i>5</i>
<b>II. Literature Search .....</b>	<b>6</b>
<i>i. Accounting Standards.....</i>	<i>6</i>
<i>ii. Review of Prior Capitalization Threshold Studies.....</i>	<i>9</i>
<i>iii. Prior Performance Audits of PP&amp;E Capitalization Thresholds .....</i>	<i>11</i>
<i>iv. Research on Management Requirements/Objectives.....</i>	<i>12</i>
<i>v. Audit Objectives, Procedures, and Requirements .....</i>	<i>13</i>
<b>III. Discussions with Other Agencies .....</b>	<b>15</b>
<i>i. Synopsis of Survey Responses and Discussions .....</i>	<i>15</i>
<b>IV. Conclusion .....</b>	<b>17</b>

## **I. Capitalization Threshold Study Overview**

The current capitalization threshold of \$100,000 for GPP&E was established by the Department of Defense (DoD) in 1996. It paralleled the expense/investment threshold used by the Congress for distinguishing DoD operating (expense) and procurement (investment) appropriations. A detailed analysis was later performed in FY1999 to validate the adequacy of the GPP&E threshold. At that time, ME was not required to be capitalized and reported on the financial statements. ME was not included in the capitalization threshold analysis.

### ***i. Purpose of Task 1***

The purpose of Task 1 is to document information obtained through literature research (e.g., accounting standards, audit requirements, and prior studies) and coordination efforts with other Federal agencies on capitalization threshold(s) analyses. The information included in this document will be used to develop the approach for analyzing the ME universe currently reported by the DoD and for determining an adequate capitalization threshold(s) for DoD ME.

## II. Literature Search

A detailed literature search was completed on capitalization threshold(s) for PP&E. This research included a review of literature within the following areas:

- i. accounting standards,
- ii. review of prior capitalization threshold studies performed by DoD,
- iii. prior performance audit reports on PP&E capitalization thresholds,
- iv. research on management requirements/objectives, and
- v. audit objectives, procedures and requirements.

In addition to the literature search, discussions were held with other Federal agencies regarding their capitalization threshold policies and procedures. Agencies completed a survey and participated in meetings to discuss their threshold work. They provided information regarding how they established their current threshold(s) for GPP&E, how they performed their analyses, what factors or conditions were included in their analyses, and what types of findings resulted from audits relating to their capitalization threshold(s) policies. A detailed summary of these discussions and results from the survey can be found in Section III of this document.

The results of the literature search and its application to the DoD's ME capitalization threshold study are summarized below.

### ***i. Accounting Standards***

Federal accounting standards serve as the Generally Accepted Accounting Principles (GAAP) for Federal entities. The Federal Accounting Standards Advisory Board (FASAB) is the authoritative body related to the issuance of Federal accounting standards and is responsible for promulgating these standards via Statements of Federal Financial Accounting Standards (SFFAS), Interpretations, and Technical Bulletins. In the absence of a relevant Federal pronouncement, accounting standards and literature for other types of entities, such as commercial companies and state and local governments, may be considered.

#### **A. Federal Accounting Standards**

The FASAB issued SFFAS No. 6 in June 1996. SFFAS No. 6 requires Federal entities to establish their own capitalization threshold(s) and serves as the basis for considering DoD's particular financial and operational conditions in establishing an appropriate capitalization threshold(s). Specifically, paragraph 13 of SFFAS No. 6 states, "*the Board believes that capitalization thresholds should be established by Federal entities rather than centrally by the Board. Because Federal entities are diverse in size and in uses of PP&E, entities must consider their own financial and operational conditions in establishing an appropriate capitalization threshold or thresholds.*"

Once established, the threshold(s) should be consistently followed and disclosed in the financial reports. The standards are silent as to how capitalization thresholds should be established and the characteristics of supportable and defensible thresholds. However, the standards do require Federal entities to consider matching and materiality when establishing a capitalization threshold(s). The requirements are as follows:

#### **1. Matching Principle**

Accounting for PP&E is based on the matching principle. The broader definition views the concept of matching as encompassing allocations of costs using systematic and rational procedures. Matching recognizes the direct relationship between costs and revenues while also recognizing the perceived indirect relationships between costs and specific accounting periods. The proper matching or allocation of the cost of using PP&E contributes to meeting the objective of accurate performance management.

According to paragraph 17 of SFFAS No. 6, PP&E that meets the following criteria must be capitalized if:

- It has an estimated useful life of 2 years or more,
- It is not intended for sale in the ordinary course of business,
- It is acquired or constructed with the intention of being used or being available for use by the entity, and
- It exceeds the capitalization threshold.<sup>1</sup>

In accordance with the matching concept, the costs of assets that meet these criteria are systematically allocated to the periods of benefit through depreciation, amortization, or depletion.<sup>2</sup> Assets that meet the first three criteria but have a value below the capitalization threshold (immaterial assets) are expensed in the year acquired. Accounting standards, such as the matching concept, do not need to be applied to immaterial items.<sup>3</sup>

## 2. Materiality

Federal entities must also consider materiality, in addition to matching, when assessing capitalization threshold(s). In defining materiality, paragraph 13 of SFFAS No. 1 states, “*the determination of whether an item is material depends on the degree to which omitting or misstating information about the item makes it probable that the judgment of a reasonable person relying on the information would have been changed or influenced by the omission or the misstatement.*”<sup>4</sup> In the context of capitalization thresholds, materiality is applied in terms of the financial statements. A decision not to disclose certain financial information may be made because report users may not have a need for specific information or because the amounts involved are immaterial to decision-makers. When management is defining materiality to establish a capitalization threshold there are several factors to consider.

Management must first determine the level of reporting at which the financial statements will be presented. Financial statement materiality should be established at the lowest level of reporting. By considering the potential uses at the lowest level, management will have a more accurate grasp of how a capitalization threshold impacts financial information furnished to financial statement users.

Further, management should determine the impact that a selected capitalization threshold will have on the financial statements. In order to determine the consequences of a proposed threshold on financial statements a Federal entity should weigh the repercussions of not capitalizing assets below the threshold on both (1) the overall value of capitalized general PP&E

---

<sup>1</sup> Paragraph 060104 of DoD Financial Management Regulation Volume 4, Chapter 6, “*Property, Plant, and Equipment.*”

<sup>2</sup> Paragraph 35 of SFFAS No. 6, “*Accounting for Property, Plant, and Equipment.*”

<sup>3</sup> Paragraph 15 of SFFAS No. 6, “*Accounting for Property, Plant, and Equipment.*”

<sup>4</sup> Paragraph 13 of SFFAS No. 1, “*Accounting for Selected Assets and Liabilities.*”

in relation to the entity's total assets and (2) the value of expensed PP&E and depreciation expense in relation to the total expenses of the entity. In relation to financial statements and materiality, management must examine a capitalization threshold's impact on reported total assets, total expenses, and net cost of operations. Also, management ought to consider the effect of a capitalization threshold on future years' financial statements, particularly if PP&E acquisitions are unpredictable or fluctuate significantly.

Management should also consider how the adjustments in the threshold impact other information users. A capitalization threshold that satisfies financial statement requirements may provide inadequate detail for other information users. As stated in Note 26 of SFFAS No. 6, "*for the purpose of record keeping, greater detail may be necessary to maintain accountability for PP&E so that assets can be safeguarded against lost, theft, misappropriation, etc.*" The standard elaborates that this does not necessarily require that accounting systems and property records follow the same level of detail. Management should consider how the revised capitalization threshold will impact reporting of required supplemental information (e.g., Deferred Maintenance or Environmental Liabilities).

Although there is little specific guidance relative to the level of misstatement that is tolerable (material) for government financial reporting purposes, the GAO Financial Audit Manual (FAM) does specify that auditors generally should set planning materiality at 3% of the related materiality base. Our capitalization threshold analyses will consider this guideline, combined with continuing discussions with the audit community, to determine an adequate and supportable capitalization threshold(s) for DoD ME.

### 3. Reporting Objectives for Federal Financial Statements

In addition to matching and materiality, paragraph 9 of SFFAS No. 6 identifies two financial reporting objectives, "Operating Performance" and "Stewardship," that have particular relevance to PP&E.

The operating performance objective is achieved by assisting report users in evaluating the service efforts, costs, and accomplishments of the reporting entity; the manner in which these efforts and accomplishments have been financed; and the management of the entity's assets and liabilities. Relative to operating performance, financial reporting should provide:

- relevant and reliable cost information for decision-making by internal users (e.g., program managers, budget examiners, and officials);
- comprehensive, comparable cost information for decision-making and program evaluation by Congress and the public; and,
- information to help assess the efficiency and effectiveness of asset management (e.g., condition of assets including deferred maintenance).

The stewardship objective is achieved by assisting the report user in assessing how the impact of the government's operations and investments on the country for the period and how the government's and the nation's financial conditions have changed and may change in the future. Relative to stewardship, financial reporting should provide:

- asset condition,
- changes in the amount and service potential of PP&E,
- cost of PP&E where applicable, and
- spending for acquisition of PP&E versus non-capital spending.

Achievement of operating performance and stewardship objectives has important managerial implications. According to SFFAS No. 4, accurate *“cost information can be used by the Congress and the Federal executives in making decisions about allocating Federal resources, authorizing and modifying programs, and evaluating program performance. The cost information can also be used by program managers in making managerial decisions to improve operating economy and efficiency.”*

#### B. Other Accounting Standards

The accounting standards setting body for state and local governments, the Government Accounting Standards Board (GASB), allows government organizations to individually establish threshold policies as stated in GASB Statement 34, paragraph 115e. This policy is similar to SFFAS No. 6.

The Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB), which promulgates GAAP for commercial entities, has not established capitalization threshold standards. In an FY2005 FASB board meeting, members discussed and rejected establishing a threshold standard. Commercial entities capitalize personal property regardless of its value, according to the International Accounting Standards (IAS) 16, which states that the cost of a PP&E item shall be recognized as an asset if it is probable that future economic benefits associated with the item will flow to the entity and the cost of the item can be measured reliably.<sup>5</sup>

The literature research did not uncover any additional capitalization threshold policies. The Office of Management and Budget (OMB), DoD Financial Management Regulation (FMR), and Federal codes, laws, and regulations incorporate FASAB standards in their entirety.

#### **1. Application to Current Study:**

**The proposed threshold(s) for DoD ME must consider accounting and auditing standards relating to matching, materiality, cost/benefit, operating performance, and stewardship objectives.**

**Statistical extrapolation and stratification analyses can be performed to assess how various threshold decisions would affect amounts capitalized over time and can be used to confirm that the recommended capitalization threshold(s) comply with these standards.**

#### ***ii. Review of Prior Capitalization Threshold Studies***

OUSD (Comptroller (C)) and OUSD (AT&L) P&E Policy Office have performed capitalization threshold studies of personal property and a limited study on ME. Prior to issuance of SFFAS No. 6, DoD’s capitalization threshold level for personal property was the same as the expense/investment threshold used by Congress to differentiate between items that would be purchased with Operations and Maintenance (O&M) funding (expenses) and those that would be purchased with Procurement funding (investments). The thresholds were \$5,000 prior to FY1994, \$25,000 in FY1994, \$50,000 in FY1995, and \$100,000 from FY1996 through the

---

<sup>5</sup> Paragraph 7 of IAS 16, “Property, Plant, and Equipment.”

current period. The expense/investment threshold increased to \$250,000<sup>6</sup> in FY2003, while the capitalization threshold remains at \$100,000.

In response to SFFAS No. 6, Federal agencies, including DoD, initiated studies to assess whether their capitalization thresholds were appropriate. However, ME was excluded from these reviews. A summary of the methodologies employed and results of the reviews are provided below:

A. Phase II - Personal Property Capitalization Threshold and Useful Life Analysis (1999)

The OUSD(C) FY1999 Capitalization Threshold Study<sup>7</sup> analyzed the effects of using the \$100,000 personal property threshold on the unaudited FY1998 financial statements for major DoD components, the Defense Finance and Accounting Service (DFAS), and the Defense Logistics Agency (DLA). The analysis compared personal property purchases during FY1998 to amounts expensed (less than \$100,000) using 3% and 6% materiality calculations. Both materiality rates were used to assess the impact of the new threshold on total assets and the total cost of operations. The methodology employed a common framework (Phase I)<sup>8</sup> created by OUSD(C), which considered reliability of financial reporting, materiality, and cost versus benefit. The study concluded that there was no material financial statement misstatements based on the materiality percentages.

B. DoD Capitalization Threshold Presentation to Deputy Chief Financial Officer (DCFO) (2003)

In March 2003, as a part of revalidation efforts, OUSD(AT&L) performed research into the capitalization threshold based on prior studies and an FY2002 GAO audit. Final recommendations suggested that the Department improve systems to capture transactional-level detail for analyzing the appropriateness of the threshold, engage the audit community, and perform a new study that would include ME.

C. Study of the Capitalization Threshold for DoD GPP&E (FY2007)

The OUSD(AT&L) P&E Policy Office performed an internal threshold study in FY2007 to determine if the current threshold level was supportable. They performed an analysis of items costing less than \$100,000 to determine if their omission from the financial statements would materially impact the Balance Sheet or Statement of Net Cost.

The FY2003 GPP&E budget appropriations for each Military Component, as shown in the FY2005 budget, were used to perform the analysis. The results revealed that Army PP&E items less than \$100,000 represented 6.7% of the PP&E value. However, the impact of actual net cost on the Statement of Net Cost was less than 1%.

---

<sup>6</sup> In FY2003, the expense/investment threshold was raised from \$100,000 to \$250,000 (Consolidated Appropriations Resolution 2003, Sec. 106 of P.L. 108-7 or USD(C) memo dated March 11, 2003).

<sup>7</sup> OUSD(C) Capitalization Threshold Study, "*Phase II-Personal Property Capitalization Threshold and Useful Life Analysis*," dated September 13, 1999.

<sup>8</sup> OUSD(C) Capitalization Threshold Study, "*Phase I-Common Framework*," dated August 31, 1999.

**2. Application to Current Study:**

**In prior capitalization threshold studies, factors considered in threshold recommendations were reliability of financial reporting, materiality, and cost versus benefit. These factors will be applied to the ME threshold study. The ME study will:**

- **analyze the ME dollars and items captured at various threshold levels.**
- **analyze the impact on financial statement GPP&E lines, total assets, and cost of operations of selected capitalization thresholds.**
- **determine the impact on subsequent financial statements.**
- **determine whether the impact of changes to financial statements caused by changes in the capitalization threshold is material.**

***iii. Prior Performance Audits of PP&E Capitalization Thresholds***

**A. GAO Report (2002)**

In FY2002, GAO conducted a survey<sup>9</sup> on the capitalization threshold policies for PP&E at 14 Federal government agencies and 12 private sector companies. The survey was designed to identify the Federal agencies' capitalization threshold policies for PP&E and compare those policies to the private sector. The purpose was not to review the adequacy of the Federal capitalization thresholds. The DoD PP&E policies were not included in the survey.

The survey states that the capitalization threshold levels at the Federal agencies are significantly higher than those reported by the private sector companies in the survey. Reported Federal capitalization threshold levels range from \$3,000 to \$250,000, compared with \$0 to \$5,000 for private sector entities. Operating differences and financial incentives between the Federal government, the private sector, and various Federal agencies may account for the different threshold levels. Although GAO did not perform a financial analysis, they state that high capitalization threshold levels may have a significant impact on the government's consolidated financial statements. High thresholds have the potential to reduce the amount of assets that are capitalized on the financial statements and negate the matching of costs to the period the asset is utilized.

The survey performed by GAO implies that capitalization threshold amounts for equipment should be similar among Federal agencies and between Federal agencies and private sector companies. The recommended parity in equipment threshold amounts does not consider the organizational differences specifically recognized by FASAB. For example, the capitalization policies of private sector companies are frequently based off the requirements of the tax code, and financial statements developed by Federal entities do not support investment decisions.

Consideration should be given to the fact that the value of government PP&E, specifically within DoD, tends to be much higher than that of private sector companies. As required by SFFAS No. 6, financial and operational requirements of individual Federal entities must be considered in determining the threshold level.

---

<sup>9</sup> GAO "Survey of Capitalization Threshold and Other Policies for Property, Plant, and Equipment," dated October 2002.

**B. DoD Inspector General (DoDIG) Capitalization Reports and Related Audit Findings**

The DoDIG has not performed any specific audits to determine the adequacy of the Department's capitalization threshold policies. Two audits were performed in FY1996 and FY1997 to determine whether the capitalization threshold was being applied correctly to personal property and fixed asset values, respectively. Audit results from the FY2008 U.S. Air Force and U.S. Special Operations Command valuation audits included findings regarding improperly capitalized assets based on the current capitalization threshold policy. A synopsis of these audit findings are stated below:

- Report No. 96-212 - *“Capitalization of DoD GPP&E.”* DoD Components capitalized and retained in their financial records low-cost items below the current capitalization threshold (\$100,000). Therefore, \$9.6 billion reported in FY1995 is of limited utility for financial management purposes.
- Report No. 97-107 - *“Defense Contract Management Command (DCMC) Capitalization of Fixed Assets.”* DCMC did not capitalize \$6.3 million in fixed assets for financial statement reporting according to established capitalization criteria.
- Report No. D-2008-074 - *“Memorandum Report on Internal Controls over the Air Force ME Baseline Effort.”* Six of the 36 F-16 modification programs did not exceed the capitalization threshold and should not have been capitalized.
- Report No. D-2008-103 - *“Memorandum Report on the Internal Control over the U.S. Special Operations Command ME Baseline Effort.”* The Raven Unmanned Aircraft System was granted a price waiver because it was below the \$100,000 capitalization threshold; however, unit costs were determined to be \$168,000, which is above the threshold.

The DoDIG did not state agreement with the current capitalization threshold. The basis of the audit procedures was to test compliance with threshold policies. In Task 4 of the study, the P&E Policy Office will brief the DoDIG on procedures performed to determine the proposed threshold in order to obtain continued support.

**3. Application to Current Study:**

**Audit coverage relating to the capitalization threshold for ME has been limited.**

**The FY2002 GAO report relating to capitalization thresholds did not consider DoD assets. In addition, this report did not contain specific recommendations relative to how to determine an acceptable capitalization threshold. The DoDIG will be briefed on procedures performed to determine the proposed capitalization threshold.**

***iv. Research on Management Requirements/Objectives***

Program managers perform various acquisition life cycle actions, such as procurements, modifications, and disposals, which impact the value of ME. When the affected ME items are required to be capitalized according to the accounting standards, data must be recorded in fixed asset accounting systems and documentation must be maintained in order to support management actions. The proposed capitalization threshold level becomes extremely important

since new information technology, data retention, and electronic and manual control requirements could be costly and cumbersome to maintain.

Modifications to the capitalization threshold will require additional effort by the program office. For instance,

- If the capitalization level is increased, information technology and accounting systems must track all transactions, regardless of acquisition value, to demonstrate that over time the capitalization threshold policy is still valid and meets accounting, audit, and management objectives.
- If the threshold is lowered, system upgrades to capture logistics data such as asset service lives, placed in service dates, asset deliveries, and statuses may be required. Most low cost programs (i.e., Acquisition Category (ACAT) 3 and 4) are not centrally managed by a program management office. If program assets are required to be tracked for financial reporting purposes, personnel, processes, and controls must be put in place to account for necessary information.

Additionally, the National Archives and Records Administration (NARA) has stringent requirements to maintain data. Documentation in electronic or hardcopy formats could be held in storage for six or more years. Internal control activities will intensify to accommodate the increases in workload to comply with the Federal Manager's Financial Integrity Act (FMFIA) and OMB A-123 internal control policies.

The cost of the proposed capitalization threshold must be justified prior to implementation. The relationship between the cost of financial information and resulting benefits should be considered in terms of the financial statements and the level at which they are prepared.

#### **4. Application to Current Study:**

**Prior to proposing a final ME threshold(s), tests should be performed to confirm that the threshold(s) will be cost effective to maintain and that the threshold(s) meet management objectives.**

#### ***v. Audit Objectives, Procedures, and Requirements***

Auditing standards do not address the auditing of capitalization thresholds. For further information, the P&E Policy Office contacted several senior level auditors to gather information regarding how to assess the adequacy of capitalization thresholds. These individuals provided insight into procedures that might be used or considered when auditing thresholds.

The discussions validated information found during the literature research. The techniques used by the auditors to assess the reasonableness of the proposed thresholds varied. However, a number of factors were consistent:

- First, the request for a change in capitalization threshold must be supported by a detailed and complete analysis of the underlying data. Statistical analyses and sampling can be used.
- Second, materiality is an important factor. The percentage of assets excluded from capitalization and the impact on the Statement of Net Cost must not be material.

- Third, the use of expenditures/transactional level data to establish a capitalization threshold is preferable to the use of budget data.
- Fourth, capitalization threshold reviews should consider the impact in changes to the threshold over time. These tests are performed in the current period and projections are made on future years to determine percentage changes on out-years, as determined based on the useful lives of the equipment.
- Fifth, capitalization thresholds should be reevaluated each year to confirm their continued relevance.
- Finally, auditors determine the reasonableness of capitalization thresholds by performing materiality assessments related to the percentage of assets capitalized and the percentage impact change on the Statement of Net Cost if the threshold is adjusted.

**5. Application to Current Study:**

**Specifically, the study will:**

- **employ statistical analysis and sampling to analyze the underlying ME data, including acquisition values and useful lives, to determine an appropriate threshold(s).**
- **research the availability and applicability of ME expenditures/transactional level data to support threshold analysis.**
- **perform sensitivity analyses to determine the impact of various thresholds over time, in the current period and in out-years.**
- **perform materiality assessments to determine the reasonableness of various thresholds based on the percentage of assets capitalized and the percentage impact change on the Statement of Net Cost at those threshold levels.**

### III. Discussions with Other Agencies

As part of the Task 1 literature research, the P&E Policy Office contacted six Executive Branch agencies that had significant amounts recorded on their financial statements for PP&E. Each agency was contacted to obtain information on the process used to develop and/or establish a capitalization threshold(s) for PP&E.

The agencies contacted included:

- National Aeronautics and Space Administration (NASA)
- Department of Interior (DOI)
- General Service Administration (GSA)
- Department of Homeland Security (DHS)/Federal Aviation Administration (FAA)
- Environmental Protection Agency (EPA)
- National Oceanic and Atmospheric Administration (NOAA)

#### *i. Synopsis of Survey Responses and Discussions*

In summary, the responses to the surveys provided by those agencies found that:

- Management must consider:
  - the percentage of asset values and items capitalized under the threshold(s),
  - what effect the threshold(s) have on financial statements, and
  - the administrative burden associated with the established threshold(s).
- Capitalization thresholds vary among the agencies, as shown below:

<b>Department/Agency</b>	<b>Personal Property</b>	<b>Software</b>
DoD	\$100,000	\$100,000
NASA	\$100,000	\$1,000,000
NOAA	\$200,000	\$200,000
FAA	\$100,000 / \$25,000 <sup>10</sup>	\$200,000
DHS/Coast Guard	Various <sup>11</sup>	\$200,000
GSA	\$10,000	\$1,000,000/\$250,000
EPA	\$25,000	\$100,000

- Capitalization thresholds at some agencies were established over ten years ago. Of the surveys received:
  - One agency just completed a review and deemed the current threshold appropriate.
  - One agency recently completed a review of its threshold and raised it as a result.
  - One agency plans on completing a review within the next year (FY2009).
  - Two agencies have no current plans to complete a review.
- One agency established a bulk purchase threshold to confirm that the purchase of a large quantity of items, each costing less than the capitalization threshold, would not distort the amount of costs reported in a given period.

---

<sup>10</sup> For assets placed in service 10/1/2008, there is a \$100,000 threshold. For assets placed in service 9/30/08 and prior, there is a \$25,000 threshold.

<sup>11</sup> Thresholds range from \$50,000 (boats) to \$200,000 (aircraft).

- Two agencies experienced marked reductions in the number of items processed for financial reporting annually. One of these agencies established a threshold that includes “a significant portion of personal property.” The agency deemed the significant percentage to be 70% of the value of property, which reduced the number of items tracked by about 68%. The agency considered this a reasonable percentage.
- All organizations surveyed had differing thresholds for property accountability and financial accounting.
- All survey respondents expressed that thresholds were established based on thorough and appropriate analyses.
- None of the respondent agencies had issues raised by internal or external auditors. One audit comment stated that the threshold should be reviewed every five years.

**6. Application to Current Study:**

**The study will analyze the following factors to determine an appropriate capitalization threshold(s):**

- **the percentage of asset values and items capitalized under the threshold(s),**
- **the effect of the threshold(s) on financial statements, and**
- **the administrative burden associated with the established threshold(s).**

## IV. Conclusion

### A. Complying with Policy

Guidance does not specify how to establish capitalization thresholds or identify procedures for auditing them. The accounting standards allow entity management to set their own capitalization thresholds since each organization is different and an adequate threshold for one entity is not necessarily applicable to another. Organizations must consider whether operating performance and stewardship requirements will be impacted as a result of a revised threshold. The threshold(s) must adequately match expenses with benefiting periods.

Accounting policies state that a materiality determination should be made prior to a decision to omit certain information from the financial statements. If the capitalization threshold for ME is adjusted in a manner which lowers the ME values reported in the financial statements, a diligent analysis must be performed to confirm that omitted information will not significantly or materially impact the decisions of financial statement users.

### B. Making Rational Decisions

Cost benefit should be taken into consideration prior to revising the ME threshold. Increased costs to record, track, and control additional assets that would result from a lower threshold should not exceed benefits of capturing this information.

### C. Leveraging Prior Studies and Data from Other Organizations and Auditors

A significant portion of efforts to make the capitalization threshold supportable and defensible to internal and external decision makers involves detailed analyses of ME financial values. The analysis should result in a capitalization threshold that captures significant ME values (i.e., excludes immaterial items), includes all necessary information that financial statement users require, and will withstand scrutiny from auditors. This can be achieved by performing detailed sensitivity, statistical, and extrapolation analyses.

Information obtained from prior capitalization threshold studies, coordination with other Federal agencies, and discussions with auditors will be utilized to structure the ME analysis.

In structuring the ME capitalization threshold analysis, techniques identified in research and coordination efforts will be applied as stated below:

- *Create a Comprehensive ME Universe.* The ME universe will be created based on data contained in the Capital Asset Management System – Military Equipment (CAMS-ME) and the current definition of ME. The universe will be compared to supporting data to confirm accuracy and completeness.
- *Analyze and Synthesize Universe Data.* The ME universe will be sorted and separated into cohorts based on a range of values (e.g., ME values between \$100,000 and \$125,000) for further analysis.
- *Determine ME Values and Number of Items Captured at Various Thresholds.* After the ME universe has been placed in cohorts, the total value and number of items will be determined for each. Concentrated analyses will be performed in cohorts where the potential threshold(s) will lie.
- *Measure Impact of the Proposed Threshold(s) on Financial Statement Line Items.* The impact of the proposed threshold(s) will be measured against financial statements. The value of non-capitalized ME as a result of the proposed threshold(s) will be applied to the

GPP&E, total assets, and cost of operations line items to determine whether these items are immaterial.

- *Measure the Impact of the Proposed Threshold(s) on Future Financial Statements.* The proposed threshold(s) will be projected several years into the future to assess the impact on prospective financial statements.
- *Identifying Cost versus Benefit of Implementing the Proposed Threshold(s).* An increase or decrease in efforts required to administer the proposed threshold will be assessed (For example, a hypothetical increase in the capitalization threshold by \$25,000 could result in a reduction in transactions captured by the fixed asset accounting system by 500 transactions.). Additional asset values capitalized as a result of a lower threshold should not exceed the benefits of capturing this information.

The Department should leverage this document as well as the information obtained from other agencies and auditors. This will help DoD strengthen their analysis and produce a defensible and supportable threshold(s) for ME.