

Summary of Business Rules for Accounting for and Reporting of Military Equipment

Componentization

Objective

- Provide guidance on accounting for end items and components of end items in a manner consistent with the provisions of the Statement of Position issued by the Accounting Standards Executive Committee of the American Institute of Certified Public Accountants entitled, *Accounting for Certain Costs and Activities Related to Property, Plant, and Equipment*.

Baseline Valuation Methodology

- Capitalize the full cost of an end item (functional unit) without attempting to segregate and value components.

Mid-Term Valuation Methodology

- Generally capitalize the full cost of a functional unit (e.g., aircraft).
- With DoD concurrence to ensure financial reporting consistency, allow Military Department management to componentize below the functional unit level.
- Where the componentization option is selected, the decision should be based on the following criteria: (1) the subpart is acquired through a separate program, (2) the estimated cost of the subpart is significant in relation to the estimated cost of the end item, (e.g., 20 percent), and (3) the estimated useful life of the subpart differs significantly from the estimated useful life of the end item (e.g., 20 percent).

Military Equipment Valuation Project

Position Paper: Componentization

Description of Issue

Military equipment acquisition often involves bringing together many separate distinguishable parts for the purpose of producing a fully functional end item.¹

Statement of Federal Financial Accounting Standards (SFFAS) No. 6, *Accounting for Property, Plant, and Equipment*, paragraph 35, provides that property, plant, and equipment (PP&E) should be depreciated through the systematic and rational allocation of the cost of general PP&E over the estimated useful life of the general PP&E. It further provides that estimates of useful life should consider factors such as physical wear and tear and technological change and that the depreciation method should best reflect the use of the PP&E. This SFFAS does not address component accounting.

Recently, the Accounting Standards Executive Committee (AcSEC) of the American Institute of Certified Public Accountants issued a Statement of Position (SOP) entitled “Accounting for Certain Costs and Activities Related to Property, Plant, and Equipment.” The Financial Accounting Standards Board (FASB) has placed this SOP on its April 2004 agenda for clearance.² The SOP provides the following framework for accounting for PP&E:

- PP&E consists of one or more components that should be recorded at cost;
- PP&E should be depreciated over its expected useful life;
- The costs of a replacement PP&E component and the component replaced should not concurrently be recorded as PP&E.

Paragraph 49 of the SOP points out that a PP&E asset is often comprised of multiple parts or portions that may require replacement before the asset

¹ An End Item is the final production product when assembled, or completed, and ready for issue/deployment. Defense Systems Management College – Glossary, *Defense Acquisition Acronyms and Terms*, Ninth Edition, November 1998.

² If the FASB modifies the AcSEC SOP in the clearance process, the PP&E Program Office will modify this business rule as necessary to bring it into conformity with the provisions of the FASB adopted document.

reaches the end of its useful life. The SOP defines a component as a tangible part or portion of PP&E that (1) management has elected to account for separately as an asset and (2) is expected to provide economic benefit for more than one year.

Paragraph 49 further provides that management should establish a component accounting policy, which determines the level of component accounting, and apply it consistently. The determination of the level of component accounting should be based on management's discretion and judgment, subject to the **functional unit** "ceiling" discussed in paragraph 50 of the SOP.

Paragraph 50 of the SOP defines a PP&E asset as a combination of distinguishable parts that, working together, provide the functional use for that PP&E asset as a whole. The SOP defines the combination of distinguishable parts as a **functional unit**³ and limits an entity's level of component accounting to no higher than the functional unit level. A rebuttable presumption exists that items that are physically detached from other items are not part of another functional unit.

Paragraph 51 provides that component identification should occur at the time of acquisition or construction. The costs assigned to components should be based on specific identification. If specific identification is not practicable, capitalized costs should be allocated to individual components based on relative fair value when the asset is placed in service. If allocation based on relative fair value is not practicable, such capitalized costs should be allocated based on another reasonable method as appropriate under the circumstances.

The SOP provides that in order for a replacement to be capitalized, the replaced item needs to have been previously accounted for as a component. If the entity replaces part or portion of a PP&E asset that previously had not been accounted for as a separate component, the replacement should be charged to expense.

³ The SOP's Glossary provides an example of a functional unit. An airplane would be considered a functional unit as its distinguishable parts work together to provide air transportation, whereas the airplane's airframe, engines, interiors, and in-flight electronic equipment do not, acting alone, provide air transportation.

Proposed Policy

DoD will generally capitalize the full cost of a functional unit. Acquisition Program Managers or other acquisition officials should define the functional unit prior to the production phase of an acquisition program. With DoD concurrence to ensure financial reporting consistency, Military Department management may capitalize subparts of functional units as components when:

- The subpart is acquired through a separate acquisition program;
- The estimated cost of the subpart is significant in relation to the estimated total cost of the end item, (e.g. 20 percent); and
- The estimated useful life of the subpart differs significantly from the estimated useful life of the end item (e.g., 20 percent).

Each separately capitalized component should be identified with the associated end item in the accounting system through a parent-child identification mechanism.

If a DoD Component elects not to apply component accounting to a specific PP&E asset, and thus not to separately account for components at a level lower than the functional unit, any subsequent replacement of any part or portion of that asset, other than the entire asset (functional unit), should be considered repairs and maintenance and should be expensed as incurred.

Authoritative Guidance

Statement of Federal Financial Accounting Standards No. 6, *Accounting for Property, Plant, and Equipment*, issued by the Federal Accounting Standards Advisory Board

Statement of Position (SOP), *Accounting for Certain Costs and Activities Related to Property, Plant, and Equipment*, issued by the American Institute of Certified Public Accountants, Accounting Standards Executive Committee