OFFICE OF THE SECRETARY OF DEFENSE

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June 8, 2005

MEMORANDUM FOR ASSISTANT SECRETARY OF THE ARMY (FINANCIAL MANAGEMENT AND COMPTROLLER)
ASSISTANT SECRETARY OF THE ARMY (ACQUISITION, LOGISTICS AND TECHNOLOGY)
ASSISTANT SECRETARY OF THE NAVY (FINANCIAL MANAGEMENT AND COMPTROLLER)
ASSISTANT SECRETARY OF THE NAVY (RESEARCH, DEVELOPMENT AND ACQUISITION)
ASSISTANT SECRETARY OF THE AIR FORCE (ACQUISITION)
DIRECTORS OF THE DEFENSE AGENCIES
USSOCOM, DIRECTOR OF SORR – J8
USSOCOM, OFFICE OF ACQUISITION EXECUTIVE

SUBJECT: Military Equipment Valuation Project Business Rules

Statement of Federal Financial Accounting Standards (SFFAS) No. 23, "Eliminating the Category National Defense Property, Plant and Equipment" (ND PP&E) dramatically changed financial reporting requirements for the Department of Defense. The reporting standard reclassified ND PP&E as military equipment and required that these assets be capitalized rather than expensed. This represented a major challenge for the Department. Military equipment had been acquired over the past 50 years and the primary focus had been on tracking and ensuring asset operability rather than on reporting asset values. No auditable valuation information existed.

To meet this challenge the Department developed a valuation methodology that used a combination of budgetary and expenditure information. Related business rules were established to help ensure consistent application of the methodology, compliance with the auditing standards, and auditability of the results. The attached business rules are principle based and track directly to the accounting standards. Their development involved iterative efforts, which addressed issues raised by Department of Defense Components and the audit community.

The military equipment valuation process consists of two phases and the business rules that apply to the two phases are slightly different. The first phase involves the development of an opening inventory of military equipment (the baseline). The business rules for this phase were modified to recognize the flexibility included in the new accounting standard and the limitations of the historical data. The second phase applies to acquisitions that occur after the baseline has been established. The related business rules anticipate better availability of accounting data.

The initial baseline phase, which is scheduled to be completed by the end of fiscal year 2006, is being managed by the Under Secretary of Defense Acquisition, Technology and Logistics, Property and Equipment Policy Office. This Office is using the "Baseline" rules to establish initial values. The "Mid-Term" business rules will be applied to acquisition occurring in fiscal year 2007 and beyond. The attached summary compares the "Baseline" and "Mid-Term" versions of the business rules.

We are in the process of incorporating the Baseline rules into the Financial Management Regulation. In addition the attached Mid-Term rules are being distributed in their entirety, with the associated rationale and source material, to assist Components in understanding the military equipment valuation effort.

If you have any questions, or need additional information, please contact Mr. Richard K. Sylvester. He can be reached on 703-604-6350 ext 121.

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Terri McKay
Deputy Chief Financial Officer
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Attachments:
As Stated

cc: DoD OIG

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

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

The enclosed summary and business rules describe the approach that the Department plans to implement for valuing military equipment. The approach consists of a Baseline Valuation Methodology for valuing military equipment as of September 30, 2006 and a Mid-Term Valuation Methodology for maintaining the baseline valuation and accounting for and reporting of post-baseline acquisitions, modifications, and other events.

Baseline Valuation Methodology

The Baseline Valuation Methodology will be applied to determine the value of all military equipment in place and related work-in-process as of September 30, 2006. These values will serve as the initial baseline for financial reporting purposes. Because of the limitations of existing Department systems, the methodology will focus on valuing acquisition programs to derive the value of end items of military equipment and work-in-process.

Mid-Term Valuation Methodology

The Mid-Term Valuation Methodology recognizes that implementation of the business rules will require changes to current Department processes and systems. The Property, Plant, and Equipment (PP&E) Policy Office has a comprehensive effort underway to identify and describe these changes and to provide an effective transition plan. The Mid-Term Valuation Methodology will focus on valuing individual end items of military equipment and work-in-process on a transaction-level basis.

The Mid-Term Valuation Methodology Business Rules will remain in effect until implementation of the Department's Business Enterprise Architecture (BEA). The PP&E Policy Office is working with the Business Management Modernization Program to ensure that these rules are included in the BEA as appropriate.

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

Full Cost

Objective

- Prescribe the costs that must be included in arriving at the full cost of an end item in accordance with the requirements of Statement of Federal Financial Accounting Standards No. 6, *Accounting for Property, Plant, and Equipment.*

Baseline Valuation Methodology

- Obtain the acquisition cost of programs to date and planned number of end items using the following:
  - For programs in which production of end items has been completed, obtain actual acquisition costs and actual end items delivered from the accounting systems and accountability systems, respectively. If accounting data are no longer available or if retrieval is not practical, other sources such as budget information may be used.
  - For programs in the production phase for which there is considerable production and cost experience and for which there is evidence of program cost stability, obtain estimated acquisition cost data and planned number of end items from the Selected Acquisition Report; Exhibit P-40, Budget Item Justification Sheet; or similar sources.
  - For programs in early stages of production for which there are limited data about cost stability, obtain acquisition costs and the number of end items to be produced directly from the current acquisition contract or comparable data sources.
- Calculate the acquisition cost of each end item placed in service by (1) dividing actual acquisition costs by end items delivered, (2) dividing estimated acquisition costs by the planned number of end items to be produced, or (3) dividing contract costs by the number of end items to be delivered under the contract.
- Determine number of end items placed in service by date, and number of end items disposed of by date.
- Calculate depreciation through date of disposal or reporting date.
- Calculate the net book value of the end items acquired.
- Calculate the net book value of disposals/losses.

- Calculate the baseline net book value by subtracting the net book value of disposals/losses from the net book value of the end items acquired.

Mid-Term Valuation Methodology

- Capitalize all costs incurred to acquire and bring military equipment to a form and location suitable for its intended use. Examples of such costs include:
    - Amounts paid to vendors.
    - Government-furnished property installed in an end item, (e.g., an engine installed in an aircraft).
    - An appropriate share of the cost of the Government-furnished materials, (e.g., titanium used in the production of end items).
    - Direct cost of maintaining the Program Management Office.
- Capitalize separately special tooling and test equipment used in both production and post-production activities.

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

Acquisition Date and Useful Life

Objective

- Provide guidance on determining the acquisition dates and useful lives of end items to ensure consistency in application and compliance with Statement of Federal Financial Accounting Standards No. 6, *Accounting for Property, Plant, and Equipment.*

Baseline Valuation Methodology

- Use the date in DD Form 250 (Block 22, Receiver's Use) to establish the end item acquisition date.

- Obtain estimated useful life from Program Manager.

- Include life extension resulting from Service Life Extension Program (SLEP) as part of estimated useful life.

Mid-Term Valuation Methodology

- Use the date in DD Form 250 (Block 22, Receiver's Use) as the PP&E acquisition date, unless DoD determines that an alternative date is acceptable.

- DoD in consultation with Components will establish appropriate useful lives for major classes of military equipment based on an analysis of actual asset usage. 1/

1/ DoD will conduct a study and establish a useful life policy by September 30, 2005.

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

Research, Development, Test, and Evaluation Costs

Objective

- Prescribe the method of accounting for research, development, test, and evaluation (RDT&E) costs and the costs of producing functional end items in accordance with the provisions of Statement of Federal Financial Accounting Standards No. 8, *Supplementary Stewardship Reporting*, and Statement of Financial Accounting Standards No. 2, *Accounting for Research and Development Costs.*

Baseline Valuation Methodology

- Expense RDT&E costs, which are considered synonymous with research and development costs, when incurred, with the following exceptions:
    - Capitalize costs associated with the production of functional end items that will be placed in service.
    - Capitalize costs for equipment, such as special tooling and special test equipment acquired or constructed for research and development, which may have alternative future uses.

Mid-Term Methodology

- Same as Baseline.

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

Work-in-Process

Objective

- Prescribe the accounting for, and reporting of, costs incurred for end items in production but not yet completed in accordance with the provisions of Statement of Federal Financial Accounting Standards No.6, *Accounting for Property, Plant, and Equipment.*

Baseline Valuation Methodology

- Calculate Work-in-Process (WIP) by subtracting the total acquisition cost of end items placed in service from total disbursements to date (outlays).

Mid-Term Valuation Methodology

- Establish a WIP account to accumulate all costs related to the acquisition of constructed PP&E.

- Determine the full cost of the end item at the time of delivery and acceptance and transfer the amount from WIP to the Military Equipment account.

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).

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

Modifications, Modernizations, Upgrades, and Improvements

Objective

- Provide guidance on accounting for and reporting of the cost of modifications that (1) extend the useful life of an end item or (2) enlarge or improve the capacity of an end item in accordance with Statement of Federal Financial Accounting Standards No. 6, *Accounting for Property, Plant, and Equipment.*

Baseline Valuation Methodology

- When modifications can be linked to individual end items:
    - The full cost of modifications that extend the useful life of an end item should be added to its net book value and depreciated over the end item's new useful life.
    - The cost of modifications that enlarge or improve the capacity of an item but do not extend its useful life should be capitalized by:
        - Adding the modification cost to the end item's net book value and depreciating the resulting cost over the remaining useful life of the end item, or
        - Capitalizing the modification as a separate item and depreciating the modification over the lesser of the life of the modification or the remaining useful life of the end item.
- In instances where modifications cannot be specifically identified with individual end items, the modification costs incurred during a given fiscal year should be aggregated, capitalized, and depreciated as a separate item. In addition, wherever possible, an estimate of the portion of these modification costs that is allocable to each item to which the modifications relate will be developed.
- Program managers will be asked to provide reasonable estimates of the useful lives of modifications, based on engineering estimates, prior experience, or other factors.
- When an end item is disposed of, both its remaining Net Book Value and the remaining Net Book Value of the related modifications will be written off.
- At times, modifications cross different acquisition programs, e.g., the same modifications may be applied to multiple types of aircraft. If it is impractical to specifically allocate the

modifications to the programs or parent end items to which they apply, there will be no attempt to associate the modification cost with individual end items. In these situations, no adjustment will be made to the cost of modifications when the parent end item is disposed of, unless extraordinary losses of the related end items occur.

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Mid-Term Valuation Methodology

- The full cost of modifications that extend the useful life of an end item should be added to its net book value and depreciated over the end item's new useful life.

- The cost of modifications that enlarge or improve the capacity of an item but do not extend its useful life should be capitalized by:

    - Adding the modification cost to the end item's net book value and depreciating the resulting cost over the remaining useful life of the end item, or

    - Capitalizing the modification as a separate item and depreciating the modification over the lesser of the life of the modification or the remaining useful life of the end item.

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

Classification

Objective

- Provide guidance to differentiate between assets classified as (1) Inventory Held for Sale, (2) Operating Materials and Supplies, and (3) Military Equipment, to facilitate compliance with the provisions of Statement of Federal Financial Accounting Standards No. 3, *Accounting for Inventory and Related Property,* Statement of Federal Financial Accounting Standards No. 6, *Accounting for Property, Plant, and Equipment,* and Statement of Federal Financial Accounting Standards No. 23, *Elimination of the Category National Defense Property, Plant, and Equipment.*

Baseline Valuation Methodology

- Inventory Held for Sale and Operating Materials and Supplies – Classify and report assets that meet the criteria established in SFFAS No. 3 as Inventory and OM&S.

- Military Equipment - Capitalize the cost of end items determined using the full cost baseline methodology business rule.

Mid-Term Methodology

- Inventory Held for Sale and Operating Materials and Supplies - Same as Baseline Valuation Methodology

- Military Equipment - Capitalize all costs incurred to acquire and bring military equipment to a form and location suitable for its intended use.

Contract Close Out Adjustments

Objective

- Prescribe the accounting requirements for contract close out costs.

Baseline Valuation Methodology

- No effect. Contract closeout adjustments are not factored into calculation of baseline valuation costs.

Mid-Term Valuation Methodology

- Expense contract closeout costs that are not considered material in relation to the total cost of the acquisition program in the period incurred.

- Capitalize contract closeout costs that are considered material in relation to the total cost of the acquisition program as part of associated end items (through cost allocation) or separately (requires creation of parent-child relationship in property accountability systems).

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

Reporting Entity

Objective

- Provide guidance on the reporting of military equipment by a user entity in instances where the equipment was acquired by a non-user entity in a manner consistent with the provisions of Statement of Federal Financial Accounting Standards No. 4, *Managerial Cost Accounting,* and Statement of Federal Financial Accounting Standards No. 7, *Accounting for Revenue and Other Financing Sources and Concepts for Reconciling Budgetary and Financial Accounting.*

Baseline Valuation Methodology

- DoD entities that possess and control (have preponderant use of) military equipment items that materially contribute to mission accomplishment should report such items in their financial statements, regardless of the organization that originally acquired or provided the funding for the items.

Mid-Term Valuation Methodology

- Same as Baseline

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

Clean-Up Costs

Objective

- Prescribe the accounting and reporting of clean-up costs in accordance with the provisions of Statement of Federal Financial Accounting Standards No. 6, *Accounting for Property, Plant, and Equipment.*

Baseline Valuation Methodology

- For military equipment in service at time of implementation of the clean-up cost standard, estimate and record the total estimated clean-up cost and the associated liability for items in service. DoD should have previously recorded these costs.

- For military equipment placed in service after the implementation of the clean-up cost standard, recognize a portion of the estimated total clean-up costs as an expense during each period the associated military equipment is in operation.

Mid-Term Valuation Methodology

- Same as Baseline

Military Equipment Valuation Project

Position Paper: Full Cost

Description of Issue

Statement of Federal Financial Accounting Standards (SFFAS) No. 4, *Managerial Cost Accounting*, requires the measurement of the "full cost" of outputs so that operational costs and total unit costs of outputs can be determined. SFFAS No. 6, *Accounting for Property, Plant, and Equipment*, provides guidance on what should be included in measuring the "full cost" of property, plant, and equipment (PP&E). SFFAS No. 23, *Eliminating the Category National Defense Property, Plant, and Equipment*, amended SFFAS 6 to include PP&E previously defined as National Defense Property, Plant, and Equipment in the definition of General Property, Plant, and Equipment.

The Department of Defense (DoD) issued policies for implementing the foregoing SFFASs as they apply to PP&E covered by SFFAS No. 6 prior to issuance of SFFAS 23. DoD has not provided policy guidance on applying the full cost principle to military equipment. This position paper provides that guidance.

Proposed Policy

In accounting and reporting the "full cost" of PP&E[1], DoD should include all material costs incurred to acquire and bring the PP&E to a form and location suitable for its intended use.

Examples of such costs include:

- Amounts paid to vendors
- Government-furnished property installed in an end item
- An appropriate share of the cost of the Government-furnished materials used in the production of end items
- Direct cost of maintaining the Program Management Office

[1] This guidance applies only to property, plant, and equipment, exclusive of real estate, which includes land and buildings.

These full cost principles apply to all end items, such as items acquired on a fixed price basis, including fixed price commercial off-the shelf items.

The cost of PP&E acquired under a capital lease shall be equal to the amount recognized as a liability for capital leases at inception. This is the present value of the lease payments calculated as specified in SFFAS No. 5, *Accounting for Liabilities of the Federal Government*, unless the present value exceeds the fair value of the asset.

Other direct costs include Government-furnished property installed in an end item (e.g., an engine installed in an aircraft) and Government-furnished materials (e.g., titanium) used in the production of end items.

Labor and other direct costs are comprised primarily of costs incurred by the contractor in the production process. However, labor and other direct costs should also include the direct costs of the Program Management Office (PMO), where material, e.g., greater than one percent of estimated total acquisition cost of the program. Direct PMO costs include personnel and travel costs, but associated costs such as occupancy costs and depreciation should not be included.

Indirect costs are costs incurred in the production of <u>two or more types</u> of end items. Indirect costs should be allocated to end items where material.

Special tooling and test equipment often remain in service long after completion of end item production and are used for follow-on maintenance and support efforts. Because special tooling and test equipment provide benefits after production, they should be capitalized separately.

Authoritative Guidance

<u>Statement of Federal Financial Accounting Standards No. 4, *Managerial Cost Accounting*</u>

Paragraph 89. Full Costing – Reporting entities should report the full costs of outputs in general purpose financial reports. The full cost of an output produced by a responsibility segment is the sum of (1) the costs of resources consumed by the segment that directly or indirectly contribute to the output, and (2) the costs of identifiable supporting services provided by other responsibility segments within the reporting entity, and by other reporting entities.

Paragraph 90. Direct costs include costs that can be specifically identified with an output. Examples include:

- Salaries and benefits for employees who work directly on the output.
- Materials and supplies <u>used</u> in the work.
- Various costs associated with office space, equipment, facilities, and utilities that are used exclusively to produce the output.
- Cost of goods and services received from other segments or entities that are used to produce the output.

Paragraph 91. Indirect costs are costs of resources that are jointly or commonly used to produce <u>two or more types of outputs</u> but are not specifically identifiable with any of the outputs. Typical examples of indirect costs include depreciation of capitalized equipment and utilities.

<u>Statement of Federal Financial Accounting Standards No. 6, *Accounting for Property Plant and Equipment*</u>

Paragraph 26. Cost shall include all costs incurred to bring the PP&E to a form and location suitable for its intended use.

Paragraph 29. The cost of general PP&E acquired under a capital lease shall be equal to the amount recognized as a liability for the capital lease at its inception (i.e., the net present value of the lease payments calculated as specified in SFFAS No. 5, *Accounting for Liabilities of the Federal Government*.)

<u>Statement of Position entitled "Accounting for Certain Costs and Activities Related to Property, Plant, and Equipment" issued by the Accounting Standards Executive Committee of the American Institute of Certified Public Accountants</u>

Paragraph 28. Costs incurred during the acquisition-or-construction stage should be charged to expense as incurred unless the costs are directly identifiable with the specific PP&E. Directly identifiable costs include certain costs directly related to activities performed by the entity (or parties not independent of the entity) for the acquisition, construction, or installation of specific PP&E. These costs include only payroll and payroll-related costs of employees who devote time to a PP&E acquisition-or-construction stage activity, to the extent of time the employees spent directly on that activity and in proportion to the total hours employed.

Paragraph 28A. Occupancy costs, including rent and depreciation of facilities and other costs associated with facilities are excluded from directly identifiable costs and should be charged to expense as incurred.

Military Equipment Valuation Project

Position Paper: Acquisition Date and Useful Life

Description of Issue

Statement of Federal Financial Accounting Standards (SFFAS) No. 6, *Accounting for Property, Plant, and Equipment*, requires that depreciation expense be calculated on property, plant and equipment (PP&E) over the PP&E's estimated useful life. It further provides that estimates of useful life must consider factors such as physical wear and tear and technological change (e.g. obsolescence).

SFFAS No. 6, paragraph 34, describes depreciation as the method of allocating the cost of tangible capital assets, less salvage value, over the estimated useful life of the asset in a systematic and rational manner.

Depreciation of PP&E is a function of rules governing acquisition date and useful life. This proposed business rule addresses acquisition date and useful life only.

Acquisition date. SFFAS No. 6 provides that PP&E shall be recognized when title passes to the acquiring entity or when the PP&E is delivered to the entity or an agent of the entity. In the case of constructed PP&E, the PP&E shall be recorded as work in process until it is placed in service, at which time the balance shall be transferred to general PP&E.

Useful life. SFFAS No. 6, Footnote 17, defines useful life as the normal operating life in terms of utility to the owner. Footnote 23 defines estimated economic life of leased property as the estimated remaining period during which the property is expected to be economically usable by one or more users, with normal repairs and maintenance, for the purpose for which it was intended at the inception of the lease, without limitation by the lease term.

Department of Defense practice. *Department of Defense Financial Management Regulation Volume 4, Chapter 6*, provides that the event that triggers the calculation of depreciation (i.e., the acquisition date) is the date of receipt shown on the asset receiving document or the date the asset is installed and ready for use (regardless of whether it is actually used). With respect to constructed PP&E, the FMR provides that the costs of constructing the PP&E shall be recorded as construction-in-progress until it is available for use, at which time the balance (total construction costs) shall be transferred to general PP&E.

DD Form 250, *Material Inspection and Receiving Report*, is the official report for use as acceptance of equipment or data by the Government (i.e., title transferred to the Government); the contractor's invoice for payment; a packing list for shipping and receiving; and evidence of the Government quality inspection. It is evidence of the Government's acceptance of the items covered by the form.

Block 22 of DD Form 250 is for the receiver's use and is where the authorized representative of the receiving activity (Government or contractor) acknowledges receipt, quantity received, and condition of items received. The authorized representative is required to enter the date the item(s) arrived.

Proposed Policy

Acquisition date. DoD Components should use the date shown on Block 22, Receiver's Use, of the DD Form 250 as the acquisition date unless DoD determines that an alternative date is acceptable. If an alternative date is deemed acceptable, the reason for the use of an alternative date should be justified and documented.

Useful life. DoD, in consultation with Components, will establish useful lives for major military equipment classes based on an analysis of actual asset usage. DoD will conduct a study and establish a useful life policy by September 30, 2005.

Initial useful life estimates should not include the extended life expectancy resulting from a Service Life Extension Program (SLEP). The SLEP acquisition date should be the date completed and accepted, and the cost of the SLEP should be amortized over the remaining useful life of the affected end item after completion of the SLEP.

DoD Components will be permitted to use different useful lives if the estimated useful lives vary significantly from the useful life prescribed for an asset class. For example, if the acquiring DoD Component determines that the estimated useful life of a satellite is 24 months (due to orbit patterns and mission/actual asset usage) and all other DoD satellites have a useful life of 7 years (or 84 months), the Component will be permitted to use the 2 year useful life.

DoD Components should consider the following factors when determining the appropriate useful lives of military equipment:

- Estimated useful life of the military equipment that was used for acquisition planning;
- Engineering estimates;
- Historical knowledge of an asset's utility/usage;
- Related source information on equipment recovery periods warehoused by DoD and other Agencies (Examples include historical information from the Bureau of Economic Analysis and Office of the Director, Program Analysis and Evaluation).

In addition to estimating useful lives for initial procurements of military equipment assets, DoD will establish useful lives for modifications and upgrades that extend the useful life or enhance the operating performance of end items or end item components.

The useful life estimates for the major PP&E classes will be reviewed periodically and modified, as appropriate. The effects of changes in useful lives should be accounted for prospectively.

Authoritative Guidance

Statement of Federal Financial Accounting Standards No. 6, *Accounting for Property, Plant, and Equipment*

Military Equipment Valuation Project

Position Paper: Research, Development, Test, and Evaluation Costs

Description of Issue

Statement of Federal Financial Accounting Standards (SFFAS) No. 4, *Managerial Cost Accounting*, requires the reporting of the "full cost" of outputs in the Entity's general purpose financial reports. SFFAS No. 6, *Accounting for Property, Plant, and Equipment*, provides guidance on the components to be included in measuring the full cost of property, plant, and equipment outputs.

The Department of Defense (DoD) incurs substantial costs for research, development, test, and evaluation (RDT&E) as part of many programs, the objective of which is the acquisition of property and equipment. DoD accounts for these costs generally in the following budget activities, although such costs may be funded by non-RDT&E appropriations.

1. *Budget Activity 1- Basic Research*. Study directed toward greater knowledge or understanding of the fundamental aspects of phenomena and of observable facts without specific applications towards processes or products in mind

2. *Budget Activity 2- Applied Research*. Systematic study to understand the means to meet a recognized and specific national security requirement.

3. *Budget Activity 3 - Advanced Technology Development (ATD).* Development of subsystems and components and efforts to integrate subsystems and components into system prototypes for field experiments and/or tests in a simulated environment.

4. *Budget Activity 4 – Advanced Component Development and Prototypes (ACD&P).* Efforts to evaluate integrated technologies and representative modes or prototype systems in a high fidelity and realistic operating environment are funded in this budget activity.

5. *Budget Activity 5 - System Development and Demonstration (SDD*). Engineering and manufacturing development tasks aimed at meeting validated requirements prior to full-rate production.

6. *Budget Activity 6 - RDT&E Management Support*. Includes research, development, test and evaluation efforts and funds to sustain and/or modernize the installations or operations required for general research, development, test and evaluation.

7. *Budget Activity 7, Operational System Development*. Includes development efforts to upgrade systems that have been fielded or have received approval for full rate production and that anticipate production funding in the current or subsequent fiscal year.

The Federal Accounting Standards Advisory Board issued a standard on accounting and reporting of research and development costs, which requires the expensing of research and development costs. However, that standard does not explicitly address circumstances unique to the research and development programs at the Department of Defense. Examples of special circumstances are those in which research and development activities result in the production of fully functional military equipment and the acquisition of PP&E or other assets that have an alternative future use in research and development or other programs or activities. The Financial Accounting Standards Board (FASB) in its Statement on research and development costs addresses special circumstances.

AU Section 411, "Meaning of Presented Fairly in Accordance with Generally Accepted Accounting Principles," of the *AICPA Professional Standards*, paragraph .14, provides guidance on where to turn in the absence of a pronouncement covered by rule 203 of the AICPA Code of Professional Ethics [ET section 203.01] or another source of established accounting principles. This Section provides that the auditor of financial statements of a federal governmental entity may consider other accounting literature, depending on its relevance in the circumstances. Other accounting literature includes, for example, FASAB Concepts Statements; the pronouncements referred to in categories (a) through (d) of paragraph .10 of AU Section 411 when not specifically made applicable to federal governmental entities by the FASAB; FASB Concepts Statements; GASB Statements, Interpretations, Technical Bulletins, and Concepts Statements; AICPA Issues Papers; International Accounting Standards of the International Accounting Standards Committee; pronouncements of other professional associations or regulatory agencies; Technical Information Service Inquiries and Replies included in AICPA Technical Practice Aids; and accounting textbooks, handbooks, and articles. The appropriateness of other accounting literature depends on its relevance to particular circumstances, the specificity of the guidance, and the general recognition of the issuer or author as an authority.

FASB Statement No.2, *Accounting for Research and Development Costs*, a pronouncement referred to in categories (a) through (d) of paragraph .10 of AU Section 411 not specifically made applicable to federal government entities by the FASAB, requires that all research and development costs encompassed by this Statement be charged to expense when incurred. The Statement also requires that materials and equipment or facilities that are acquired or constructed for research and development activities and that have alternative future uses (in research and development projects or otherwise) be capitalized as tangible assets when acquired or constructed. The provisions of this Statement are summarized in the Authoritative Guidance section, which follows the proposed policy section below.

It is important to distinguish between the nature of costs incurred and the source of funding. It is the nature of the costs incurred that determines the accounting treatment. In basic terms, research and development costs are to be expensed, but production costs are to be capitalized.

Proposed Policy

DoD should expense RDT&E costs (which are considered synonymous with research and development costs discussed above) when incurred with the following exceptions.

- Capitalize costs associated with the production of an end-item or end item component [1](as defined in the paper on componentization)[2] that is produced for service.

- Capitalize the cost of equipment, such as special tooling and special test equipment, acquired or constructed for research and development, which may have alternative future uses (in research and development projects or otherwise).

DoD should disclose the total research and development costs charged to expense in each period for which a statement of net cost is presented.

[1] Future functional end items or end item components do not include prototypes.
[2] This provision applies to circumstances in which at acquisition program commencement, Congress authorizes DoD to use RDT&E funding to produce end items that will be placed-in-service.

Authoritative Guidance

Statement of Federal Financial Accounting Standards No. 8 *Supplementary Stewardship Reporting*

Paragraph 96 provides the following: "Investment in research and development" refers to those expenses (emphasis added) incurred to support the search for new or refined knowledge and ideas and for the application or use of such knowledge and ideas for the development of new or improved products and processes with the expectation of maintaining or increasing national economic productive capacity or yielding other future benefits. Research and development is composed of:

- Basic research: systematic study to gain knowledge or understanding of the fundamental aspects of phenomena and of observable facts without specific applications toward processes or products in mind;

- Applied research: systematic study to gain knowledge or understanding necessary for determining the means by which a recognized and specific need may be met; and

- Development: systematic use of the knowledge and understanding gained from research for the production of useful materials, devices, systems, or methods, including the design and development of prototypes and processes.

Financial Accounting Standards Board Statement No. 2, *Accounting for Research and Development Costs*

Paragraph 8 defines research and development as follows:

a) Research is the planned search or critical investigation aimed at discovery of new knowledge with the hope that such knowledge will be useful in developing a new product or service (hereinafter "product") or a new process or technique (hereinafter "process") or in bringing about a significant improvement to an existing product or process.

b) Development is the translation of research findings or other knowledge into a plan or design for a new product or process or for a significant improvement to an existing product or process whether intended for sale or use. It includes the conceptual formulation, design, and testing of product alternatives, construction of prototypes, and operation of pilot plants. It does not include routine or periodic alterations to existing products, production lines, manufacturing processes, and other on-going operations even though those alterations may represent improvements and it does not include market research or market testing activities.

Paragraph 9 provides the following as examples of activities that typically would be included in research and development, which are similar to the DoD RDT&E budget activities discussed above:

1. Laboratory research aimed at discovery of new knowledge;
2. Searching for applications of new research findings or other knowledge;
3. Conceptual formulation and design of possible product or process alternatives;
4. Testing in search for or evaluation of product or process alternatives;
5. Modification of the formulation or design of a product or process;
6. Design, construction, and testing of pre-production prototypes and models;
7. Design of tools, jigs, molds, and dies involving new technology;
8. Design, construction, and operation of a pilot plant that is not of a scale economically feasible to the enterprise for commercial production;
9. Engineering activity required for advancing the design of a product to the point that it meets specific functional and economic requirements and is ready for manufacture.

Paragraph 11 defines the following cost elements that should be identified with research and development activities:

a) Materials, equipment, and facilities. The costs of materials (whether from the enterprise’s normal inventory or acquired specifically for research and development activities) and equipment or facilities that are acquired or constructed for research and development activities and that have alternative future uses (in research and development projects or otherwise) shall be capitalized as tangible assets when acquired or constructed. The cost of such materials consumed in research and development activities and the depreciation of such equipment or facilities used in those activities are research and development costs. However, the costs of materials, equipment, or facilities that are acquired or constructed for a particular research and development project and that have no alternative future uses (in other research and development projects or otherwise) and therefore no separate economic values are research and development costs at the time the costs are incurred.

b) Personnel. Salaries, wages, and other related costs of personnel engaged in research and development activities should be included in research and development costs.

c) Intangibles purchased from others. The costs of intangibles that are purchased from others for use in research and development activities and that have alternative future uses (in research and development projects or otherwise) shall be capitalized and amortized as intangible assets in accordance with APB Opinion No. 17. The amortization of those intangible assets used in research and development activities is a research and development cost. However, the costs of intangibles that are purchased from others for a particular research and development project and that have no alternative future uses (in other research and development projects or otherwise) and therefore no separate economic values are research and development costs at the time the costs are incurred.

d) Contract services. The costs of services performed by others in connection with the research and development activities of an enterprise, including research and development conducted by others in behalf of the enterprise.

e) Indirect costs. Research and development costs shall include a reasonable allocation of indirect costs. However, general and administrative costs that are not clearly related to research and development activities shall not be included as research and development costs.

Paragraph 12 requires that all research and development costs encompassed by this Statement be charged to expense when incurred.

However, paragraph 11 requires that materials and equipment or facilities that are acquired or constructed for research and development activities and that have alternative future uses (in research and development projects or otherwise) be capitalized as tangible assets when acquired or constructed.

Paragraph 13 states that disclosure should be made in the financial statements of the total research and development costs charged to expense in each period for which an income statement is presented.

Military Equipment Valuation Project

Position Paper: Work-in-Process

Description of Issue

Some items of property, plant, and equipment (PP&E) acquired by DoD are commercial items that require no unique government modifications or maintenance over the life cycle of the product to meet the needs of the procuring DoD Component. Often referred to as "commercial off-the-shelf" items, these items frequently are ordered, received, and paid for on acceptance. However, most major DoD acquisition programs, particularly those dealing with items of military equipment, do not involve off-the shelf purchases, but rather, involve the research, development, and production of complex items of PP&E. The acquisition costs of these programs include vendor progress payments, the cost of government-furnished property, and the operating costs of the Program Management Office, all of which are paid for over an extended period of time. Most of these programs result in multiple end items delivered over time, thereby complicating the process of determining the total cost of individual end items.

With costs incurred over an extended period and individual end items completed at different times, the question is what mechanism should DoD use to accumulate and assign costs to individual end items so that the costs can be capitalized in accordance with Federal Accounting Standards.

Statement of Federal Financial Accounting Standards (SFFAS) No.6, *Accounting for Property, Plant, and Equipment*, Paragraph 34, states that in the case of constructed PP&E, the PP&E should be recorded as construction work-in-process until it is placed in service, at which time the balance shall be transferred to general PP&E.

Proposed Policy

DoD will establish a Work-in-Process (WIP) account to accumulate all costs (direct and indirect) related to the acquisition of constructed PP&E. When an individual PP&E item is delivered and accepted, DoD will transfer the total cost of the item from the WIP account to the general PP&E account. The individual end item should be recorded at full cost.

In establishing a WIP account, costs must be accounted for by acquisition program and must include all costs incurred to acquire and bring the PP&E to a form and location suitable for its intended use. The full cost of PP&E items is discussed in the Full Cost position paper.

Authoritative Guidance

Statement of Federal Financial Accounting Standards No. 6, *Accounting for Property, Plant, and Equipment*

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

Military Equipment Valuation Project

Position Paper: Modifications, Modernizations, Upgrades, and Improvements

Description of Issue

Statement of Federal Financial Accounting Standards (SFFAS) No. 6, *Accounting for Property, Plant, and Equipment,* provides guidance concerning modifications, modernizations, upgrades, and improvements to general property, plant, and equipment (PP&E).

The Department of Defense incurs substantial costs to maintain and enhance military equipment. Items of military equipment require routine maintenance in order to perform as intended. Unscheduled repairs may be needed to correct breakdowns or other unanticipated performance problems. Further, military equipment often is modified to enhance performance and/or extend the useful life. Performance-enhancing modifications frequently are not anticipated in advance, but rather are made as result of new or improved technologies, changes in mission requirements, or in response to new or modified threats. Modifications that affect the useful life of military equipment may, or may not, be a planned element of the equipment's life cycle. To illustrate, an item of military equipment, such as a ship, may be determined to have a useful life of 35 years. However, it is anticipated that if the ship is overhauled after approximately 35 years of service, its useful life can be extended by 15 years. To illustrate further, an item of military equipment may be determined to have a useful life of 20 years, provided that an overhaul is performed after the item has been in service for half of its useful life, or 10 years. In this case, the useful life is not actually extended, but rather the overhaul is necessary in order to achieve the intended useful life.

Paragraph 37 of SFFAS No. 6 states that, "Costs which either extend the useful life of existing general PP&E, or enlarge or improve its capacity shall be capitalized and depreciated/amortized over the remaining useful life of the associated general PP&E."

Proposed Policy

A distinction is to be made between the treatment of a modification that extends the useful life of an item and a modification that enhances the performance of an item, but does not extend its useful life.

A modification that extends the useful life of an item should be added to the net book value of the end item and depreciated over the end item's new useful life.

A modification that enlarges or improves the capacity of an item of equipment, but does not extend its useful life, should be capitalized by:

- Adding the cost of the modification to the net book value of the modified item and depreciating the resulting adjusted total cost over the remaining useful life of the end item, <u>or</u>

- Capitalizing the modification as a separate item and:

    - If the useful life of the modification **equals** or is **greater** than the remaining useful life of the end item, depreciating the modification cost over the remaining useful life of the end item;

    - If the useful life of the modification is **less** than the remaining useful life of the end item or the end item is fully depreciated, depreciating the modification cost over its useful life.

When a modification is capitalized separately from an end item, the modification should be linked to the end item (parent-child relationship) in the property accounting or accountability system.

Authoritative Guidance

Statement of Federal Financial Accounting Standards No. 6, *Accounting for Property, Plant, and Equipment.*

Military Equipment Valuation Project

Position Paper: Classification

Description of Issue

The Department of Defense maintains a large number of assets that could be (historically have been) classified as property, plant, and equipment; inventory held for sale; or operating materials and supplies. This position paper provides criteria for use in properly classifying these assets consistently among Military Departments.

Statement of Federal Financial Accounting Standards (SFFAS) No. 3, *Accounting for Inventory and Related Property*, defines inventory and operating materials and supplies as follows:

- Inventory is tangible personal property that is (1) held for sale, (2) in the process of production for sale, or (3) to be consumed in the production of goods for sale or in the provision of services for a fee. The term "held for sale" shall be interpreted to include items for sale or transfer to (1) entities outside the federal government, or (2) other federal entities. "Other federal entities" may include entities within the same organization or agency. Inventory includes inventory held for repair.

- Operating materials and supplies consist of tangible personal property to be consumed in normal operations. Excluded are goods that have been acquired for use in constructing real property or in assembling equipment to be used by the entity

SFFAS No. 6, Accounting for Property, Plant, and Equipment, defines property, plant, and equipment (PP&E) as tangible assets, including land, that meet the following criteria:

- They have an estimated useful life of two years or more;

- They are not intended for sale in the ordinary course of operations; and

- They have been acquired or constructed with the intention of being used, or being available for use by the entity.

Paragraph 23 defines General PP&E as PP&E used in providing goods and services. General PP&E typically has one or more of the following characteristics:

- It could be used for alternative purposes but is used to produce goods or services, or to support the mission of the entity, or

- It is used in business-type activities, or

- It is used by entities in activities whose costs can be compared to those of other entities performing similar activities.

SFFAS No. 10, *Accounting for Internal Use Software*

Paragraph 15 provides that entities should capitalize the cost of software when such software meets the criteria for General PP&E.

Paragraph 16 describes the stage at which the cost of internally developed software should be capitalized.

Proposed Policy

Assets meeting the criteria for inventory held for sale and operating materials and supplies stated above should be accounted for and reported accordingly.

Assets meeting the PP&E criteria should be capitalized. PP&E below the capitalization threshold and not purchased as part of a bulk purchase should be expensed.

Military Equipment Valuation Project

Position Paper: Contract Close Out Adjustments

Description of Issue

Statement of Federal Financial Accounting Standards No. 6, *Accounting for Property, Plant, and Equipment,* paragraph 26, provides that all general property, plant, and equipment (PP&E) shall be recorded at cost. Cost shall include all costs required to bring PP&E to a form and location suitable for its intended use. The cost of acquiring property, plant, and equipment may include amounts paid to vendors; labor and other direct or indirect production costs (for assets produced or constructed); and engineering, architectural, and other outside services for designs, plans, specifications; and surveys**.** Additional guidance on costs to be included is provided in the position paper entitled "Full Cost."

Once an item is delivered and accepted, it should be capitalized and entered into DoD's accounting and accountability systems. However, it is likely that subsequent to delivery, additional transactions such as final vendor payments, claims, liquidated damages, or recoveries, will occur, often over a lengthy period. These transactions are referred to herein as "contract close out adjustments."

Proposed Policy

If contract close out adjustments are not considered material in relation to the total cost of the acquisition program, they should be charged to expense in the period in which incurred.

If the contract close out adjustments are considered material in relation to the total cost of the acquisition program, they should be capitalized. Adjustments may be capitalized as a separate item and depreciated over the average remaining useful life of the items of PP&E to which they apply or added to the acquisition cost of individual end items of PP&E and depreciated over the remaining useful lives of the individual end items.

Authoritative Guidance

Statement of Federal Financial Accounting Standards No.6, *Accounting for Property, Plant, and Equipment*

Military Equipment Valuation Project

Position Paper: Reporting Entity

Description of Issue

DoD Components purchase certain items of property, plant, and equipment (PP&E) with their own funds and then transfer custody to other DoD organizations to facilitate mission performance. For example, the first organization purchases certain items of military equipment with its own funds and transfers custody of the items to a second organization. Subsequently, the receiving organization makes substantial modifications to the items of military equipment to make them suitable for its mission. The receiving organization controls the military equipment items and has the authority for the use and deployment of the items. The issue is whether the organization that originally paid for the PP&E or the organization that controls and uses the PP&E should report the PP&E.

Statement of Federal Financial Accounting Concepts No.2, *Entity and Display*, provides that a reporting entity for financial reporting purposes must have all of the following characteristics:

- Management that is held accountable for the entity's performance and is responsible for controlling and deploying resources, producing outputs and outcomes, and executing a budget;
- Scope of activities such that its financial statements provide a meaningful representation of operations and financial condition;
- There are likely to be users of financial statements who rely upon the statements to provide them with information necessary to make resource allocation and other decisions and who hold the entity's management accountable for its deployment and use of resources.

Statement of Federal Financial Accounting Standards (SFFAS) No. 7, *Accounting for Revenue and Other Financing Sources and Concepts for Reconciling Budgetary and Financial Accounting*, Paragraph 74, provides that an intragovernmental transfer of cash or other capitalized asset without reimbursement changes the resources available to both the receiving and transferring entities. The receiving entity should recognize a transfer-in as an additional financing source in its result of operations for the period. The transferring entity should recognize the transfer-out as a decrease in its result of operations. The value recorded should be the transferring entity's book value of the asset. If the receiving entity does not know the book value, the asset should be recorded at its estimated fair value as of the date of the transfer.

The DoD Financial Management Regulation states that for asset reporting purposes, the following characteristics are essential:

- The asset has the capacity to contribute to mission accomplishment;
- The entity can use the asset or control access of others to the asset;
- The transaction or event giving rise to the entity's right to, or financial control over, the asset has already occurred.

Proposed Policy

DoD entities that possess and control (have preponderant use of) PP&E items that materially contribute to their mission accomplishment should report such PP&E in their financial statements[1], regardless of the organization that originally acquired the items or provided the funding for the PP&E. The receiving entity should recognize a transfer-in as an additional financing source in its result of operations for the period. The transferring entity should recognize the transfer-out as a decrease in its result of operations. The value recorded should be the transferring entity's book value of the asset. If the receiving entity does not know the book value, the asset should be recorded at its estimated fair value as of the date of the transfer.

Authoritative Guidance

Statement of Federal Financial Accounting Concepts No.2, *Entity and Display*

Statement of Federal Financial Accounting Standards (SFFAS) No. 7, *Accounting for Revenue and Other Financing Sources and Concepts for Reconciling Budgetary and Financial Accounting*

[1] This recommendation only applies to entities that prepare financial statements in accordance with generally accepted accounting principles.

Military Equipment Valuation Project

Position Paper: Clean-up Costs

Description of Issue

The purpose of this paper is to describe the proper accounting for clean-up costs.

Statement of Federal Financial Accounting Standards (SFFAS) No. 6, *Accounting for Property, Plant, and Equipment*, Paragraph 85, defines clean-up costs as the costs of removing, containing, and/or disposing of (1) hazardous waste from property, or (2) material and/or property that consists of hazardous waste at permanent or temporary closure or shutdown of associated property, plant, and equipment (PP&E). This position paper describes the accounting and reporting of clean-up costs relating to property, plant, and equipment (PP&E), exclusive of land and buildings.

Paragraph 104 provides two approaches for accounting and reporting of liabilities relating to estimated total clean-up costs associated with general property, plant, and equipment (PP&E) in service on the standard's effective date.

The first approach provides that a liability shall be recognized for the portion of the estimated total clean-up cost attributable to that portion of the physical capacity used or the estimated useful life that has passed since the PP&E was placed in service. The remaining cost shall be allocated over the remaining life of the asset.

The second approach, which is only available upon initial implementation of the standard, provides that if costs are not intended to be recovered primarily through user charges, management may elect to recognize the estimated total clean-up cost as a liability upon implementation. In addition, in periods following the implementation period, any changes in the estimated total clean-up costs shall be expensed when reestimates occur and the liability balance adjusted.

Paragraph 105 provides that the offsetting charge for the liability recognized upon implementation shall be made to the Net Position of the entity. The amount of the adjustment shall be shown as a "prior period adjustment" in any statement of changes in net position that may be required. No amounts shall be recognized as an expense in the period of implementation. The amounts involved shall be disclosed, and to the extent possible, the amount associated with current and prior periods should be disclosed.

Proposed Policy

Expense and Liability Recognition

PP&E in service at time of implementation of the standard. Total estimated clean-up cost and the associated liability should already be recorded for items in service as of September 30, 2003.

PP&E placed in service after implementation of the standard. For PP&E placed in service after September 30, 2003, a portion of estimated total clean-up costs should be recognized as an expense during each period that the PP&E is in operation. This should be accomplished in a systematic and rational manner based on the estimated useful life of the associated PP&E. The recognition of the expense and liability should begin on the date that the PP&E is placed in service, continue in each period that operation continues, and be completed when the PP&E ceases operation.

The total estimated clean-up costs should be recorded as a deferred charge along with the associated liability when the PP&E is placed in service. At the end of each financial reporting period, the unrecognized total estimated clean-up costs (balance in the deferred charge account) should be charged to the liability account and disclosed in accordance with paragraph 109 of SFFAS No. 6. This entry should be reversed at the beginning of the subsequent fiscal year.

Reestimates after implementation of the standard. As total estimated clean-up cost reestimates are made, the cumulative effect of changes in total estimated clean-up costs related to current and past operations should be recognized as an expense, and the liability adjusted in the period of the change in estimate.

Payments relating to actual clean-up activities. As clean-up costs are paid, payments should be recognized as a reduction in the liability for total estimated clean-up costs. Payments include those related to the acquisition of PP&E for use in clean-up activities.

Disclosure Requirements

Disclose the following:

- The sources (applicable laws and regulations) of clean-up requirements.
- The method for assigning total estimated total clean-up costs to current operating periods.
- The unrecognized portion of estimated total clean-up costs (e.g., the estimated total clean-up costs less the cumulative amounts charged to expense at the balance sheet date).
- Material changes in total estimated clean-up costs due to changes in laws, technology, or plans. In addition, the portion of the change in estimate that relates to prior period operations should be disclosed.
- The nature of estimates and the disclosure of information regarding possible changes due to inflation, deflation, technology, or applicable laws and regulations.

Authoritative Guidance

Statement of Federal Financial Accounting Standards No. 6, *Accounting for Property, Plant, and Equipment*