DEFENSE CONTRACT AUDIT AGENCY
DEPARTMENT OF DEFENSE
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IN REPLY REFER TO

PAC 730.3.B.01/2004-03 February 24, 2004
04-PAC-015(R)

MEMORANDUM FOR REGIONAL DIRECTORS, DCAA
DIRECTOR, FIELD DETACHMENT, DCAA

SUBJECT: Audit Guidance on Changes to FAR 31.205-11, Depreciation Costs

Summary

The depreciation cost principle at FAR 31.205-11 has been revised to improve clarity and structure and to remove unnecessary and duplicative language. The revised rule became effective January 12, 2004. This new rule does not change the allowability of depreciation costs; however, changes could affect certain non-CAS covered contractors in determining annual depreciation costs. The changes also eliminated any conflicting provisions with CAS 409, Depreciation of Tangible Capital Assets, contained in the prior cost principle.

The revised FAR cost principle reflects two significant changes: (1) adoption of the 10 percent residual value rule provided in CAS 409, and (2) elimination of all references to Federal income tax accounting. The new rule will allow the contractor the same flexibility provided under CAS 409, in that only residual values in excess of 10 percent of the capitalized cost of tangible personal property need be used in establishing depreciation costs. In addition, the cost principle no longer requires contractors to consider depreciation costs claimed for tax purposes in determining allowable depreciation costs for Government contracts. The auditor should be alert to these changes in evaluating contractors proposed pricing actions based on historical cost data.

Changes to FAR 31205-11, Depreciation cost

Detailed changes to the cost principle language are included in the Enclosure in line-in and line-out format. A synopsis of the changes is provided below.

1. <u>The 10 Percent Residual Value Rule Adopted</u>. Prior to this revision, for non-CAS covered contracts FAR 31.205-11 differed from the provision of CAS 409-50(h), which permits contractors to not consider residual values that are less than 10 percent of the capitalized asset value in computing depreciation costs. The revised cost principle makes it consistent with the CAS. (See paragraph (a)).

2. References to Federal Income Tax Accounting Eliminated. Prior paragraphs (d) and (e), which effectively limited the allowable depreciation costs for contracts not subject to CAS 409 to the lesser of the depreciation costs used for tax purposes or for financial statements, have been eliminated. The cost principle no longer refers to Federal income tax accounting. The new paragraph (c) states:

   > For contracts to which 48 CFR 9904.409 is not applied, except as indicated in paragraphs (g) and (h) of this subsection, allowable depreciation shall not exceed the amount used for financial accounting purposes, and shall be determined in a manner consistent with the depreciation policies and procedures followed in the same segment on non-Government business.

3. Other Changes:

   a. The definition of depreciation (prior paragraph (a)) has been moved to FAR 31.001, Definitions, to be consistent with the ongoing FAR streamlining efforts.

   b. Prior paragraph (b) contained instructions that "CAS requirements supersede any conflicting requirements of this cost principle." That language has been removed because the revised cost principle no longer contains conflicting requirements.

   c. Prior paragraph (m) is essentially the current paragraph (i), which provides concise language on capital leases. The revised cost principle eliminates redundant references to CAS 404, Capitalization of tangible assets; and FAS 13, Accounting for leases, requirements.

   d. Prior paragraphs (f), (g), (h), and (i) were deleted in their entirety because the language is obsolete or redundant, adding no value to the cost principle as revised.

   e. The remaining prior paragraphs, (j), (k), (l), (n), and (o) have been realigned with minor editorial changes and are now (d), (e), (f), (g), and (h), respectively.

Guidance

The revised depreciation cost principle at FAR 31.205-11 could affect certain non-CAS covered contractors in determining allowable depreciation costs for an accounting period. The amount of allowable depreciation for an accounting period may increase because of the 10 percent residual value rule adopted by the new cost principle. The auditor should be cognizant of those non-CAS covered contractors who have not previously adopted CAS 409 compliant accounting practices when evaluating their pricing proposals based on historical cost data. The auditor should also ensure that the annual depreciation cost does not reduce the book value of a tangible capital asset below its estimated residual value, since such costs are expressly unallowable pursuant to FAR 31.205-11(a).

Closing Remarks

If FAO personnel have any questions on the subject, they should contact regional personnel. If regional personnel have any questions, they should contact Ms. Rose M. Autmon, Program Manager, Accounting and Cost Principles Division, at (703) 767-3250 or rautmon@dcaa.mil.

/Signed/
Robert DiMucci
Assistant Director
Policy and Plans

Enclosure:
Revision to FAR 31.205-11, Depreciation (Line-in/Line-out)

DISTRIBUTION: C

Line in/Line out Revision to FAR 31.205-11 Depreciation
(Revision from the Prior Cost Principle to Final Rule 12/11/2003)

(a) Depreciation on a contractor's plant, equipment, and other capital facilities is an allowable contract cost, subject to the limitations contained in this cost principle. For tangible personal property, only estimated residual values that exceed 10 percent of the capitalized cost of the asset need be used in establishing depreciable costs. Where either the declining balance method of depreciation or the class life asset depreciation range system is used, the residual value need not be deducted from capitalized cost to determine depreciable costs. Depreciation cost that would significantly reduce the book value of a tangible capital asset below its residual value is unallowable. ~~is a charge to current operations which distributes the cost of a tangible capital asset, less estimated residual value, over the estimated useful life of the asset in a systematic and logical manner. It does not involve a process of valuation. Useful life refers to the prospective period of economic usefulness in a particular contractor's operations as distinguished from physical life; it is evidenced by the actual or estimated retirement and replacement practice of the contractor.~~

(b) Contractors having contracts subject to 48 CFR 9904.409, Depreciation of Tangible Capital Assets, ~~must~~ shall adhere to the requirement of that standard for all fully CAS-covered contracts and may elect to adopt the standard for all other contracts. All requirements of 48 CFR 9904.409 are applicable if the election is made, and ~~its requirements supersede any conflicting requirements of this cost principle. Once electing to adopt 48 CFR 9904.409 for all contracts,~~ contractors must continue to follow it until notification of final acceptance of all deliverable items on all open negotiated Government contracts. ~~Paragraphs (c) through (e) below apply to contracts to which 48 CFR 9904.409 is not applied.~~

(c) For contracts to which 48 CFR 9904.409 is not applied, except as indicated in paragraphs (g) and (h) of this subsection, ~~Normal depreciation on a contractor's plant, equipment, and other capital facilities is an allowable contract cost, if the contractor is able to demonstrate that it is reasonable and allocable (but see paragraph (i) of this section).~~

~~(d) Depreciation shall be considered reasonable if the contractor follows policies and procedures that are —~~

~~(1) Consistent with those followed in the same cost center for business other than Government;~~

~~(2) Reflected in the contractor's books of accounts and financial statements; and~~

~~(3) Both used and acceptable for Federal income tax purposes.~~

~~(e) When the depreciation reflected on a contractor's books of accounts and financial statements differs from that used and acceptable for Federal income tax purposes, reimbursement shall be based on the asset cost amortized over the estimated useful life of the property using depreciation methods (straight line, sum of the years' digits, etc.) acceptable for income tax purposes. A~~ allowable depreciation shall not exceed the amount~~s~~ used for financial accounting ~~book and statement~~ purposes, and shall be determined in a manner consistent with the depreciation policies and procedures followed in the same ~~cost center~~ segment on non-Government business~~(but see paragraph (o) of this subsection)~~.

~~(f) Depreciation for reimbursement purposes in the case of tax-exempt organizations shall be determined on the basis described in paragraph (e) of this section.~~

~~(g) Special considerations are required for assets acquired before the effective date of this cost principle if, on that date, the undepreciated balance of these assets resulting from depreciation~~

~~policies and procedures used previously for Government contracts and subcontracts is different from the undepreciated balance on the books and financial statements. The undepreciated balance for contract cost purposes shall be depreciated over the remaining life using the methods and lives followed for book purposes. The aggregate depreciation of any asset allowable after the effective date of this 31.205-11 shall not exceed the cost basis of the asset less any depreciation allowed or allowable under prior acquisition regulations.~~

~~(h) Depreciation should usually be allocated to the contract and other work as an indirect cost. The amount of depreciation allowed in any accounting period may, consistent with the basic objectives in paragraph (a) above, vary with volume of production or use of multishift operations.~~

~~(i) In the case of emergency facilities covered by certificates of necessity, a contractor may elect to use normal depreciation without requesting a determination of “true depreciation,” or may elect to use either normal or “true depreciation” after a determination of “true depreciation” has been made by an Emergency Facilities Depreciation Board (EFDB). The method elected must be followed consistently throughout the life of the emergency facility. When an election is made to use normal depreciation, the criteria in paragraphs (c), (d), (e), and (f) of this section shall apply for both the emergency period and the post-emergency period. When an election is made to use “true depreciation”, the amount allowable as depreciation—~~

~~(1) With respect to the emergency period (five years), shall be computed in accordance with the determination of the EFDB and allocated rateably over the full five year emergency period; *provided* no other allowance is made which would duplicate the factors, such as extraordinary obsolescence, covered by the Board’s determination; and~~

~~(2) After the end of the emergency period, shall be computed by distributing the remaining undepreciated portion of the cost of the emergency facility over the balance of its useful life provided the remaining undepreciated portion of such cost shall not include any amount of unrecovered “true depreciation.”~~

(~~j~~ d) ~~No d~~ Depreciation, rental, or use charges ~~shall be~~ are ~~allowed~~ unallowable on property acquired ~~at no cost~~ from the Government at no cost by the contractor or by any division, subsidiary, or affiliate of the contractor under common control.

(~~k~~ e) The depreciation on any item which meets the criteria for allowance at ~~a “~~price~~”~~ under 31.205-26(e) may be based on that price, provided the same policies and procedures are used for costing all business of the using division, subsidiary, or organization under common control.

(~~l~~ f) No depreciation or rental ~~shall be~~ is allowed on property fully depreciated by the contractor or by any division, subsidiary, or affiliate of the contractor under common control. However, a reasonable charge for using fully depreciated property may be agreed upon and allowed (but see 31.109(h)(2)). In determining the charge, consideration must ~~shall~~ be given to cost, total estimated useful life at the time of negotiations, effect of any increased maintenance charges or decreased efficiency due to age, and the amount of depreciation previously charged to Government contracts or subcontracts.

~~(m) 48 CFR 9904.404, Capitalization of Tangible Assets, applies to assets acquired by a “capital lease” as defined in Statement of Financial Accounting Standard No. 13 (FAS-13), Accounting for Leases, issued by the Financial Accounting Standards Board (FASB). Compliance with 48 CFR 9904.404 and FAS-13 requires that such leased assets (capital leases) be treated as purchased assets; *i.e.*, be capitalized and the capitalized value of such assets be distributed over their useful lives as depreciation charges, or over the leased life as amortization charges as appropriate. Assets whose leases are classified as capital leases under FAS-13 are~~

~~subject to the requirements of 31.205-11 while assets acquired under leases classified as operating leases are subject to the requirements on rental costs in 31.205-36. The standards of financial accounting and reporting prescribed by FAS-13 are incorporated into this principle and shall govern its application, except as provided in subparagraphs (1), (2), and (3) of this paragraph.~~

~~(1) Rental costs under a sale and leaseback arrangement shall be allowable up to the amount that would have been allowed had the contractor retained title to the property.~~

~~(2) Capital leases, as defined in FAS-13, for all real and personal property, between any related parties are subject to the requirements of this subparagraph 31.205-11(m). If it is determined that the terms of the lease have been significantly affected by the fact that the lessee and lessor are related, depreciation charges shall not be allowed in excess of those which would have occurred if the lease contained terms consistent with those found in a lease between unrelated parties.~~

~~(3) Assets acquired under leases that the contractor must capitalize under FAS-13 shall not be treated as purchased assets for contract purposes if the leases are covered by 31.205-36(b)(4).~~

(~~n~~ g) Whether or not the contract is otherwise subject to CAS, the requirements of 31.205-52, which limit the allowability of depreciation, shall be observed.

(~~o~~h) In the event of a write-down from carrying value to fair value as a result of impairments caused by events or changes in circumstances, allowable depreciation of the impaired assets shall be limited to the amounts that would have been allowed had the assets not been written down (see 31.205-16(g)). However, this does not preclude a change in depreciation resulting from other causes such as permissible changes in estimates of service life, consumption of services, or residual value.

(~~m~~i) ~~48 CFR 9904.404, Capitalization of Tangible Assets, applies to assets acquired by a~~ A "capital lease" as defined in Statement of Financial Accounting Standard No. 13 (FAS-13), Accounting for Leases, is subject to the requirements of this cost principle. (See 31.205-36 for Operating Leases.) ~~issued by the Financial Accounting Standards Board (FASB). Compliance with 48 CFR 9904.404 and~~ FAS-13 requires that ~~such leased assets (~~capital leases~~)~~ be treated as purchased assets; i.e., be capitalized and the capitalized value of such assets be distributed over their useful lives as depreciation charges, or over the leased life as amortization charges, as appropriate,~~. Assets whose leases are classified as capital leases under FAS-13 are subject to the requirements of 31.205-11 while assets acquired under leases classified as operating leases are subject to the requirements on rental costs in 31.205-36. The standards of financial accounting and reporting prescribed by FAS-13 are incorporated into this principle and shall govern its application~~, except ~~as~~ that~~-provided in subparagraphs (1), (2), and (3) of this paragraph.~~

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(2)~~ Capital leases, as defined in FAS-13, for all real and personal property, between any related parties are subject to the requirements of this subparagraph 31.205-11(m).~~ If it is determined that the terms of the lease have been significantly affected by the fact that the lessee and lessor are related, depreciation charges shall not be allowed in excess of those which would have occurred if the lease contained terms consistent with those found in a lease between unrelated parties.

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~~(n) Whether or not the contract is otherwise subject to CAS, the requirements of 31.205-52, which limit the allowability of depreciation, shall be observed.~~
~~(o) In the event of a write-down from carrying value to fair value as a result of impairments caused by events or changes in circumstances, allowable depreciation of the impaired assets shall be limited to the amounts that would have been allowed had the assets not been written down (see 31.205-16(g)). However, this does not preclude a change in depreciation resulting from other causes such as permissible changes in estimates of service life, consumption of services, or residual value.~~