



APR 4 2003

MEMORANDUM FOR RONALD POUSSARD
DIRECTOR
DEFENSE ACQUISITION REGULATIONS COUNCIL

FROM: RODNEY P. LANTIER, DIRECTOR
REGULATORY AND FEDERAL ASSISTANCE
PUBLICATIONS DIVISION

SUBJECT: FAR Case 2001-026, Depreciation Cost Principle

<u>Response Number</u>	<u>Date Received</u>	<u>Comment Date</u>	<u>Commenter</u>
2001-026-1	03/28/03	03/28/03	Lockheed Martin
2001-026-2	03/31/03	03/31/03	AIA

Attachments

201-026-1

March 28, 2003

General Services Administration
FAR Secretariat (MVA)
1800 F Street N.W., Room 4035
Washington, DC 20405

Attn: Laurie Duarte

Subject: FAR Case 2001-026

Dear Ms. Duarte:

Lockheed Martin Corporation (LMC) appreciates the opportunity to comment on the proposed revisions to the Depreciation Cost Principle. In addition, as the industry representative on the Cost Accounting Standards (CAS) Board, my comments reflect industry's perspective regarding CAS in FAR Cost Principles.

General

LMC supports Cost Principles streamlining efforts. The proposed changes to the Depreciation Cost Principles are good steps in the right direction. As further improvement, LMC has two classes of suggestions.

1. We should strive to either eliminate CAS in FAR, only use CAS clause references or direct CAS quotes.
2. Following is a specific list of recommended changes.

Specific Recommendations

- **31.205-11(a)** In the second sentence, change the word "shall" to "may". Not all contractors use the 10% residual value as a basis for determining its use. For those using something less, the cost principle should allow its use. An alternate suggestion to either reference CAS 409-50(h) or directly quote that clause.
- **31.205-11(a)** Delete last sentence starting with "Depreciation..." The sentence appears to be contradictory to the previous sentence and, in addition, this requirement is already covered in the definition of "depreciation".
- **31.205-11(d)** Delete the entire paragraph. Depreciation, by definition, requires a "cost". If there is no cost there is no depreciation. Comments on rental or use charges are already

2001-026-1

- covered in Part 45 and should be covered under 31.205.36 Rental Costs, if considered necessary, and not under the Depreciation Cost Principle.
- **31.205-11(f)** Delete the third sentence that begins with “In determining the charge...”. The requirements of this sentence are overly prescriptive and instructional. *FAR 31.109* already provides guidance on how to arrive at advance agreements.
 - **31.205.11(g)** Change the wording after 31.205.52 to read, “...which prescribe different rules for the allowability of depreciation under business combinations.” *FAR 31.205-52* does not necessarily “limit” allowability as stated in the proposed words.
 - **31.205-11(i)** Delete third sentence that begins with “Capital leases...”. This sentence is redundant to the first and second sentences.
 - **31.205-11(i)** Delete fourth sentence that begins with “Operating leases...” and sub-paragraph (1). The subject of this paragraph is Capital Leases. Operating leases and sale and lease back arrangements are covered under *FAR 31.205-36* and need not be repeated in the depreciation cost principle.
 - **31.205-11(i)** Delete the fifth sentence that begins with “The standards...”. Again, this sentence is repetitive of the first two sentences. Incorporate the “except as follows” at the end of this sentence to the end of the second sentence and include sub paragraph (2) only.
 - **31.205-11(j)** Change the second sentence to read: ‘However, assets purchased after the effective date of this cost principle shall be depreciated using methods prescribed in this cost principle.’ The sentence as proposed, requires contractors to change their depreciation methods if different. Existing government contracts are not required to change their practices. It appears that FAR is requiring non CAS covered contractors to follow CAS rules without considering equitable adjustments.
 - **31.205-36(a)** Delete the second sentence. This sentence discusses depreciation issues already covered under the Depreciation Cost Principle and need not be repeated under Rental Costs.

LMC believes that the above comments further streamline the proposed Depreciation Cost Principle without modifying the intent and should be considered in the final rule. If there are any questions, please feel free to contact me at... 301-897-6781.

Sincerely,

Anthony M. DiPasquale



2001-026-2

March 31, 2003

General Services Administration
FAR Secretariat (MVA)
1800 F Street, NW
Room 4035
ATTN: Ms. Laurie Duarte
Washington DC 20405

Subject: FAR Case 2001-026 on the Depreciation Cost Principle

Dear Ms. Duarte:

The Aerospace Industries Association (AIA) is pleased to submit comments on the proposed rule to amend the cost principle on depreciation costs. The AIA member companies applaud the Councils' streamlining endeavor and are pleased to see that the Councils have adopted many of the recommendations we previously proposed to eliminate unnecessary and restrictive regulatory language.

Our member companies benefit a great deal from making FAR language more consistent with applicable Cost Accounting Standards, eliminating references to Federal income tax accounting, recognizing the unique allowability issues associated with asset write-downs, deleting obsolete language regarding emergency facilities, and improving the structure and eliminating redundancies throughout the cost principle. Therefore, except for the editorial changes recommended in the attachment, we concur with the proposed FAR revisions.

We would also like to recommend, as we did in our responses to FAR Cases 2001-024 and 2002-001, the establishment of a uniform structure for the cost principles of Subpart 31.205. We strongly believe that such a user-friendly format will facilitate application in the field and reduce disputes.

If you have any questions concerning our recommendations for changes to the coverage, please contact Mr. Dick Powers of my staff. Dick can be reached on (202) 371-8526. His e-mail address is powers@aia-aerospace.org. Thank you for your consideration.

Sincerely,

A handwritten signature in black ink, appearing to read 'Robert T. Marlow', written over a horizontal line.

Robert T. Marlow
Vice President, Government Division

Attachment

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Ph. (703) 358-1000 / Fax (703) 358-1011 www.aia-aerospace.org

PROPOSED RULE	RATIONALE FOR CHANGES
<p>FAR 31.205-11</p> <p>(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 shall need <u>be used</u> in establishing depreciable costs. <u>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.</u> Depreciation cost that would <u>significantly</u> reduce the book value of a tangible capital asset below its residual value is unallowable.</p>	<p>Cost principle should allow flexibility in the use of residual values which are less than 10% in computing depreciation costs. Some contractor systems are set up to recognize the residual value irrespective of value. Consistent with CAS, other contractors only use residual values that exceed 10 percent. The cost principle should allow either approach and not require costly system changes for those which recognize lower residual values when computing depreciation.</p> <p>For clarification and consistency with the Councils' goal to make the requirements of this principle and CAS 409 the same in this area, we added (1) language re the recognition of residual values when certain depreciation methods are used, and (2) the term "significantly" when referring to the allowability of depreciation costs that reduce assets below their residual value.</p>
<p>(b) Contractors having contracts subject to 48 CFR 9904.409, Depreciation of Tangible Capital Assets, 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 contractors shall continue to follow it until notification of final acceptance of all deliverable items on all open negotiated Government contracts.</p>	
<p>(c) 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.</p>	
<p>(d) Depreciation, rental, or use charges are unallowable on property acquired from the Government at no cost by the contractor or by any division, subsidiary, or affiliate of the contractor under common control.</p>	<p>Deleted entire paragraph. GAAP requires depreciation costs be calculated on the basis of historical cost. If there is no cost to the contractor, there can be no depreciation cost incurred. Rental or use charges should be addressed under 31.205-36.</p>
<p>(e) The depreciation on any item that meets the</p>	

<p>criteria for allowance at 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.</p>	
<p>(f) No depreciation or rental 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, the contractor shall consider 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.</p>	<p>Rental or use charges should be addressed under 31.205-36.</p> <p>Deleted language that is overly prescriptive and instructional. These determinations will normally be made during the contract negotiation process, which is adequate for limiting costs in these circumstances.</p>
<p>(g) Whether or not the contract is otherwise subject to CAS, the contractor shall comply with the requirements of 31.205-52, which limit the allowability <u>prescribe additional rules for the allowability of depreciation when the purchase method of accounting for a business combination is used.</u></p>	<p>Revised language to more closely reflect the requirements of 31.205-52(a). That cost principle does not necessarily limit allowable depreciation costs.</p>
<p>(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 is 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.</p>	
<p>(i) 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. FAS-13 requires that 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. Capital leases under FAS 13 are subject to the requirements of 31.205-11. Operating leases are subject to the requirements of 31.205-36. The standards of financial accounting and reporting prescribed by FAS-13 are incorporated into this principle and govern its application, except as follows:</p>	<p>Deleted language that effectively duplicates language in the first sentence.</p> <p>This paragraph addresses capital leases. Operating leases are addressed in 31.205-36 and it is redundant to restate that here.</p> <p>Referencing FAS 13 requirements in this cost principle is an unnecessary restatement of FAR</p>

026-2

<p>(1) Rental costs under a sale and leaseback arrangement are allowable up to the amount that would have been allowed had the contractor retained title to the asset.</p> <p>(2) If it is determined that the terms of the capital lease have been significantly affected by the fact that the lessee and lessor are related, depreciation charges are not allowable in excess of those that would have occurred if the lease contained terms consistent with those found in a lease between unrelated parties.</p>	<p>31.201-2(a)(3). Deleted (1) because limitations on rental costs under sale and leaseback arrangements are addressed in 31.205-36. Similar statements need not be made here.</p>
<p>(j) The undepreciated balance of assets acquired before the effective date of this cost principle need not be retroactively adjusted if the assets were properly depreciated on Government contracts at the time the depreciation was charged. However, the remaining undepreciated balance as of the effective date of this cost principle shall be depreciated using the same method as used for financial statement purposes.</p>	<p>Deleted entire paragraph. It is obsolete in that it only applies to assets acquired before the effective date of this cost principle (i.e., pre-ASPR time frame). Also, it adds language that suggests a test must be performed on assets acquired before the effective date of this cost principle to determine if they were properly depreciated on Government contracts. Such a test would be impractical to perform for assets acquired so long ago and, heretofore, it was considered unnecessary. Since no explanation was given by the Councils for this additional requirement, we assume the additional language is not considered significant and should be deleted.</p>
<p>FAR 31.205-16 – No revisions recommended</p>	
<p>FAR 31-205-36</p>	
<p>(a) This subsection is applicable to the cost of renting or leasing real or personal property acquired under "operating leases" as defined in Statement of Financial Accounting Standards No. 13 (FAS-13), Accounting for Leases. Compliance with 31.205-11(i) requires that assets acquired by means of capital leases, as defined in FAS-13, 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 lease term as amortization charges, as appropriate.</p>	<p>Deleted reference to 31.205-11 and the detailed description of its provisions which have no relevance to this cost principle. As stated in the first sentence, this subsection is applicable only to operating leases. Adding language on capital leases is unnecessary and confusing.</p>
<p>(b) The following costs are allowable:</p> <p>(1) Rental costs under operating leases, to the extent that the rates are reasonable at the time of the lease decision, after consideration of –</p> <p>(i) Rental costs of comparable property, if any;</p> <p>(ii) Market conditions in the area;</p> <p>(iii) The type, life expectancy, condition, and value of the property leased;</p>	<p>No explanation was given by the councils for</p>

026-2

<p>(iv) <u>Alternatives available; and</u> (v) <u>Other provisions of the agreement.</u></p>	<p>deleting criteria (iv). Recommend it be retained.</p>
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