CAS: The Series – Episode 9: Assets & Material – CAS 404, 409, 411

Forvis Mazars US

Presented by: Brian Gallagher

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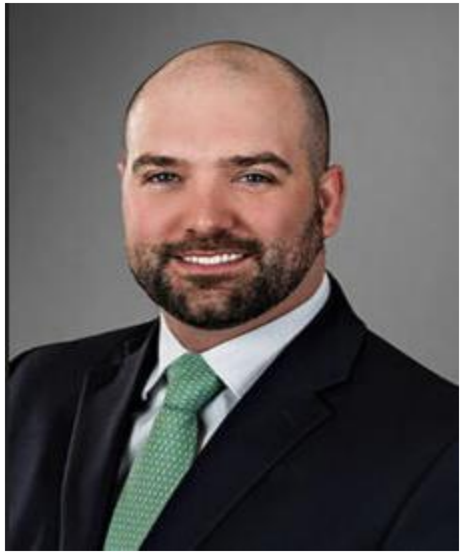
Your Instructors



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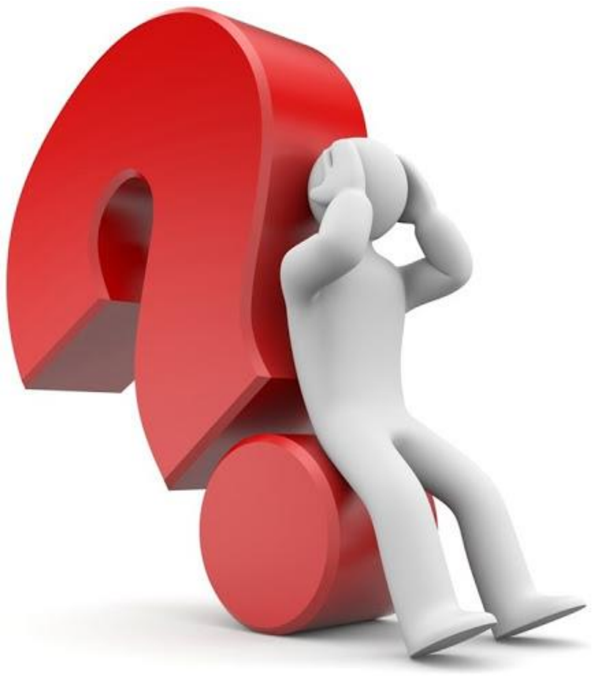
Polling Question



Where are you working from today?

1. Home or alternate work location
2. My company office
3. A different work location
4. Traveling
5. Other

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Layout of the Series

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CAS in a minute!

- Contracts are subject to CAS – not contractors!

Contract Subject to CAS? ← 9 Exemptions listed in 9903.201-1(b)

Modified vs. Full ← $50 million threshold

Disclosure Statement ← Full – yes – Modified - maybe

Layout of CAS the Series

- Pilot Episode – 90-minute webinar to kick off the series
- Individual 90-minute episodes:
- Episode 1 – CAS Clauses, Exemptions and Full/Modified CAS
- Episode 2 – Cost Accounting Practice Changes & Administration
- Episode 3 – CAS 401, 402, 405 & 406
- Episode 4 – Compensation – CAS 408, 412, 413 & 415
- Episode 5 – Direct and Indirect Costs – CAS 418
- Episode 6 – Home office allocations – CAS 403

Layout of CAS the Series

- Episode 7 – G&A and B&P/ IR&D – CAS 410 & 420
- Episode 8 – COM and Standard Costs – CAS 407, 409 & 411
- Episode 9 – Assets & Material – CAS 404, 409 & 411
- Episode 10 – Insurance and CAS 419 – CAS 416 and the mystery of CAS 419
- Episode 11 – Disclosure Statements
- Episode 12 – CAS Administration – Roles of DCMA & DCAA

The Cost Accounting Standards

- BASIC Standards
  - CAS 401: Consistency
  - CAS 402: Direct v. Indirect Costs
  - CAS 405: Unallowable Costs
  - CAS 406: Cost Accounting Period
- The Cost Allocation Standards
  - CAS 407: Standard Costs
  - CAS 409: Cost of Money
  - CAS 410: General & Administrative
  - CAS 403: Home Office expenses
  - CAS 418: Direct & Indirect
  - CAS 420: B&P and IR&D
- Asset Accounting Standards
  - CAS 404: Capitalization
  - CAS 409: Depreciation
  - CAS 411: Self Constructed Assets
- Compensation Standards
  - CAS 408: Compensated Assets
  - CAS 412 & 413: Pensions
  - CAS 415: Deferred Compensation
- Other Standards
  - CAS 411: Material Costs
  - CAS 416: Insurance Costs

The Format of the Standards

- Purpose (.20)
- Definitions (.30)
- Fundamental Requirement (.40)
- Techniques for Application (.50)
- Illustrations (.60)
- Interpretation (.61)
- Exemption (.62)
- Effective Date (.63)

CAS 404

History

- CAS 404 – Capitalization of Tangible Assets
  - Published on February 27, 1973
  - Took effect on July 31, 1973
- Companion Standard with CAS 409
- CASB identified the need to determine:
  1. acquisition costs to be capitalized as opposed to those charged against revenues of the current period
  2. appropriate depreciation charges for a given fiscal period
  3. appropriate allocation of depreciation charges among contractor activities, and
  4. appropriate techniques for treating dispositions of fixed assets.
- CAS 404 addressed item 1, CAS 409 items 2 to 4.
- In 1996, the threshold was increased from $1,500 to $5,000

CAS 404 - Capitalization of Tangible Assets

- For purposes of cost measurement, contractors must establish and adhere to policies with respect to capitalization of tangible assets which satisfy this Standards criteria.
- Normally, cost measurements are based on the concept of enterprise continuity; this concept implies that major asset acquisitions will be capitalized, so that the cost applicable to current and future accounting periods can be allocated to cost objectives of those periods.

CAS 404 - Definitions

- **Asset accountability** means a tangible capital asset which is a component of plant and equipment that is capitalized when the unit is removed, transferred, sold, abandoned, demolished, or otherwise disposed of.
- **Original complement of low-cost equipment** means a group of items acquired for the initial outfitting of a tangible capital asset or an operational unit, or a new addition to either.
  - The items in the group individually cost less than the minimum amount established by the contractor for capitalization for the classes of assets acquired but in the aggregate they represent they represent a material investment.
  - The group, as a complement, is expected to be held for continued service beyond the current period. Initial outfitting of the unit is completed when the unit is ready and available for normal operations.
- **Repairs & maintenance** generally means the total endeavor to obtain the expected service during the life of tangible capital assets. they represent a material investment.
  - The group, as a complement, is expected to be held for continued service beyond the current period. Initial outfitting of the unit is completed when the unit is ready and available for normal operations.
- **Tangible capital asset** means an asset that has physical substance, more than minimal value, and is expected to be held by an enterprise for continued use or possession beyond the current accounting period for the service it yields.

CAS 404 – Fundamental Requirement

- The acquisition cost of tangible capital assets must be capitalized
- Requires a written policy that is reasonable and consistently applied
- The policy must designate economic and physical characteristics for capitalization of tangible assets:
  - Estimated service life > 2 years; and
  - Minimum acquisition cost > $5,000
- Policy must identify:
  - Asset accountability units
  - May designate higher limitation for original compliment of low cost equipment
- Costs incurred subsequent to capitalization:
  - that extend the life or increase the productivity of that asset (e.g., betterments and improvements) and which meet the criteria for capitalization must be capitalized with appropriate accounting for replaced asset accountability units
  - for repairs and maintenance that either restore the asset to, or maintain it at, its normal or expected service life or production capacity are costs of the current period

Techniques for Application – Capitalized Amount

- The cost to acquire a tangible capital asset includes the purchase price of the asset and costs necessary to prepare the asset for use:
  - Purchase price:
    - is the consideration given in exchange for an asset and is determined by cash paid or an amount equivalent to what would be the cash price basis
    - is adjusted for premiums and extra charges paid or discounts and credits received
    - Donated assets are capitalized at their fair value
  - Cost to prepare the asset for use:
    - Include the cost of placing the asset in location and bringing the asset to a condition necessary for normal or expected use
    - Where material in amount, costs include initial inspection and testing, installation and similar expenses

Techniques for Application – Other values

- Tangible capital assets constructed or fabricated by a contractor for its own use shall be capitalized at amounts which include all indirect costs properly allocable to such assets
- When purchase or donation is not an arm's length transaction, acquisition cost shall be limited to the capitalized cost of the asset to the owner who last acquired the asset through an arm's-length transaction, reduced by depreciation charges

Techniques for Application – Business Combination

- Purchase method of accounting:
  - When prior depreciation was charged to negotiated federal contracts - capitalized by the buyer at the net book value of the asset as reported by the seller at the time of the transaction
  - When prior depreciation was not charged to negotiated federal contracts - shall be assigned a portion of the cost of the acquired company not to exceed their fair value at the date of acquisition
- Pooling of interest method of accounting:
  - The values established for tangible capital assets for financial accounting shall be the values used for determining the cost of such assets

Illustration #1 – Costs which must be capitalized

- Contractor A has an established policy of capitalizing tangible assets which have a service life of more than 1 year and a cost of $6,000
  - The contractor's policy must be modified to conform to the $5,000 minimum acquisition cost
- Contractor A acquires a tangible capital asset with a life of 18 months at a cost of $6,500
  - The Standard requires that the asset be capitalized in compliance with contractor's policy as to service life
- Contractor A acquires a tangible asset with a life of 18 months at a cost of $900.
  - The asset need not be capitalized unless the contractor's revised policy establishes a minimum cost criterion below $900.

Illustration #2 – Costs which must be capitalized

- Contractor B has an established policy for treating its heavy presses and their power supplies as separate asset accountability units. A power supply is replaced during the service life of the related press.
  - Based on the contractor's policy, the new power must supply be capitalized with appropriate accounting for the replaced unit.
- Contractor C has an established policy of capitalizing tangible assets which have a service life of more than 1 year and a cost of $250. Contractor acquires a tangible asset with a life of 18 months and a cost of $300.
  - Based on the Contractor's policy, the asset must be capitalized

Illustration #3 – Costs which need not be capitalized

- The contractor has an established policy of capitalizing tangible assets which have a service life of 2 years and a cost of $500. The contractor acquires an asset with a useful life of 18 months and a cost of $5,000.
  - The tangible asset should be expensed because it does not meet the 2-year criterion.
- The contractor establishes a new assembly line. In outfitting the line, the contractor acquires $5,000 of small tools. On similar assembly lines under similar conditions, the original complement of small tools was expensed because the complement was replaced annually as a result of loss, pilferage, breakage, and physical wear and tear.
  - Because the unit of original complement does not meet the contractor's service life criterion for capitalization (1 year), the small tools may be expensed.

Fun Facts about CAS 404

- CASB Staff Discussion Paper 2020-01 on conformance of CAS to GAAP – CAS 404 and CAS 411
- 3 gaps between GAAP and CAS 404
  - Minimum capitalization threshold
  - Written policy for capitalization
  - Assets acquired through a business combination

CAS 409

History

- Companion Standard to CAS 404
- CAS 409
  - Published on January 29, 1975
  - Took effect on July 1, 1975
- 2 proposed rules
- 200 comments
- CASB Industry member dissented on CAS 409 – first standard not unanimously adopted
- Congress held hearings
- DoD felt that the inability to use accelerated depreciation – industry might not be motivated to invest

CAS 409 - Depreciation of Tangible Assets

- Provides criteria and guidance for assigning costs of tangible capital assets to cost accounting periods and for allocating such costs in cost objectives within such periods in an objective and consistent manner
- Based on the concept that depreciation costs identified with cost accounting periods and benefiting cost objectives within periods should be a reasonable measure of the expiration of service potential of the tangible assets subject to depreciation
- Standard should provide a systematic and rational flow of the costs of tangible capital assets to benefitted cost objectives over the expected service lives of the assets.
- CAS 409 does not cover nonwasting assets or natural resources which are subject to depletion.

CAS 409 - Definitions

- **Residual value** means the proceeds (less removal and disposal costs, if any) realized upon disposition of a tangible capital asset.
  - It usually is measured by the net proceeds from the sale or other disposition of the asset, or its fair value if the asset is traded in on another asset.
  - The estimated residual value is a current forecast of the residual value .
- **Service life** means the period of usefulness of a tangible asset (or group of assets) to its current owner.
  - The period may be expressed in units of time or output.
  - The estimated service life of a tangible capital asset (or group of assets) is a current forecast of its service life and is the period over which depreciation cost is to be assigned.
- **Tangible capital asset** means an asset that has physical substance, more than minimal value, and is expected to be held by an enterprise for continued use or possession beyond the current accounting period for the services it yields.

Fundamental Requirement - Assignment

- The depreciable cost of a tangible capital asset (or group of assets) shall be assigned to cost accounting periods in accordance with the following criteria:
  - The depreciable cost of a tangible capital asset shall be its capitalized cost less its estimated residual value.
  - The estimated service life of a tangible capital asset (or group of assets) shall be used to determine the cost accounting periods to which the depreciable cost will be assigned.
  - The method of depreciation selected for assigning the depreciable cost of a tangible capital asset (or group of assets) to the cost accounting periods representing its estimated service life shall reflect the pattern of consumption of services over the life of the asset.
  - The gain or loss which is recognized upon disposition of a tangible capital asset shall be assigned to the cost accounting period in which the disposition occurs.

CAS 409 – Fundamental Requirement - Allocation

- The annual depreciation cost of a tangible capital asset (or group of assets) shall be allocated to cost objectives for which it provides service in accordance with the following criteria:
  - Depreciation cost may be charged directly to cost objectives only if such charges are made on the basis of usage and only if depreciation costs of all like assets used for similar purposes are charged in the same manner.
  - Where tangible capital assets are part of, or function as, an organizational unit whose costs are charged to other cost objectives based on measurement of the services provided by the organizational unit, the depreciation cost of such assets shall be included as part of the cost of the organizational unit.
  - Other depreciation costs shall be included in appropriate indirect cost pools.
- The gain or loss recognized upon disposition, where material in amount, shall be allocated in the same manner as the depreciation cost of the asset has been or would have been allocated for the cost accounting period in which the disposition occurs.
- Where a gain or loss is not material, the amount may be included in an appropriate indirect cost pool.

Techniques for Application – Service Lives

- Determination of the appropriate depreciation charges involves estimates:
  - Service life, and
  - Likely pattern of consumption of services
- In selecting service life estimates and in selecting depreciation methods, many of the same physical and economic factors should be considered.
- Factors which may be considered:
  - Quantity and quality of expected output,
  - costs of repair and maintenance,
  - standby or incidental use,
  - technical or economic obsolescence of the asset (or group of assets), or of the product or service it is involved in producing.

CAS 409 – Techniques for Application – Timing

- Depreciation begins when the asset and any others on which its effective use depends are ready for use in a normal or acceptable fashion.
- Where partial utilization is identified with a specific operation, depreciation shall commence on any portion of the asset which is substantially completed and used for that operation.
- Depreciable spare parts which are required for operation must be accounted for over the service life of the assets.
- A consistent policy must be followed in determining the depreciable cost to be assigned to the beginning and ending cost accounting periods of asset use. The policy may provide for any reasonable starting and ending dates in computing the first and last year depreciable cost.

Techniques for Application – Est. Service Lives

- Estimated service lives initially established must be reasonable approximations of expected actual periods of usefulness
- Estimate does not need to include the additional period the assets are retained for standby or incidental use where adequate records are maintained which reflect the withdrawal from active use
  - The expected actual periods of usefulness must be supported by records adequate to show the age at retirement or, at withdrawal from active use
  - Records must be developed from current and historical fixed asset records and be used as a basis for estimates of service lives of future assets
  - Estimated service lives used for financial accounting purposes, if not unreasonable, must be used until adequate supporting records are available
- Estimated service lives where the contractor has no available data or no prior experience for similar assets – use IRS guidelines until able to develop estimates appropriately supported by experience
- Contracting parties may agree on the estimated service life where the unique purpose for which the equipment was acquired or other special circumstances warrant a shorter estimated service life

Techniques for Application – Depreciation Method

- The method of depreciation used for financial accounting purposes must be used for contract costing unless:
  - The method does not reasonably reflect the expected consumption of services for the asset, or
  - the method is unacceptable for Federal income tax purposes.
- Factors for consideration of expected consumption:
  - Hours of operation,
  - Number of operations performed,
  - Number of units produced, or
  - Number of miles traveled.
  - Surrogate for expected activity or output might be a monetary measure of that activity or output generated by the asset
- The appropriate method of depreciation should be selected as follows:
  - An accelerated method of depreciation is appropriate where the expected consumption of asset services is significantly greater in early years of asset life.
  - The straight-line method of depreciation is appropriate where the expected consumption of asset services is reasonably level over the service life of the asset

Techniques for Application – Residual Value

- Estimated residual values must be determined for all tangible capital assets (or groups of assets)
- For tangible personal property, only estimated residual values which exceed ten percent of the capitalized cost of the asset (or group of assets) 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 consistent with the provisions of this Standard, the residual value need not be deducted from capitalized cost to determine depreciable costs.
- No depreciation cost shall be charged which would significantly reduce book value of a tangible capital asset (or group of assets) below its residual value.
- Estimates of service life, consumption of services, and residual value shall be reexamined whenever circumstances change significantly.

CAS 409 – Illustration #1

- Companies X, Y, and Z purchase identical milling machines to be used for similar purposes.
  - Company X estimates service life for tangible capital assets on an individual asset basis. Its experience with similar machines is that the average replacement period is 14 years.
    - CAS 409 requires Company X to use the estimated service life of 14 years for the milling machine unless it can demonstrate changed circumstances or new circumstances to support a different estimate.
  - Company Y estimates service life for tangible capital assets by grouping assets of the same general kind and with similar service lives. Accordingly, all machine tools are accounted for as a single group. The average replacement life for machine tools for Company Y is 12 years.
    - CAS 409 requires Company Y to use a life of 12 years for the acquisition unless it can support a different estimate for the entire group.
  - Company Z estimates service life for tangible capital assets by grouping assets according to use without regard to service lives. Accordingly, all machinery and equipment is accounted for as a single group. The average replacement life for machinery and equipment in Company Z is 10 years.
    - CAS 409 requires Company Z to use an estimated service life of ten years for the acquisition unless it can support a different estimate for the entire group.

CAS 409 – Illustration #2

- Company X wants to charge depreciation of the milling machine in the previous example directly to final cost objectives.
- Usage of the milling machine can be measured readily based on hours of operation.
- Company X may charge depreciation cost directly on a unit of time basis provided he uses one depreciation charging rate for all like milling machines in the machine shop and charges depreciation for all such milling machines directly to benefiting cost objectives.

CAS 409 – Illustration #3

- A contractor acquires a test facility with an estimated physical life of 10 years, to be used on contracts for a new program.
- The test facility was acquired for $5 million. It is expected that the program will be completed in 6 years and the test facility acquired is not expected to be required for other products of the contractor.
- Although the facility will last 10 years, the contracting parties may agree in advance to depreciate the facility over 6 years.

CAS 411

History

- CAS 411 – Accounting for the Acquisition Cost of Material
  - Published on May 5, 1975
  - Took effect on January 1, 1976
- Existing GAAP seemed to cover the elements of CAS 411 – CASB felt the Standard was needed – "even if the Standard does no more than establish as a CAS the currently prevailing procurement regulations dealing with the allocation of costs to cost objectives."

CAS 411 - Accounting for Acquisition Costs of Material

- Provides criteria for the accounting for acquisition costs of material.
- Includes provisions on the use of inventory costing methods.
- Does not cover accounting for the acquisition costs of tangible capital assets nor accountability for Government-furnished materials.

CAS 411 - Definitions

- **Allocate** means to assign an item of cost, or a group of items of cost, to one or more cost objectives. This term includes both direct assignment of cost and the reassignment of a share from an indirect cost pool.
- **Business Unit** means any segment of an organization, or an entire business organization which is not divided into segments.
- **Category of material** means a particular kind of goods, comprised of identical or interchangeable units, acquired or produced by a contractor, which are intended to be sold, or consumed, or used in the performance of either direct or indirect functions.
- **Cost objective** means a function, organizational subdivision, contract or other work unit for which cost data are desired and for which provision is made to accumulate and measure the cost of processes, products, jobs, capitalized projects, etc.
- **Material inventory record** means any record used for the accumulation of actual or standard costs of a category of material recorded as an asset for subsequent cost allocation to one or more cost objectives.
- **Moving average cost** means an inventory costing method under which an average unit cost is computed after each acquisition by adding the cost of the newly acquired units to the cost of the units of inventory on hand and dividing this figure by the new total number of units.
- **Weighted average cost** means an inventory costing method under which an average unit cost is computed periodically by dividing the sum of the cost of beginning inventory plus the cost of acquisitions by the total number of units included in these two categories.

CAS 411 – Fundamental Requirement

- Requires written statements of accounting policies and practices for accumulating the costs of material and for allocating costs of material to cost objectives.
- The cost of units of a category of material may be allocated directly to a cost objective provided the cost objective was specifically identified at the time of purchase or production of the units.
- The cost of material used solely in performing indirect functions, or is not a significant element of production cost, may be allocated to an indirect cost pool.
- The cost of a category of materials must be accounted for in material inventory records.
- In allocating to cost objectives the costs of a category of material issued from company-owned material inventory, the costing method used shall be acceptable under this CAS and shall be used in a manner which results in systematic and rational costing of issues of material to cost objectives.
- The same costing method shall, within the same business unit, be used for similar categories of materials.

Techniques for Application – Material Cost

- Material cost must be the acquisition cost of a category of material, whether or not a material inventory record is used.
- The purchase price of material shall be adjusted by extra charges incurred or discounts and credits earned.
- Adjustments shall be charged or credited to the same cost objective as the purchase price of the material, except that where it is not practical to do so, the contractor's policy may provide for the consistent inclusion of such charges or credits in an appropriate indirect cost pool.

Techniques for Application – Inventory Methods

- One of the following inventory costing methods must be used when issuing material from a company-owned inventory:
  - The first-in, first-out (FIFO) method.
  - The moving average cost method.
  - The weighted average cost method.
  - The standard cost method.
  - The last-in, first-out (LIFO) method.
- The method of computation used for any inventory costing method selected must be consistently followed.

CAS 411 – Illustration #1

- Contractor “A” has one contract which requires two custom-ordered, high-value, airborne cameras.
  - The contractor's established policy is to order such special items specifically identified to a contract as the need arises and to charge them directly to the contract.
  - Another contract is received which requires three more of these cameras, which the contractor purchases at a unit cost which differs from the unit cost of the first two cameras ordered.
  - When the purchase orders were placed, the contractor identified the specific contracts on which the cameras being purchased were to be used.
  - Although these cameras are identical, the actual cost of each camera is charged to the contract for which it was acquired without establishing a material inventory record.
- This practice would not be a violation of CAS 411.

CAS 411 – Illustration #2

- A Government contract requires use of electronic tubes identified as “W.” The contractor expects to receive other contracts requiring the use of tubes of the same type.
- In accordance with its written policy, the contractor establishes a material inventory record for electronic tube “W,” and allocates the cost of units issued to the existing Government contract by the FIFO method.
- This practice conforms to the requirements of CAS 411

Public Contracting Institute

CAS 411 – Illustration #3

- A contractor has established inventories for various categories of material which are used on Government contracts. During the year the contractor allocates the costs of the units of the various categories of material issued to contracts by the moving average cost method. The contractor uses the LIFO method for tax and financial reporting purposes and, at year end, applies a pooled LIFO inventory adjustment for all categories of material to Government contracts.
- This application of pooled costs to Government contracts would be a violation of CAS 411 because the lump sum adjustment to all of the various categories of material is, in effect, a noncurrent repricing of the material issues.

Fun Facts about CAS 411

- CASB Staff Discussion Paper 2020-01 on conformance of CAS to GAAP – CAS 404 and CAS 411
- 2 gaps between GAAP and CAS 411
  - Written policy for accumulating and allocating cost of material
  - Average cost method for inventory costing

Positioning for future sessions . . .

October 24th – 2:00 Eastern . . .

Episode 10 – Insurance and CAS 419 – CAS 416 & the mystery of CAS 419

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Last Chance for Some Questions