DEFENSE CONTRACT AUDIT AGENCY
DEPARTMENT OF DEFENSE
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IN REPLY REFER TO

PAC 730.3.B.01/2006-12 August 15, 2006
06-PAC-028(R)

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

SUBJECT: Audit Guidance on Revised FAR 31.205-11 Limiting the Allowable Depreciation Costs for Assets Reacquired Subsequent to a Sale-and-Leaseback Transaction

SUMMARY

Effective July 28, 2006, FAR 31.205-11, *Depreciation*, limits allowable depreciation costs for assets that have been reacquired subsequent to a sale-and-leaseback arrangement. The allowable depreciation costs for the reacquired assets are based on the original acquisition costs of the assets that have since been sold and leased back, and then reacquired. Auditors should question costs claimed by the contractor in excess of this limitation.

GUIDANCE

Revised FAR 31.205-11, *Depreciation*, (see Enclosure 1) taken with the recent FAR requirement on the recognition of gains or losses associated with sale-and-leaseback transactions (see MRD 05-PAC-053(R), dated August 15, 2005), ensures that the Government reimburses a contractor for its continuous use of an asset at no more than its original acquisition cost. Auditors should be aware of the following key elements of the revised rule and question costs claimed by the contractor in excess of the limitation:

Allowable Depreciation Cost Limitation: The allowable depreciation costs are calculated based on the following formula (FAR 31.205-11(g)(3)):

1) Net book value of the asset on the sale-and-leaseback date, plus
2) Allowable gain/loss recognized on the sale-and-leaseback date (FAR 31.205-16(b)), less,
3) Depreciation expense considered when determining the allowable lease costs (FAR 31.205-36(b)(2) or 31.205-11(h)(i)(1))

Reacquired Property: The new depreciation limitation at FAR 31.205-11(g)(3) is applicable only to those assets that generated costs in the most recent accounting period prior to reacquisition. Auditors should recognize that the rule would not apply in those situations where a contractor has re-acquired an asset subsequent to the passing of a full accounting period after the lease is terminated and the contractor ceases use of the asset.

To help auditors better understand the application of the sale-and-leaseback rules, we have attached comprehensive examples that demonstrate 1) the recognition of a gain or loss, 2) the lease cost limitation, and 3) the depreciation cost limitation when the asset is subsequently reacquired (see Enclosure 2).

CONCLUDING REMARKS

Field audit office personnel should direct questions regarding this memorandum to their regional offices. Regional offices should direct their questions to Accounting and Cost Principles Division, at (703) 767-3245.

/Signed/
Terry M. Schneider
Deputy Assistant Director
Policy and Plans

Enclosures: 2
1. Final Rule – Line In / Line Out
2. Examples

DISTRIBUTION: C

FAR CASE 2004-014, Asset Buy Back
FINAL RULE

Baseline is the FAR, current through FAC 2005-09, with changes indicated by **[bold]** and deletions are indicated by strikethrough. The final rule was published on June 28, 2006 at 71 FR 36939 (effective July 28, 2006).

31.205-11 Depreciation

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(g) Whether or not the contract is otherwise subject to CAS, **[the following apply:**

(1) T]~~t~~he requirements of 31.205-52 shall be observed.

(**[2]**~~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.

[(3)(i) In the event the contractor reacquires property involved in a sale and leaseback arrangement, allowable depreciation of reacquired property shall be based on the net book value of the asset as of the date the contractor originally became a lessee of the property in the sale and leaseback arrangement—

(A) Adjusted for any allowable gain or loss determined in accordance with 31.205–16(b); and

(B) Less any amount of depreciation expense included in the calculation of the amount that would have been allowed had the contractor retained title under 31.205–11(h)(1) and 31.205– 36(b)(2).

(ii) As used in this paragraph (g)(3), ''reacquired property'' is property that generated either any depreciation expense or any cost of money considered in the calculation of the limitations under 31.205–11(h)(1) and 31.205–36(b)(2) during the most recent accounting period prior to the date of reacquisition.]

(**[h]**~~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. (See 31.205-36 for Operating Leases.) 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, except that-

(1) Lease costs under a sale and leaseback arrangement are allowable only up to the amount that would be allowed if the contractor retained title, computed based on the net book value of the asset on the date the contractor becomes a lessee of the property adjusted for any gain or loss recognized in accordance with 31.205-16(b); and

(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.

EXAMPLES

Application of the Cost Principles for Assets Involved in Sale-and-Leaseback Transactions And the Subsequent Reacquisition of the Subject Asset

The following examples demonstrate the implementation of the rules regarding: (1) the recognition of gains and losses as a result of a sale-and-leaseback transaction, in accordance with FAR 31.205-16; (2) its impact on the rental/lease cost limitations of FAR 31.205-36 and FAR 31.205-11; and (3) the depreciation limitation on assets that are reacquired in accordance with FAR 31.205-11.

The examples shown below involve a sale-and-leaseback transaction taking place at the end of year 2 after initial acquisition of the asset. The asset is subsequently reacquired by the contractor at the end of the sale-and-leaseback period (end of year 7).

Note: Had the subject asset been reacquired at the beginning of year 9 or later, the buy back provisions of FAR 31.205-11, which limits future depreciation costs, would not apply per FAR 31.205-11(g)(3)(ii).

Assumptions	**Gain Transaction**	**Loss Transaction**	
Acquisition Cost:	$400,000	$400,000	
Residual Value:	0	0	
Useful Life (Straight Line):	10 Yrs	10 Yrs	
Accumulated Depreciation	80,000	80,000	
Net Book Value at End of Year 2	320,000	320,000	
Sale/Leaseback Agreement at the End of Year 2			
Fair Market Value of the Asset at Sale/Leaseback	$430,000	$300,000	
Net Amount Realized at Sale/Leaseback	410,000	280,000	
Lease Cost Per Year	55,000	45,000	
Lease Term	5 Yrs	5 Yrs	
Reacquired Asset at the End of the Lease Term			
Reacquisition Cost:	$180,000	$120,000	
Remaining Useful Life	3 Yrs	3 Yrs	
(1) Gain/Loss at a Sale-and-Leaseback			
Gain or Loss Resulting from Asset Disposition			
Net Amount Realized at Sale/Leaseback	$410,000	$280,000	
Less – Net Book Value	320,000	320,000	
Gain / (Loss) (FAR 31.205-16(b)(1))	90,000	(40,000)	Note 1
Recognized Gain (FAR 31.205-16(d))	$80,000		Note 2
Allowable Loss (FAR 31.205-16(b)(2)(ii))		($20,000)	Note 3

(2) Lease Cost Limitation During Leaseback Period

Allowable Annual Lease / Rental Costs			
Net Book Value on Lease Date	$320,000	$320,000	
Add Recognized Gain / (Subtract Allowable Loss)	80,000	(20,000)	
Adjusted Net Book Value	400,000	300,000	
Remaining Useful Life of Asset	8 Yrs	8 Yrs	
Annual Depreciation Cost	50,000	37,500	
Add: Other Annual Costs of Ownership (e.g., cost of money, taxes, insurance, etc.)	1,000	1,000	
Constructive Ownership Costs (Allowable Annual Lease Cost)	51,000	38,500	Note 4
Annual Lease Cost per Sale/Leaseback Agreement	55,000	45,000	
Unallowable Cost	4,000	6,500	

(3) Asset Reacquisition

Net Book Value on Lease Date (FAR 31.205-11(g)(3)(i))	$320,000	$320,000	
Add Recognized Gain / (Subtract Allowable Loss) (FAR 31.205-11(g)(3)(i)(A))	80,000	(20,000)	Notes 2 & 3
Less: Depreciation Expense Had the Contractor Retained Title (FAR 31.205-11(g)(3)(i)(B))	(250,000)	(187,500)	Note 5
Adjusted Net Book Value	150,000	112,500	
Remaining Useful Life of Asset	3 Yrs	3 Yrs	
Annual Depreciation Expense Limitation	50,000	37,500	
Annual Depreciation Based on Reacquisition Cost	60,000	40,000	Note 6
Unallowable Cost	10,000	2,500	

Note 1: In accordance with FAR 31.205-16(b)(1), under a sale-and-leaseback transaction, the gain or loss is the difference between the net amount realized and the undepreciated balance of the asset on the lease date.

Note 2: While FAR 31.205-16(b)(1) provides criteria by which gains will be determined under a sale-and-leaseback transaction, FAR 31.205-16(d) limits the gain recognized for contract costing purposes "to the difference between the acquisition cost . . . .of the asset and its undepreciated balance . . . ." In this particular example, the recognized gain is limited to $80,000 (as opposed to the $90,000 gain calculated above), which represents the difference between the original acquisition cost of $400,000 and the undepreciated balance of $320,000. In other words, FAR 31.205-16(d) limits the recognized gain to the amount of depreciation costs previously taken.

Note 3: As noted above, FAR 31.205-16(b)(1) provides criteria by which gains and losses will be calculated under a sale-and-leaseback transaction. However, FAR 31.205-16(b)(2)(ii) limits allowable losses to the difference between the fair market value of the asset and its undepreciated balance. In the example, the allowable loss is limited to $20,000 (as opposed to the $40,000 loss calculated above), which represents the difference between the fair market value of $300,000 and its net book value of $320,000 on the date of the sale and leaseback transaction. Although not present in the example, FAR 31.205-16(b)(2)(i) states that when an asset's fair market value exceeds its undepreciated balance the allowable loss is zero.

Note 4: In accordance with FAR 31.205-36(b)(2) and FAR 31.205-11(h)(1), the subsequent rental / lease expense under a sale-and-leaseback transaction is limited to the amount the contractor would have been allowed (including additional costs of ownership, e.g., cost of money, insurance, taxes, etc), adjusted for any gain or loss recognized, had the contractor retained title to the asset. The following summarizes these limitations as applied to the above examples:

- **Gain Transaction –** In accordance with the provisions noted above, the allowable annual lease amount of $51,000 is determined by; a) adjusting the net book value of the asset as of the lease date ($320,000) for any recognized gain ($80,000) as determined under Note 2 above, and dividing that amount ($400,000) by the remaining useful life of the asset (8 years) to arrive at the calculated annual depreciation cost of $50,000, and b) adding to this amount the other annual costs of ownership of $1,000.

- **Loss Transaction**. – As noted in the gain transaction above, the allowable annual lease cost of $38,500 is determined by adding the other annual costs of ownership ($1,000) to the calculated annual depreciation cost of $37,500. The $37,500 annual depreciation cost is determined by adjusting the asset's net book value for the recognized loss as determined under Note 3 above, and dividing that amount by the remaining useful life of the asset ($320,000 - $20,000 = $300,000/8yrs = $37,500).

Note 5 In accordance with the provisions at FAR 31.205-11(g)(3)(i), the allowable depreciation for assets reacquired subsequent to a sale-and-leaseback arrangement is determined based on the net book value of the subject asset on the leaseback date (end of year 2), plus or minus the allowable gain or loss as recognized at the lease inception (Notes 2 and 3, respectively), less the amount of depreciation expense that would have been allowed had the contractor retained title to the asset. The annual allowable depreciation expense had the contractor retained title is $50,000 (gain transaction) and $37,500 (loss transaction) as calculated under Note 4, which is multiplied by the 5 year lease period to arrive at $250,000 and $187,500, respectively.

Note 6 The annual depreciation based on reacquisition cost is simply the cost to reacquire the asset of $180,000 for the gain transaction and $120,000 for the loss transaction divided by the remaining useful life of 3 years to arrive at $60,000 and $40,000 respectively.