GSA Office of the Chief Acquisition Officer

AUG 24 2005

MEMORANDUM FOR ROBERT R. JARRETT
DIRECTOR
DEFENSE ACQUISITION REGULATIONS COUNCIL

FROM: RALPH J. DESTEFANO, DIRECTOR
REGULATORY AND FEDERAL ASSISTANCE
DIVISION

SUBJECT: FAR Case 2004-014, Buy-Back of Assets

Attached is a late comment received on the subject FAR case published at 70 FR 34080; June 13, 2005. The comment closing date was August 12, 2005.

Response Number	Date Received	Comment Date	Commenter
2004-014-1	08/13/05	08/12/05	Lockheed Martin

Attachment

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2004-014-1

LOCKHEED MARTIN

Anthony M. DiPasquale
Vice President
Government Financial Management

August 12, 2005

General Services Administration
Regulatory Secretariat (V)
Attn: Laurieann Duarte
1800 F Street, NW, Room 4035
Washington, DC 20405

Re: FAR Case 2004-014

Dear Ms. Duarte:

Lockheed Martin Corporation appreciates the opportunity to submit comments concerning proposed revisions to FAR 31.205-11, Depreciation.

The Councils state that FAR Case 2004-014 was established to address DCAA's concerns regarding the cost treatment when a contractor "buys back" an asset after a sale and leaseback transaction is recognized. The Councils acknowledge that a myriad of situations exist were a contractor depreciates an asset or charges cost of ownership in lieu of lease costs, disposes of the asset, and then reacquires the asset. However, the Councils state that no situations in which the Government was a risk in the areas of typical sale and reacquisition, or capital leases were identified. Therefore, it appears that the proposed change is only needed as a result of changes made to FAR 31.205-11(i)(1) and FAR 31.205-36(b)(2) that were included in the final rule under FAR Case 2004-005, Gains and Losses. It is important to note that the proposed language presented in the Federal Register under FAR Case 2004-005 only included changes to FAR 31.205-16, not 31.205-11 and 31.205-36. Therefore, the public was not given the chance to comment on the changes, which is procedural incorrect and circumvents the process of exchanging ideas.

When coupled with the recent changes in FAR Case 2004-005, we believe that a trend is emerging whereby the Government is not maintaining neutrality in regulations affecting the contractors' financing decisions. The Councils state their belief that for Government costing purposes a contractor should not benefit or be penalized for entering into a sale and leaseback arrangement. However, the recent changes to FAR 31.205-11, 31.205-16 and 31.205-36, have constructed parameters that indeed penalize a contractor for having owed its facilities at any time during contract performance. These rules ensure that the Government never pays more than the initial capitalized cost of an asset regardless of changes in ownership, changes in invested capital and changes in market rate. Additionally, limiting the allowable depreciation costs to that which would have resulted if the contractor retained title throughout the service life of the asset, ignores

2004-014-1

the fundamental GAAP and CAS 404 requirements that an asset be capitalized at its purchase price, even if that purchase is a reacquisition of a previously owned asset. Further, the proposed rule ignores the basic principle that a contractor should be reimbursed for reasonable cost incurred in the course of business. The Councils comment regarding the intent of FAR 31.205-52 is confusing since the cited cost principle is limited to asset valuations resulting from a business combination and would not apply to the sale of a single asset or group of assets from one contractor to another. Consequently, the proposed revision would cause a situation where a given asset's value and allowable depreciation will be different depending on who the asset is acquired from. The administrative time required to document and track the ownership trail of assets will become needlessly complex and excessively burdensome.

To illustration our concerns, we attached two examples of a situation where a contractor reacquires an asset (building) after a sale and leaseback transaction. The examples show one scenario when the initial disposition resulted in a gain and one that resulted in a loss. In both scenarios, the contractor that owned its building is compared to a contractor in a like location and like building that has leased its building. In both scenarios, the contractor that leases building space is reimbursed significantly more costs than the contractor that owned its building. Additionally, the contractor that owned its building is forced to absorb millions of dollars of costs deemed unallowable for Government costing purposes. Clearly this results in an equitable treatment between similar contractors and discourages contractors from investing in the facilities they occupy.

We appreciate your consideration in this matter.

Sincerely,

for Anthony M. DiPasquale

Attachments

Attachment to AIA Letter on FAR Case 2004-014
Examples of an Asset Reacquisition After a Sale & Leaseback Transaction

2004-014-1

Initial assumptions for both scenarios:

- Contractor A acquires a new building for $40 million. The building has a 40-year life. The building is used exclusively for Contractor A's Government contracts. Annual depreciation is straight-line at $1M/year.

- Contractor A sells the building and land to Investment Company B after 10 years. The remaining net book value (NBV) of the building is $30M.

- Contractor A leases back the building for 10 years at a rate of $1.3M/year.

- Contractor C leases the building near Contractor A. Contractor C uses the leased building exclusively for its Government contracts. Contractor C has never owed the building it occupies. In Year 1, Contractor C signs a 10-year lease for $1.1M/year. The lease includes a 10% escalation for each subsequent 10-year lease period. Therefore, lease costs for Years 1-10 are $1.1M/yr, Years 11-20 are $1.21M/yr, Years 21-30 are $1.33M/yr and Years 31-40 are $1.46M/yr.

Scenario 1 – Gain on Initial Disposition

- Assume the proceeds of the sale of the building from Contractor A to Investment Company B are $36M.

- The recognized gain is the net proceeds of the sale ($36M) less the undepreciated value ($30M) or $6M, which is recognized when title changes hand (i.e., when the Contractor A becomes the lessee).

- The $6M gain is credited to the overhead pool that held the depreciation, thus providing a recapture of depreciation. So in essence the depreciation cost that flowed to the Government is reduced to $4M ($1M depreciation cost for 10 years = $10M, recapture $6M through the gain, results in $4M accumulated depreciation over 10 years).

- Before the new FAR rules, Contractor A would have had the option to either credit the Government by recognizing the gain as an adjustment to previously recorded depreciation costs, or limit the allowable portion of lease payments to the $1M/year cost of ownership (thus absorbing the $300K difference as an unallowable cost).

- However, after the new FAR rules [31.205-16(b)(1) and 31.205-11(i)(1)], the recognition of the gain resets the undepreciated value of the building to $36M. The allowable portion of the lease payments is the $36M divided by the 30-year remaining life of the building, or $1.2 M/year. Thus Contractor A must absorb $100K ($1.3M less $1.2M) per year as unallowable lease cost.

2004-014-1

- Assume at the end of the lease term (i.e., 20th year of building life), Contractor A reacquires the building for $30M.

- GAAP and CAS 404 require that the building be valued at its acquisition cost of $30M. Assume the useful life has not changed; therefore the building has a 20 year remaining useful life. Depreciation expense for GAAP purposes is $1.5M/year ($30M divided by 20 years).

- Proposed FAR rule 31.205-11(g)(3)(i) limits the allowable depreciation expense to:

  - The NBV at the time Contractor A originally became the lessee (thus, the $30M undepreciated balance),

  - Adjusted for any allowable gain or loss determined in accordance with 31.205-16(b) (so, plus the $6M gain),

  - Less any amount that Contractor A was allowed in lease payments in accordance with new 31.205-11(i)(1) (which becomes redesignated as (h)(1) in the proposed rule), (so, less the $1.2M per year for 10 years = $12M),

  - Leaving a new depreciable balance of $24M ($30M NBV + $6M Gain - $12M allowed lease expense) for a building with a 20-year remaining useful life. Therefore, for Government contracting purposes, the allowable depreciation expense after the reacquisition is limited to $1.2M per year ($24M divided by 20 year life),

  - Contractor A's total unallowable lease payments during the 10 years as a lessee = $1M ($1.3M lease cost less $1.2M allowable equivalent cost of ownership times 10 years),

  - Contractor A's total unallowable depreciation costs after reacquisition = $6M ($1.5M GAAP depreciation less $1.2M equivalent ownership cost times 20 years),

  - Thus, Contractor A's total unallowable facility cost for the 40 years in the building is $7M.

Comparison of Contractor A to Contractor C:

- At the end of the first 10-year period, the Government contracts in Contractor A's building will have absorbed $4M in facility costs (i.e., the $10M in depreciation less the $6M adjustment for the gain on sale), while the Government contracts in Contractor C's building will have absorbed $11M in facility costs for a similar building in the same area. Neither Contractor had unallowable costs related to the buildings.

- At the end of the second 10-year period, the Government contracts in Contractor A's building will have absorbed a total of $16M in facility costs (with Contractor A absorbing $1M in unallowable lease costs), while Government contracts in Contractor C's building will have absorbed $23.1M in facility costs (with no unallowable lease costs).

- At the end of the next 20-year period, the Government contracts in Contractor A's building will have absorbed a total of $40M in facility costs (with Contractor A absorbing $1M in unallowable lease costs and $6M in unallowable depreciation costs), while the Government contracts in Contractor C's building will have absorbed $51M in facility costs (with no unallowable lease costs).

Example #1 – Reacquisition After a Sale Leaseback That Resulted in a Gain on Disposition

Building	Depr. Paid by "A"	Leaseback Paid by "A" to "B"	Allowable Cost to "A"	Allowable to Lessee "C"
Year 1	$1 M		$1 M	$1.1 M
Year 2	$1 M		$1 M	$1.1 M
Year 3 - 10	$8 M		$8 M	$8.8 M
Subtotal Yrs 1-10	$10 M		$10 M	$11 M
Gain on Sale	($6 M)		($6 M)	
Depr. Expense to Date	$4 M		$4 M	
Year 11		$1.3 M	$1.2 M	$1.21 M
Year 12		$1.3 M	$1.2 M	$1.21 M
Year 13 - 20		$10.4 M	$9.6 M	$9.68 M
Subtotal Yrs 11 - 20		$13 M	$12 M	$12.1 M
Total Yrs 1 - 20		"A" eats $1M as unallowable	$16 M	$23.1 M
"A" Reacquires Bldg for $30M w/20 yr life				
Year 21	$1.5 M		$1.2 M	$1.33 M
Year 22	$1.5 M		$1.2 M	$1.33 M
Year 23 - 40	$27 M		$21.6 M	$25.24 M
Subtotal Yrs 21 - 40	$30 M	"A" eats $6M as unallowable	$24 M	$27.9 M
Total Allowable Cost for 40 Yr Life of Building		"A" eats a total of $7M as unallowable	$40 M	$51 M

Scenario 2 – Loss on Initial Disposition

- Assume the proceeds of the sale allocable to the building are $24M.

- The loss is the net proceeds of the sale ($24M) less the undepreciated value ($30M) or $6M. To determine the allowable portion of the loss, you must compare the FMV to the undepreciated value on the date that the contractor becomes the lessee. Assume that the proceeds of the sale establish the FMV at $24M. Since the FMV is less than the undepreciated value of $30M, the allowable portion loss is limited to the difference between the FMV and the undepreciated balance. Therefore the entire $6M loss is recognized as an additional expense in the overhead pool, thus bringing the accumulated depreciation cost to the Government to $16M ($1M depreciation per year for 10 years = $10M, plus the loss of $6M).

- Before the new FAR rules, Contractor A's lease payments would only be allowable up to the $1 M/year cost of ownership and the $300K would be unallowable.

- However, after the new FAR rules (31.205-16(b)(2)(ii) and 31.205-11(i)(1)), the recognition of the loss resets the undepreciated value of the building to $24 M. The allowable portion of the lease payments is the $24 M divided by the 30-year remaining life of the building, or $800K/year. Thus Contractor A must absorb $500K ($1.3M less $800K) per year as unallowable lease cost.

- Assume at the end of the lease term (i.e., 20th year of building life), Contractor A reacquires the building for $30M.

- GAAP and CAS 404 require that the building be valued at its acquisition cost of $30M. Assume the life has not changed; therefore the building has a 20-year remaining useful life. Depreciation expense for GAAP purposes is $1.5M/year ($30M divided by 20 years).

- Proposed FAR rule 31.205-11(g)(3)(i) limits the allowable depreciation expense to:

  - The NBV at the time Contractor A originally became the lessee (thus, the $30M undepreciated balance),

  - Adjusted for any allowable gain or loss determined in accordance with 31.205-16(b) (so, plus the $6M loss),

  - Less any amount that Contractor A was allowed in lease payments in accordance with new 31.205-11(i)(1) (which becomes redesignated as (h)(1) in the proposed rule) (so, less the $800K per year for 10 years = $8M)

  - Leaving a new depreciable balance of $16M ($30M NBV - $6M Loss - $8M allowed lease expense) for a building with a 20-year remaining useful life. Therefore, for Government contracting purposes, the allowable depreciation expense after the reacquisition is limited to $800K per year ($16M divided by a 20-year life).

  - Contractor A's total unallowable lease payments during the 10 years as a lessee = $5M ($1.3M lease cost less $800K allowable equivalent cost of ownership times 10 years),

  - Contractor A's total unallowable depreciation costs after reacquisition = $14M ($1.5M GAAP depreciation less $800K equivalent ownership cost times 20 years),

  - Thus, Contractor A's total unallowable facility cost for the 40 years in the building is $19M.

Comparison of Contractor A to Contractor C:

- At the end of the first 10-year period, the Government contracts in Contractor A's building will have absorbed $16M in facility costs (i.e., the $10M in depreciation plus the

$6M adjustment for the loss on sale), while the Government contracts in Contractor C's building will have absorbed $11M in facility costs for a similar building in the same area. Neither Contractor had unallowable costs related to the buildings.

- At the end of the second 10-year period, the Government contracts in Contractor A's building will have absorbed a total of $24M in facility costs (with Contractor A absorbing $5M in unallowable lease costs), while Government contracts in Contractor C's building will have absorbed $23.1M in facility costs (with no unallowable lease costs).

- At the end of the next 20-year period, the Government contracts in Contractor A's building will have absorbed a total of $40M in facility costs (with Contractor A absorbing $5M in unallowable lease costs and $14M in unallowable depreciation costs), while the Government contracts in Contractor C's building will have absorbed $51M in facility costs (with no unallowable lease costs).

Example #2 – Reacquisition After a Sale Leaseback That Resulted in a Loss on Disposition

Building	Depr. Paid by "A"	Leaseback Paid by "A" to "B"	Allowable Cost to "A"	Allowable to Lessee "C"
Year 1	$1 M		$1 M	$1.1 M
Year 2	$1 M		$1 M	$1.1 M
Year 3 - 10	$8 M		$8 M	$8.8 M
Subtotal Yrs 1-10	$10 M		$10 M	$11 M
Loss on Sale	$6 M		$6 M	
Depr. Expense to Date	$16 M		$16 M	
Year 11		$1.3 M	$0.8 M	$1.21 M
Year 12		$1.3 M	$0.8 M	$1.21 M
Year 13 - 20		$10.4 M	$6.4 M	$9.68 M
Subtotal Yrs 11 - 20		$13 M	$8 M	$12.1 M
Total Yrs 1 - 20		"A" eats $5M as unallowable	$24 M	$23.1 M
"A" Reacquires Bldg for $30M w/20 yr life				
Year 21	$1.5 M		$0.8 M	$1.33 M
Year 22	$1.5 M		$0.8 M	$1.33 M
Year 23 - 40	$27 M		$14.4 M	$25.24 M
Subtotal Yrs 21 - 40	$30 M	"A" eats $14M as unallowable	$16 M	$27.9 M
Total Allowable Cost for 40 Yr Life of Building		"A" eats a total of $19M as unallowable	$40 M	$51 M

2004-014-2

October 11, 2005

General Services Administration
Regulatory Secretariat (V)
Attn: Laurieann Duarte
1800 F Street, NW, Room 4035
Washington, DC 20405

Re: FAR Case 2004-014

Dear Ms. Duarte:

At a recent working group meeting attended by members of the AIA Cost Principles Committee (CPC), the proposed rule in FAR Case 2004-014 was discussed at length. While we understand that comments on this rule are being submitted late, company representatives that are members of the CPC believe that it is important for the Councils to be apprised of AIA's concerns about the proposed revisions to FAR 31.205-11, Depreciation. Therefore, we request that the DAR Council Finance Committee be asked to give consideration to these late comments in drafting a final rule for submission to the DAR Council and the Civilian Agency Acquisition Council.

After reviewing the proposed rule and the recent changes to the FAR that were made in issuing a final rule under FAR Case 2004-005, we believe that Councils are taking actions that will penalize a contractor for having owned its facilities at any time during contract performance. The 2004-005 final rule and this rule, if finalized as proposed, will make certain that the Government never pays more than the initial capitalized cost of an asset regardless of changes in ownership, invested capital, and the rate of market escalation of capital assets. If the Councils limit the allowable depreciation costs to that which would have resulted if the contractor retained title throughout the service life of the asset, the Councils' actions will be at variance with provisions in CAS 404 and Generally Accepted Accounting Principles, which require that an asset be capitalized at its purchase price even if that purchase is a reacquisition of a previously owned asset.

Also, we believe the proposed revision would cause a situation where a given asset's value and allowable depreciation will be different depending on the relationships of the parties from whom the asset is acquired In that regard, during our working group meeting we discussed examples of a situation where a contractor reacquires an asset (building) after a sale and leaseback transaction. One example showed a circumstance where the initial disposition resulted

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2004-014-2

in a gain, and the disposition in the second example produced a loss. In both scenarios, the contractor that owned its building is compared to a contractor that is conducting its business under an operating lease in a building similar in size and furnishings that is in the same geographic area. In both scenarios, the contractor that leases building space is reimbursed significantly more costs than the contractor that owned its building. Additionally, the contractor that owned its building is forced to absorb millions of dollars of costs deemed unallowable for Government costing purposes. We will be pleased to furnish you with copies of the examples, if required.

Again, we apologize for the tardiness of the above comments, but we ask that you forward them (through the DAR Council) to its Finance Committee for consideration in drafting a final rule for the review and approval of the Councils.

If there are any questions concerning the above comments, please call Mr. Dick Powers of my staff at 703 358-1042. Dick's email address is dick.powers@aia-aerospace.org.

Sincerely,

Robert T. Marlow
Vice President, Acquisition Policy