GASB 42

Capital Asset Impairment and Insurance Recoveries

Instructions

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ACCOUNTING AND FINANCIAL REPORTING FOR IMPAIRMENT OF CAPITAL ASSETS AND FOR INSURANCE RECOVERIES

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ACCOUNTING AND FINANCIAL REPORTING FOR IMPAIRMENT OF CAPITAL ASSETS AND FOR INSURANCE RECOVERIES

Overview

In November 2003, the Governmental Accounting Standards Board (GASB) issued GASB Statement No. 42, *Accounting and Financial Reporting for Impairment of Capital Assets and for Insurance Recoveries* (GASB 42). This Statement established accounting and financial reporting standards for impairment of capital assets. A capital asset is considered impaired when its service utility has declined significantly and unexpectedly. Before the issuance of this Statement, there was no specific requirement to reduce the carrying value of a capital asset other than through the application of depreciation. This Statement also clarified and established accounting requirements for insurance recoveries, including those not associated with asset impairments. The requirements of GASB 42 are effective for the State fiscal year ending June 30, 2006. Subsequent to this date, the issuance of GASB Statement No. 51, Accounting and Financial Reporting for Intangible Assets (GASB 51), GASB Statement No. 62, Codification of Accounting and Financial Reporting Guidance Contained in Pre-November 30, 1989 FASB and AICPA Pronouncements (GASB 62), and GASB Statement No. 63, Financial Reporting of Deferred Outflows of Resources, Deferred Inflows of Resources, and Net Position (GASB 63) had minor impacts to the implementation of GASB 42. We have included the impact of these changes.

We have included a comprehensive summary of GASB 42, a capital asset impairment decision tree (Appendix A), a checklist for assessing capital asset impairments (Appendix B), an illustrative example for a building with physical damage (Appendix C), and an illustrative example on the retroactive application of GASB 42 (Appendix D). The checklist in Appendix B will assist agencies in determining if they have any impaired capital assets and will also provide documentation for their auditors.

If you have any questions about the statewide implementation of GASB 42 or about potential capital asset impairments, please contact The State Controller's Office, GAAP Reporting Section, at stategovreports@sco.ca.gov.

Other Resources

- Copies of GASB 42, 51, 62, and 63 can be obtained by calling the GASB at (800) 748-0659 or by placing an order online at www.gasb.org (click the "Publications" link).

- Appendix C of GASB 42 presents illustrative examples of asset impairments and the various methods used to calculate the amount of the impairment.

- The GASB's *Comprehensive Implementation Guide - 2005* includes questions and answers on capital asset impairment (see questions 7.466 through 7.475).

- The November 2003 issue of the *GAAFR Review* examines in detail the new guidance offered in GASB 42. [Note: The *GAAFR Review* is the Government Finance Officers Association's (GFOA) monthly newsletter on government accounting, auditing, and financial reporting]. To subscribe to the *GAAFR Review* or to obtain past issues, call the GFOA at (312) 977-9700 or email them at GAAFRReview@gfoa.org.

Summary of GASB Statement 42

The requirements of GASB 42 only apply to capital assets **with material carrying values** (e.g., this standard would not apply to fully depreciated capital assets). When agencies have such capital assets that are impaired or potentially impaired, they should read the following summary of GASB 42 and use the checklist in Appendix B to determine whether there is an impairment as described under GASB 42 and whether the impairment loss should be reported and disclosed.

Definition of Impairment

GASB 42 defines asset impairment as a *significant, unexpected decline in the service utility* of a capital asset. The events or changes in circumstances that lead to impairments are not considered normal and ordinary. That is, at the time the capital asset was acquired, the event or change in circumstance would not have been expected to occur during the useful life of the capital asset. Service utility, in turn, is defined as the usable capacity that a capital asset was expected to provide at its acquisition.

Assessment of Impairment

The determination of whether a capital asset has been impaired is a two-step process of (a) identifying potential impairments and (b) testing for impairment. The events or changes in circumstances affecting a capital asset that may indicate impairment should be prominent (i.e., conspicuous or known to the agency). That is, the events or circumstances that may indicate impairment generally are expected to have already been the subject of discussion by the governing board or management or would otherwise have been the topic of press coverage. **Therefore, your agency will not have to undertake any extraordinary efforts to identify capital assets that are potentially impaired.**

A. <u>Identify Potential Impairment</u>

The five most common indicators of potential impairment, as defined by GASB 42, are listed below. This list is not all-inclusive since it was not possible for the GASB to identify every potential indicator of asset impairment.

1. Evidence of physical damage to the capital asset that requires repair efforts to restore the asset's service utility. Examples would include a building damaged in a natural disaster or a building facing the costs associated with mold remediation or asbestos removal.

2. Enactment or approval of laws or regulations, or other changes in environmental factors, that limit or curtail the use of the capital asset because the asset does not meet and cannot be modified to meet the requirements of the new laws or regulations **The GASB requires these impairments to be reported when the**

change occurs and not when the change goes into effect. Examples would include underground storage tanks or water treatment plants that cannot meet new EPA requirements.

3. Technological development or evidence of obsolescence resulting in the capital asset being used much less frequently, or not at all. Examples would include magnetic resonance imaging (MRI) equipment of the enclosed type following the introduction of the more popular open models or other diagnostic or research equipment that is rarely used because newer equipment provides better service.

4. A change in the way an asset is used or in the length of time it is expected to be used. Examples would include a school building now used as a warehouse, the closure of a street prior to the end of it useful life for safety reasons, or the closure of a school prior to the end of its useful life because of a decline in enrollment.

5. A permanent construction stoppage prior to the completion of an asset. Examples include the halting of building construction due to a lack of funding or a stoppage following the discovery of an endangered species at a construction site.

In addition, GASB 51 expounded that a common indicator of impairment for internally generated intangible assets is development stoppage, such as stoppage of development of computer software due to a change in the priorities of management.

In some instances, the level of demand for a capital asset may be significantly less than anticipated. Such reduced demand, in and of itself, is not considered a separate indicator of impairment. However, a change in demand associated with one of the five indicators of impairment listed above should be tested for impairment. GASB 42 provides the following example. "*A decrease in school enrollment is another example of a change in demand. If this decrease in enrollment prompts management to close a school, a change in manner or duration of use has also resulted and a test for impairment should be performed. If however, the decrease in enrollment results in the school's changing from an overcrowded condition to one in which classroom sizes are now below the state-required maximum and is not associated with another indicator of impairment, a test for impairment is not required*".

GASB 42 applies to all capital assets, including nondepreciable capital assets. However, for the purposes of this Statement, land is considered to be a separate capital asset from buildings and depreciable improvements and therefore, should be evaluated separately for impairment. Because depreciable and nondepreciable capital assets are different in nature and potential for impairment, the GASB did not want an unrealized gain in the fair value of land to be used to offset an impairment loss on buildings.

B. <u>Impairment Test</u>

Once a capital asset has been identified as being potentially impaired, the agency needs to apply the following two impairment tests, both of which must be met for assets to be considered impaired:

1. The magnitude of the decline in service utility is significant. The expenses associated with continued operation and maintenance (including depreciation) or costs associated with restoration of the capital asset are significant in relation to the current service utility. This modifier would limit testing to only those capital assets that have experienced significant events or changes in circumstances.

2. The decline in service utility is unexpected. The restoration cost or other impairment circumstance is not a part of the normal life cycle of the capital asset. This modifier would limit testing to only those capital assets that have experienced events or circumstances other than a normal decline in utility during the capital asset's expected useful life and normal changes in estimated useful lives. Establishing the expected use and useful life of an asset is not a precise science, but there is a reasonable range of expectations about an asset's service utility and useful life at the time of acquisition.

If the above impairment tests are met, the capital asset is considered to be impaired. However, only losses from permanent impairments of capital assets should be recognized in the financial statements (Note: impairments from physical damage are always considered to be permanent). GASB 42 establishes the presumption that capital asset impairment is permanent, unless evidence demonstrates that the impairment is only temporary. The Statement provides the following example of a situation that would meet this burden of proof. "*For example, a middle school that is not being used due to declining enrollment should not be written down if evidence, such as future middle school enrollment projections substantiated by current elementary school enrollment, residential development data, birth rates, or other economic indicators, demonstrates that the closing of the middle school will be temporary*." GASB 42 further provides that impairment losses recognized in accordance with this Statement should not be reversed in future years, even if the events or circumstances causing the impairment have changed. If the above example was modified to assume that the impairment was permanent and a loss was recognized, no recovery would be reported in a subsequent year if the school was placed back in service.

Capital Assets Not Meeting the Impairment Test

If an event or circumstance indicates that an asset may be impaired, but the test of impairment indicates that an impairment has not occurred, then your agency should reevaluate the estimated useful life and salvage value accordingly. Any such changes should be accounted for on a prospective basis in future depreciation expense.

Measurement of Impairment

A. Capital Assets That Will Continue To Be Used By The Agency

GASB 42 prescribes three different methods for calculating the amount of the impairment (i.e., the portion of historical cost that should be written off) for impaired capital assets that will continue to be used by the agency. The methods are explained below.

1. The **restoration cost approach** derives the amount of impairment from the estimated cost to restore the utility of the capital asset to its original condition, exclusive of any amount attributable to improvements and additions. This method requires applying a damage ratio to the carrying value of the capital asset to determine the relative portion of the capital asset that should be written off. The damage ratio would be calculated by dividing the capitalizable restoration costs by a measure of the cost of the entire capital asset. Both elements of the ratio must be expressed on the basis of either current year dollars or acquisition year dollars. Demolition and cleaning costs should generally be considered noncapitalizable costs (i.e., excluded from capitalizable restoration costs).

2. The **service units approach** isolates the historical cost of the service utility of the capital asset that cannot be used due to the impairment. This method estimates the total or maximum service units that the asset could have provided both before and after the impairment event or change in circumstance. The percentage change in units would be applied to the carrying value of the capital asset to determine the amount of the impairment loss.

3. The **deflated depreciated replacement cost approach** replicates the historical cost of the service produced. The method estimates the current cost to replace the asset at the level of service it now provides (e.g., warehouse instead of a school). The current cost would be depreciated to reflect the fact that the asset is not new and then deflated to convert it to historical cost dollars. The difference between the resulting depreciated, deflated replacement cost and the carrying value of the original asset represents the impairment loss.

The amount of impairment should be measured using the method that best reflects the decline in service utility of the capital asset. For assets that will remain in service, the method used to calculate the impairment loss should be based on the indicator of impairment as follows:

INDICATOR OF IMPAIRMENT	METHOD USED TO CALCULATE IMPAIRMENT LOSS
Physical damage	Restoration cost approach
Enactment or approval of laws or regulations or changes in environmental factors	Service units approach
Technological development or evidence of obsolescence	Service units approach
Change in manner or duration of use	Service units approach or Deflated depreciated replacement cost approach

B. Capital Assets That Will No Longer Be Used By The Agency, Construction Stoppage, and Development Stoppage

Impaired capital assets that will no longer be used by the agency should be reported at the lower of carrying value or fair value. Capital assets impaired from construction stoppage and internally generated intangible assets impaired from development stoppage also should be reported at the lower of carrying value or fair value.

Reporting Impairment Losses

GASB 42 requires the recognition of capital asset impairments as soon as they occur. Losses from permanent impairments should be recognized in the statement of activities and statement of revenues, expenses, and changes in fund balances as a program or operating expense, special item, or extraordinary item, in accordance with the guidance in paragraphs 41-46, 55, 56, 101, and 102 of GASB Statement No. 34, *Basic Financial Statements – and Management's Discussion and Analysis - for State and Local Governments*. GASB Statement No. 62, *Codification of Accounting and Financial Reporting Guidance Contained in Pre-November 30, 1989 FASB and AICPA Pronouncements* paragraphs 45-49 further defined the transactions that would qualify as a special or extraordinary item. The only impairment type that would typically qualify as a special item (i.e., within the control of management) would be a change in manner or duration of use.

Insurance Recoveries

In the agency's financial statements, the restoration or replacement of the impaired capital asset should be reported as a separate transaction from the impairment loss and insurance recovery. The impairment loss should be reported net of the associated insurance recovery when the loss and recovery occur in the same fiscal year. Insurance recoveries reported in years subsequent to the impairment loss should be reported as program revenue, nonoperating revenue, or extraordinary items, as appropriate. Insurance recoveries should be recognized in the financial statements only when realized or realizable, such as when the insurer has acknowledged or admitted coverage (Note: if

the insurer has denied coverage, the insurance recovery generally would not be realizable). An accounting gain can occur if the insurance recovery exceeds the historical cost of the asset impairment. This situation typically occurs when the insurance coverage is based on replacement cost. The GASB 42 guidance related to insurance recoveries applies to all such recoveries, not just those associated with impairment of capital assets (e.g., those related to the theft of capital assets or embezzlement of cash or other monetary assets).

State appropriations and federal grants (i.e., FEMA grants) should not be netted against any associated impairment loss. Insurance recoveries are netted with associated impairment losses because the insurance recovery is received in accordance with an insurance contract in effect prior to the impairment event. Federal and state financial assistance is provided after the impairment event occurs and in some instances only after a government applies for and meets applicable grant requirements. Such awards constitute separate transactions from the impairment event (GASB's Comprehensive Implementation Guide – 2005, question 7.469).

Reporting Summary

The table below summarizes the GASB 42 approach for reporting capital asset impairments:

Overview of GASB 42 Treatment of Capital Asset Impairment

	Out of service		Still in service	
	Permanently	Temporarily	Same useful life	Shorter useful life
Statement of net position	Lower of carrying value or fair value	Carrying value	Impairment loss subtracted from carrying value	Impairment loss subtracted from carrying value
Statement of activities	Write down to fair value if necessary	Suspend depreciation until service resumes	Impairment loss net of insurance recoveries	Impairment loss net of insurance recoveries

Source: Government Finance Officers Association's GAAFR Review, November 2003

Note Disclosures

GASB 42 requires the following note disclosures for impaired capital assets:

1. A general description of the impairment, the amount of the loss, and the financial statement classification of the impairment loss if not apparent from the face of the financial statements.

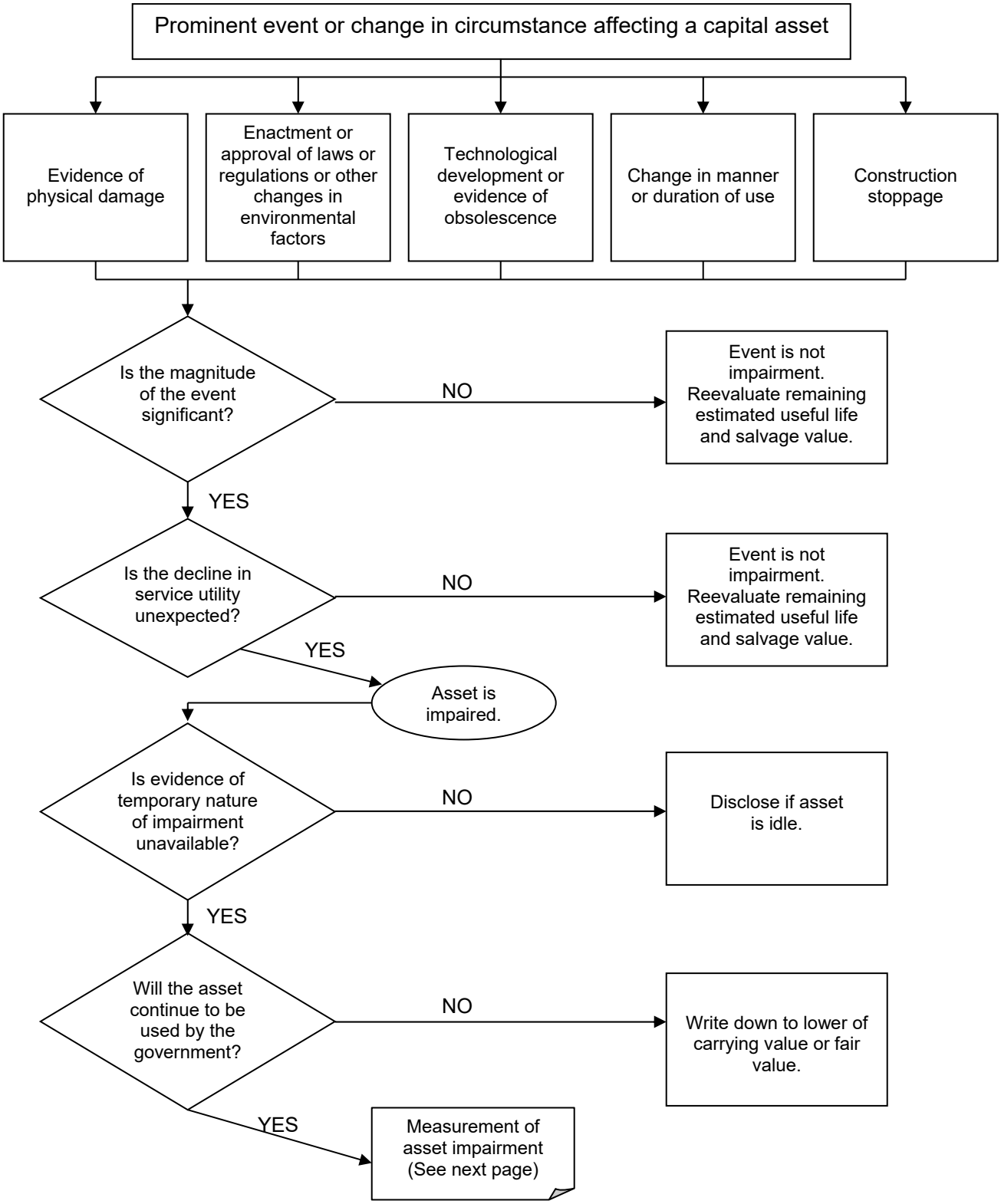
2. The carrying amount of impaired capital assets that are idle at year-end, regardless of whether the impairment is considered permanent or temporary.

3. The amount and financial statement classification of insurance recoveries if not apparent from the face of the financial statements.

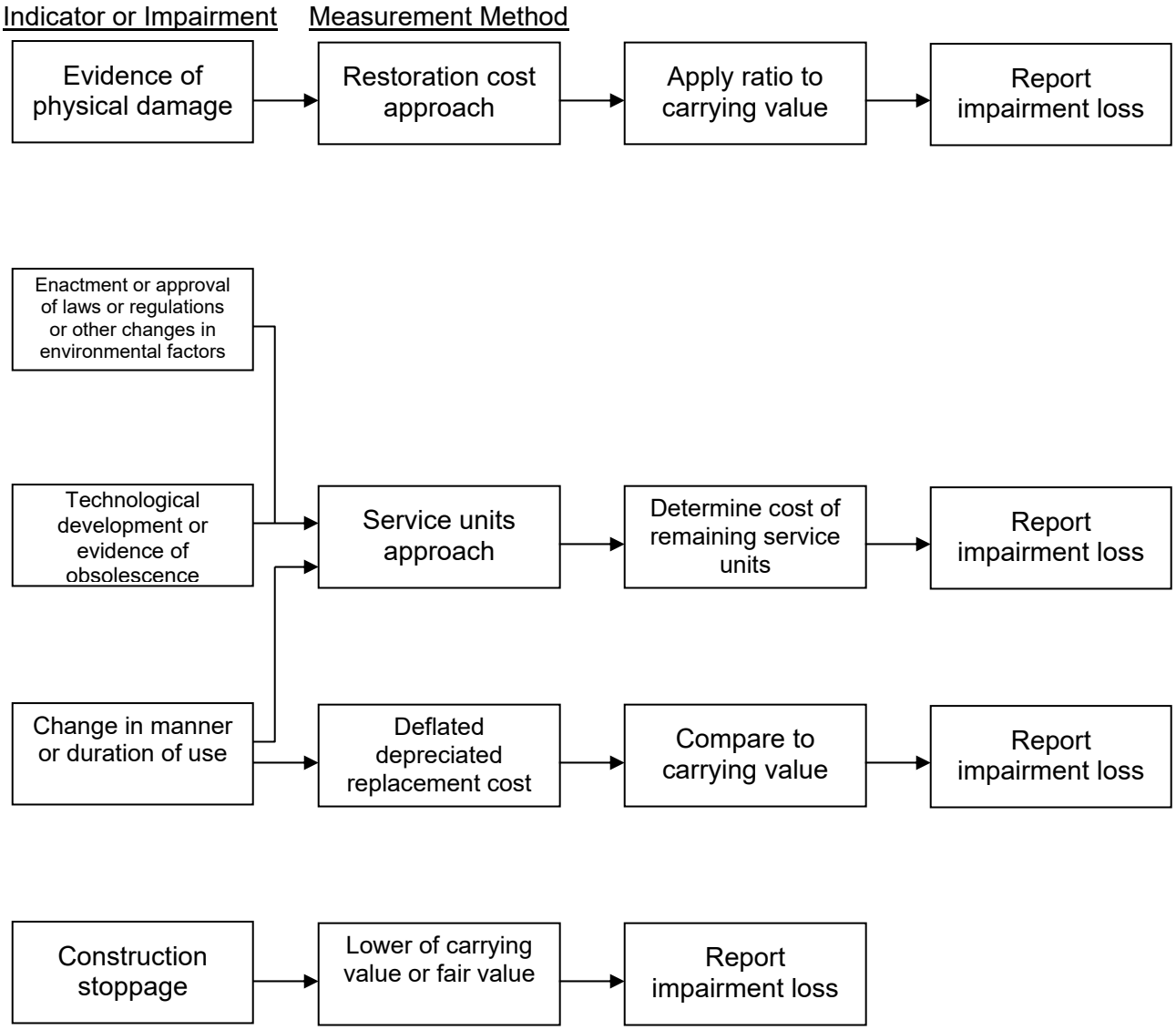
Effective Date

The provisions of GASB 42 are effective for fiscal years beginning after December 15, 2004 (i.e., State fiscal year ending June 30, 2006).

APPENDIX A
Capital Asset Impairment Decision Process



APPENDIX A (continued)
Measurement of Asset Impairment
(for assets that will continue to be used by the government)



Source: GASB No. 42, *Accounting and Financial Reporting for Impairment of Capital Assets and for Insurance Recoveries*, Appendix D

APPENDIX B
Checklist for Assessing Capital Asset Impairments

Date: _____

Agency Name: _____

Asset Description: _____

Event or Change in Circumstance: _____

_____

Agency Contact Name: _____ Phone No. _____

GASB Statement No. 42, *Accounting and Financial Reporting for Impairment of Capital Assets and for Insurance Recoveries* (GASB 42) provides guidance on determining whether a capital asset has been impaired and provides four methods of measuring the impairment loss. The preparer of this checklist should be familiar with GASB 42 and the instructions provided by the State Controller's Office. Except when noted otherwise, all paragraph references in this checklist are to GASB 42. **This checklist should only be completed if the carrying value (cost less accumulated depreciation) of the capital asset is material**. Disclosure requirements are not addressed in this checklist.

GASB 42 - TEST FOR CAPITAL ASSET IMPAIRMENT

PART 1 - TESTING FOR IMPAIRMENT

YES	NO
GO TO STEP 2	GO TO STEP 12

1. Has there been a prominent event or change in the circumstances affecting the asset? (Para. 8)

The event or change in circumstances affecting a capital asset should be "conspicuous or known to the government". Also, the events or changes "are expected to have prompted discussion by the governing board, management, or the media". Para. 9 provides common indicators of impairment.

Note: Land must be considered separate of other capital assets. (Para. 4)

YES	NO
GO TO STEP 3	GO TO STEP 12

2. Is the magnitude of the decline in service utility significant? (Para. 11a)

Note: GASB standards do not define "significant".

APPENDIX B (continued)

YES	NO
GO TO STEP 4	GO TO STEP 12

3. Is the decline in the service utility of the asset unexpected? (Para. 11b)

"Unexpected" means that the event or change in circumstances identified in Step 1 was not expected to occur during the life of the asset. (Para. 5)

YES	NO
GO TO STEP 12	GO TO STEP 5

4. Is there evidence that the impairment is temporary? (Para. 18)

GASB 42 establishes the presumption that a capital asset impairment is permanent, unless evidence demonstrates that the impairment is only temporary. Impairment should always be considered permanent when it is by physical damage.

Note: Losses do not arise from temporary impairments.

YES	NO
GO TO STEP 6	GO TO STEP 11

5. Will the agency continue to use the asset? (Paras. 12 & 16)

PART 2 - MEASURING FOR IMPAIRMENT LOSS

YES	NO
SEE NOTE	GO TO STEP 7

6. Is the impairment based on evidence of physical damage? (Para. 9a)

Note: Stop here. Measure the impairment loss using the restoration cost approach. (Paras. 12a & 13)

(See Appendix C of GASB 42, Illustrations 1 & 2)

YES	NO
SEE NOTE	GO TO STEP 8

7. Is the impairment the result of enactment or approval of new laws or regulations that govern the asset's use or other changes in environmental factors? (Para. 9b)

Note: Stop here. Measure the impairment loss using the service units approach. (Paras. 12b & 14)

(See Appendix C of GASB 42, Illustration 3)

APPENDIX B (continued)

YES	NO
SEE NOTE	GO TO STEP 9

8. Is the impairment the result of change in technology or obsolescence? (Para. 9c)

Note: Stop here. Measure the impairment loss using the service units approach. (Paras. 12b & 14)

(See Appendix C of GASB 42, Illustration 4)

YES	NO
SEE NOTE	GO TO STEP10

9. Is the impairment the result of a change in the manner or duration of use of the asset? (Para. 9d)

A change in demand for the services of a capital asset, in and of itself, is not considered a separate indicator of impairment. (Para 10) (See Appendix C of GASB 42, Illustration 10)

Note: Stop here. Measure the impairment loss using either the service units or the deflated depreciated replacement cost approaches. (Paras. 12b, 12c, & 15)

(See Appendix C of GASB 42, Illustrations 5, 6, 7 & 8)

YES	NO
SEE NOTE	GO TO STEP12

10. Is the impairment the result of a permanent construction stoppage or development stoppage? (Para. 9e and GASB 51 Para. 18)

Note: Stop here. The asset should be reported at the lower of the carrying value of the asset {historical cost less accumulated depreciation} or the fair value of the asset. If the fair value is lower, the impairment loss is equal to the difference in values. (Para. 16)

(See Appendix C of GASB 42, Illustration 9)

YES	NO
SEE NOTE	GO TO STEP12

11. The asset will no longer be used by the agency.

Note: Stop here. The asset should be reported at the lower of the carrying value of the asset {historical cost less accumulated depreciation} or the fair value of the asset. If the fair value is lower, the impairment loss is equal to the difference in values. (Para. 16)

YES
SEE NOTE

12. The asset is not impaired.

Estimates of remaining useful life and salvage value used to calculate depreciation expense should be reevaluated and changed, if necessary. (Para. 19)

Note: The asset should not be reassessed unless there are new events or circumstances as discussed in Items 1 through 3 of this checklist.

Source: Adopted from PPC's Guide to Preparing Governmental Financial Statements under GASB Statement No. 34, Tenth Edition (October 2005)

APPENDIX C
Illustrative Example – Building with Physical Damage

Assumptions

An administrative building at XYZ University was damaged by a tornado. Management of the university does **not** consider the event to be both unusual in nature and infrequent in occurrence, as defined by APB Opinion 30. The administrative building was constructed in 1999 at a cost of $28 million and was expected to provide service for thirty years. In 2006, after seven years of use, a tornado caused severe structural problems to the building. Due to safety concerns, the building was closed and structural and other repairs costing $4.5 million were made to restore the building to a usable condition. Of the total restoration costs, $3.5 million was capitalizable in accordance with the capitalization policies of the university. The remaining costs were primarily for demolition and cleanup. The building was insured, and the university received an insurance recovery of $2.5 million during the fiscal year. Replacement cost of the building is not available.

Evaluation of Impairment

The evidence of physical damage indicates impairment. The magnitude of the physical damage would be considered significant. Both the ongoing costs associated with the office building and the $4.5 million repair cost would be considered significant in relation to the service provided, which is zero because the building cannot be used until the structural repairs are made. The damage was not part of the normal life cycle of the building. Impairment loss using the restoration cost approach is determined as follows:

a	Historical cost	$	28,000,000
	Accumulated depreciations (**a** / 30 x 7)		6,533,333
b	Carrying value	$	21,466,667
	Restoration cost	$	3,500,000
	Deflation factor, compounded		0.813090
c	Deflated restoration cost	$	2,845,815
d	Restoration cost ratio (**c** / **a**)		10.1636%
	Impairment loss (**b** x **d**)	$	2,181,792
	Insurance recovery		2,500,000
	Net gain	$	318,208

APPENDIX C (continued)

Accounting Entries

The university would report the net gain after insurance recovery of $318,214 as a nonoperating revenue. The accounting entries would be as follows:

	DR	CR
Captial asset writedowns (operating expense)	$2,181,786	
Buildings		$2,181,786
(To record loss on capital asset impairment)		
Cash	$2,500,000	
Capital asset writedowns (operating expense)		$2,181,786
Misc. nonoperating revenue (net gain on recovery)		318,214
(To net impairment loss against related recovery)		
Buildings	$3,500,000	
Cleaining/demolition expense	1,000,000	
Cash		$4,500,000
(To record restoration cost of building)		

APPENDIX D
Illustrative Example – Retroactive Application

Assumptions

GASB 42 is required to be applied retroactively by restating financial statements. Assume a city acquired a capital asset with an estimated useful life of twenty years at the beginning of 1994 for $2 million. In the city's financial statements, depreciation expense of $100,000 per year has been reported for the ten years from 1994 through 2003. At the beginning of 1999, however, the capital asset suffered impairment that resulted in a 50 percent reduction in its service utility during the remaining fifteen years of its estimated useful life. The estimated useful life remains the same. How would the effect of retroactive application be calculated if the government applies GASB 42 for its 2004 financial statements?

Evaluation of Impairment

The following illustration was included in the GASB's *Comprehensive Implementation Guide – 2005*. The carrying value of the capital asset at the beginning of 1999 (at the date of impairment) is as follows:

APPENDIX D (continued)

The carrying value of the capital asset at the beginning of 1999 (at the date of impairment) is as

Acquisition cost	$	2,000,000
Accumulated depreciation ($2,000,000 / 20 year life x 5 years {1994-1999})		500,000
Carrying value, beginning of 1999, prior to impairment	$	1,500,000

The impairment loss and subsequent carrying value of the capital asset at the beginning of 1999 is determined as follows:

Carrying value, beginnning of 1999, prior to impairment	$	1,500,000
Impairment loss ($1,500,000 x 50%)		750,000
Carrying value, beginnning of 1999, after to impairment	$	750,000

The carrying value of the impaired capital asset at the beginning of 2004 is determined as follows:

Carrying value, beginning of 1999, after impairment	$	750,000
Accumulated depreciation ($750,000 divided by 15-year remaining useful life x 5 years from 1999 to 2004)		250,000
Carrying value, beginning of 2004, after impairment	$	500,000

The current carrying value of the capital asset at the beginning of 2004 prior to implementing Statement 42 is calculated as follows:

Acquisition cost, beginning of 1994	$	2,000,000
Accumulated depreciation ($2,000,000 divided by 20-year life x 10 years from 1994 to 2004)		1,000,000
Carrying value, beginning of 2004, prior to implementing Statement 42	$	1,000,000

Cummulative effect of retroactive application of Statement 42 is calculated as follows:

Carrying value, beginning of 2004, prior to implementing Statement 42	$	1,000,000
Carrying value, beginning of 2004, after impairment		500,000
Cummulative effect of application of Statement 42 at the beginning of 2004	$	500,000

Accounting Entries

The accounting entry to report the retroactive application of GASB 42 is as follows:

	DR	CR
Restatement. Net Assets	$500,000	
Capital Assets		$500,000
(To record retroactive application of GASB 42)		