

GASB 42 IMPLEMENTATION ISSUES

Buildings and CIP

Issue

What are the criteria and methods for measuring the GASB 42 impairments for buildings and construction in progress?

Background

Approximately 1500 state buildings have been damaged by Hurricanes Rita and Katrina. Facility Planning has estimated the cost to repair most of these buildings, which include university and college buildings. The estimates are preliminary and based on apparent damage. Some facilities may have damage that wasn't apparent at the time the estimate was given. Inflation may be expected as construction activity increases. The estimates are for construction costs only and do not include designer fees, contingencies, administration costs, or upgrades. These preliminary costs include 47 buildings damaged by Hurricane Rita and 297 buildings damaged by Hurricane Katrina that have estimated damages of \$100,000 or more.

Based on the proposed criteria in the *Impairment Test Criteria* Issue Paper, an impairment loss should be calculated for those buildings that meet the capital asset threshold amount (\$100,000) and where the restoration cost is equal to or greater than the capital asset threshold amount or meets the percentage impairment threshold test (20% of the capitalized cost of the building). For example, for a 25 year old state building placed on the books at a cost of \$75,000 damaged by the hurricane and estimated to cost \$200,000 to repair, an impairment loss calculation would not be necessary because the building didn't meet the capitalization threshold, although the restoration cost did exceed the capitalization threshold.

For GASB 42 purposes, we are only concerned with the buildings that have restoration costs of \$100,000 or more, which is about 23% of the buildings on Facility Planning's spreadsheet of damaged buildings. We propose that an impairment loss be calculated on all buildings that meet the impairment test criteria unless we know by June 30, 2006, that the building will not be repaired.

Facility Planning's preliminary cost estimates do not include administrative or inflation costs in the estimated restoration costs on individual buildings; however, they did add these fees or costs to the total estimated restoration costs at the end of the spreadsheet. They added 20% to the final total of these estimates for inflation and 20% to the total for administrative costs. Inflation costs are added in part because as demand for construction materials and labor increase, the costs rise. If inflation and administrative costs are added to the estimated restoration costs, then additional buildings will meet the impairment test criteria.

If an entity has actual restoration costs or more exact estimated restoration costs than Facility Planning, then those figures should be used. If not, the entity should use Facility Planning's preliminary cost estimates and professional judgment should be used to determine if additional costs should be added to estimated restoration costs for inflation, administrative, and other costs.

The current restoration cost method, discussed below, may be used to calculate the impairment loss. This method uses the replacement cost of the impaired building in the impairment loss calculation. The Office of Risk Management (ORM) conducts building appraisals (for all buildings) over a four year period to update replacement cost. The appraisals include an architectural cost factor (10%) and the construction costs included in the appraisal include an inflation factor. However, it is unlikely that the appraisals that were performed before the hurricane would have factored in the current inflation and huge demand for building materials that resulted from the rebuilding of homes and businesses damaged by the hurricanes.

We recommend that professional judgment be used when determining if additional costs should be added to an impaired building's estimated restoration cost for fees already factored into the impaired building's replacement cost.

Buildings - Restoration Cost Approach

The Restoration Cost Approach is the best method for determining the amount of the impairment for capital assets with physical damage. Restoration cost is the cost necessary to return the asset to its original condition and does not include any amounts attributable to improvements and/or additions. The restoration cost approach uses the estimated cost to restore the capital asset to identify the portion of the historical cost of the capital asset that should be written off. Applying the restoration cost approach involves several steps:

1. The estimated cost to restore the physical damage must be identified.
2. A damage ratio must be calculated by comparing either a) restoration cost (today's dollars) to replacement cost of the entire asset (today's dollars) or b) deflated restoration cost (acquisition year's dollars) to original historical cost (acquisition year dollars).
3. The damage ratio must then be applied to the carrying value of the capital asset to determine the relative portion of that amount that would be written off as an impairment loss.
4. The gross impairment should be netted against anticipated insurance recoveries received in the same year as the loss to arrive at the net impairment loss/gain.

The estimated restoration cost can be translated into the amount of the historical cost to be written off using one of two approaches:

Applying a ratio of deflated estimated restoration cost (using an appropriate cost index) over the historical cost of the asset to the net book value of the capital asset,

OR

Applying a ratio of estimated restoration cost over estimated replacement cost to the net book value of the capital asset.

The following table illustrates these two approaches. Deciding which approach to use will depend on what information is available on the capital asset. If the replacement cost is known, it may be easier to calculate the impairment loss using the ratio of estimated restoration cost over the replacement cost to the carrying value of the asset. However, if the

replacement cost is unknown, a deflation factor must be used to deflate the estimated restoration costs to acquisition year dollars.

Deflated Restoration Cost Method		
<u>Deflated Restoration Cost</u> Historical Cost	X	Carrying Value = Impairment Loss
Current Restoration Cost Method		
<u>Current Restoration Cost</u> Current Total Replacement Cost	X	Carrying Value = Impairment Loss

Mike Nielson, capital asset consultant, provided us with different indexes which list deflation factors by year for buildings, construction cost, etc. Using the appropriate index (buildings, in this case), use the deflation factor that would correspond to the year in which the building being restored was acquired.

Example –

Deflated Restoration Cost Method

Assume that a building has a historical cost of \$28,000,000 and accumulated depreciation of \$6,533,333 (carrying value of \$21,466,667). The restoration costs are estimated to amount to \$3.5 million, all of which qualify for capitalization.

- A ratio of comparing restoration costs to the total original cost of the capital asset is calculated. Because restoration costs are in current year dollars and the historical cost is in year of acquisition dollars, we need to deflate the cost of restoration to restate the amount on the basis of acquisition year dollars. Since the appropriate deflator is determined to be .81309, restoration costs in acquisition year dollars equal \$2,845,815 ($\$3,500,000 \times .81309$).
- The ratio of restated restoration costs applied to the original historical cost of the asset ($\$2,845,815 / \$28,000,000 = 10.1636\%$) is then applied to the current carrying value of the asset to determine the portion of the historical cost that has been impaired ($\$21,466,667 \times 10.1636\% = \$2,181,786$). Any insurance recoveries received in the same year as the loss would be netted against this amount.

Current Restoration Cost Method

Assume that a building with an original cost of \$2,435,000 and accumulated depreciation of \$920,000 (carrying value = \$1,515,000) has structural damage from Hurricane Katrina. Assume the restoration costs are estimated to amount to \$2,400,000 all of which qualify for capitalization. The building's replacement cost is \$6,200,000. If the damage ratio is calculated in current year dollars the following calculation is performed:

- Calculate the ratio of capitalizable restoration costs (\$2,400,000) to the total current estimated replacement cost of the building (\$6,200,000).

- This ratio is then applied to the carrying value of the asset to calculate the portion of historical cost that has been impaired ($\$2,400,000/\$6,200,000 \times \$1,515,000 = \$586,452$). Any insurance recoveries received in the same year as the loss would be netted against this amount.

Calculation of the Impairment Loss

OSRAP will calculate the impairment losses for state agencies reported in the governmental funds. Component units and proprietary entities will be responsible for calculating their own impairment losses. If actual restoration costs are unknown, OSRAP intends on using Facility Planning’s list of damaged buildings to obtain the damage estimates and calculate the impairment losses. The BTAs and the component units may use Facility Planning’s list also, if they do not have more accurate figures. The list also contains an insurance replacement cost for the buildings, which can be found on the Statewide Land and Buildings System (SLABS). Other building information stored on SLABS includes original cost, actual cost, and a move-in-date or acquisition date (if a deflator factor is needed).

SLABS does not reflect the carrying value of buildings. OSRAP doesn’t plan on updating SLABS until the actual costs of the restoration is known. OSRAP maintains a separate depreciation schedule for buildings meeting the \$100,000 capitalization threshold, which lists the current carrying value of the governmental buildings reported in the CAFR. The carrying value should be updated after the impairment loss is calculated. The estimated restoration cost should not be added to the carrying value; the actual restoration costs should be added to the carrying value once the restoration is complete.

Approach to adjusting carrying value:

- Subtract gross impairment loss (ignore insurance recoveries)
- Add actual restoration cost once restoration is complete

Example:

Assumptions:

Reporting year:	2006	Estimated restoration cost	\$120,000
Carrying value:	\$150,000	Replacement cost	\$250,000
Original cost:	\$200,000	Remaining useful life:	25 years

$$\begin{array}{r}
 \$120,000 \text{ (estimated restoration cost)} \\
 \text{-----} \quad \times \quad \$150,000 \text{ (carrying value)} = \$72,000 \text{ (impairment loss)} \\
 \$250,000 \text{ (replacement cost)}
 \end{array}$$

New carrying value: $\$150,000 - \$72,000 = \$78,000$ (without depreciation)

The building would be depreciated at the new carrying value of \$78,000 until the restoration is complete. The restoration cost would be shown in the entity’s construction-in-progress until the restoration is complete and then it would be moved to the building and it would be

added to the carrying value. For instance, if the restoration was complete in 2008 the carrying value would be as follows

2006 carrying value:	\$78,000	
2006 depreciation	-3,120	{\$78,000/25}
2007 depreciation	-3,120	
actual restoration cost	125,000	higher than estimated

New carrying value	\$196,760	(before depreciation)
2008 depreciation	8,555	{\$196,760/23}

Net carrying value 2008	\$188,205	

If the building's useful life will not be extended by remaining idle, then depreciation should not be suspended, per conversation with Roberta Reese from GASB.

Improvements and/or additions, which cost over \$100,000 (the capitalization threshold) that are being made to the impaired building at the same time as the reconstruction, should be removed from the impairment loss calculation and be capitalized and depreciated separately. These improvements and/or additions would be handled in the same manner that improvements have been handled in the past.

GASB 42 requires that the carrying amount of impaired capital assets that are idle at year-end should be disclosed, regardless of whether the impairment is considered permanent or temporary. OSRAP will add a note in the Annual Fiscal Report (AFR) to capture this data.

Construction in Progress – Lower of Carrying Value or Fair Value

Construction stoppage can be caused by numerous sources including lack of funding. The lower of carrying value or fair value is the best measure for capital assets impaired due to construction stoppage because these capital assets do not yet provide service. If the government plans to use the capital asset in the future, the construction will be completed and the impairment would be temporary. If the government does not intend to use the capital asset, its value is the cash it could generate upon sale. According to Facility Planning and Control, Louisiana does not have any construction in progress on hold because of Hurricanes Katrina or Rita.

Recommendation

We recommend that the Restoration Cost Approach be used to calculate the impairment loss on buildings. We suggest that an impairment loss be calculated on all the buildings that meet the proposed impairment test criteria unless we know by June 30, 2006, that the building will not be repaired. The carrying value should be updated after the impairment loss is calculated, and the carrying value should reflect the impairment loss and the actual restoration costs, once restoration is complete.

We recommend that professional judgment be used when determining if additional costs should be added to estimated restoration costs provided by FP&C for inflation and

administrative costs when determining if the restoration cost meets the \$100,000 impairment threshold and when calculating the impairment loss.

We recommend that depreciation continue on all of the buildings regardless if they are idle or temporarily out of service due to the need for repair. Buildings that are not being used are still exposed to the weather, heat, and humidity and we do not think that their service life will be extended because they are idle.

Any impairment to construction-in-progress from construction stoppage should be calculated using the carrying value, unless the fair value is readily available and is lower than the carrying value. Construction-in-progress that has been placed on hold because of the hurricanes, but will be resumed, should be considered a temporary impairment and no impairment loss will be calculated. Impaired capital assets that are idle at year-end should be disclosed in the notes, per GASB 42, paragraph 20.