Impaired Capital Assets: A Closer Look At GASB Statement No. 42

By: **Dwayne N. McSwain, Ph.D., CPA**

Abstract

Garnering international attention, hurricanes Katrina and Rita successively battered or destroyed property from Florida to Texas. Homes, businesses and other entities were all affected by the devastation of these storms. The destruction of this double-shot will take years to clean up, and some communities may never recover. As businesses struggle to recuperate, they also face the arduous task of identifying and testing for impairment of capital assets.

McSwain, D. (2006). "Impaired Capital Assets: A Closer Look at GASB Statement No. 42." *TENNESSEE CPA JOURNAL*: July 2006, 20-22. NC Docks permission to re-print granted by author.

Impaired Capital Assets: A Closer Look at GASB Statement No. 42

By Dwayne N. McSwain, Ph.D., CPA

Garnering international attention, hurricanes Katrina and Rita successively battered or destroyed property from Florida to Texas. Homes, businesses and other entities were all affected by the devastation of these storms. The destruction of this double-shot will take years to clean up, and some communities may never recover. As businesses struggle to recuperate, they also face the arduous task of identifying and testing for impairment of capital assets.

Government agencies are not spared from this duty and are currently working to apply the requirements of GASB Statement No. 42, *Accounting and Financial Reporting for Impairment of Capital Assets and for Insurance Recoveries*, which applies to all state and local government (SLG) financial statements for periods beginning after Dec. 15, 2004. Accounting and reporting for asset impairment is new to governments, as Statement No. 42 is the first authoritative guidance on this topic. Much like the adoption of any other new standard, issues exist with this statement that are either unclear or may be misinterpreted. This article examines the requirements for GASB Statement No. 42 and identifies some of these key issues.

In the following discussion, the process of identifying potentially impaired capital assets and the methods used to test those assets for impairment are described. Secondly, the issues of accounting and reporting for impaired assets and the new accounting requirements for all insurance recoveries are discussed. Finally, this article concludes with comments about the effects of Statement No. 42 on SLG financial statements and possible consequences to preparers and users of such reports.

Identification of an Impaired Capital Asset

Capital asset impairment is defined in Statement No. 42 as the "significant, unexpected decline in the service utility of a capital asset."[1] Over time, unusual events or circumstances may occur that significantly diminish the useful life or intended use of an asset. It is these unexpected decreases in service utility that are considered impairments. The key qualifying terms in identifying impairments, "significant" and "unexpected," are discussed in more detail below.

Assessing Impairment

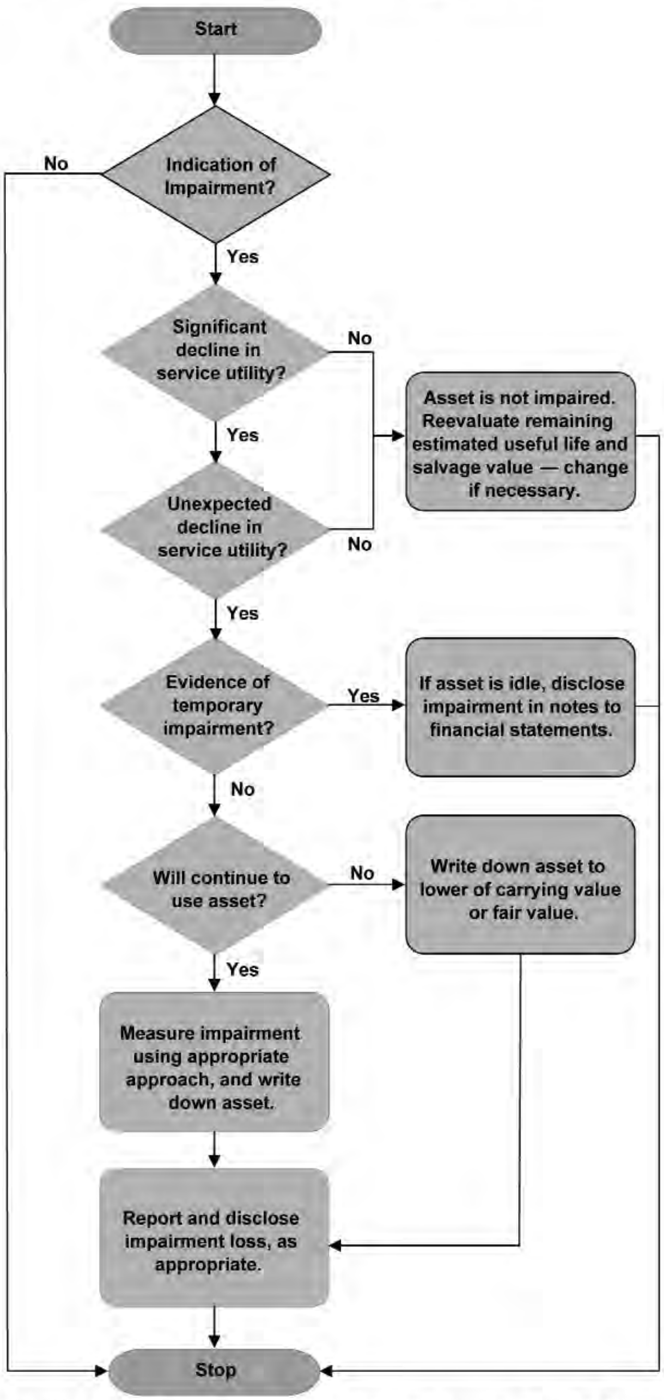
Government agencies are required to determine whether a capital asset is impaired if prominent events or circumstances affecting an asset have occurred. There are two steps to determining capital asset impairment: (1) *identification* of potential impairments and (2) *testing* for impairment.

Identification. As stated above, an asset becomes impaired when a significant decrease in its service utility occurs before the end of the asset's normal life expectancy. Statement No. 42 defines common indicators of impairment as:

- Evidence of physical damage, such as for a building damaged by fire or flood, when the level of damage is such that restoration efforts are needed to restore service utility;
- Enactment or approval of laws or regulations or other changes in environmental factors, such as new water quality standards that a water treatment plant does not meet (and cannot be modified to meet);
- Technological development or evidence of obsolescence, such as that related to a major piece of diagnostic or research equipment;
- A change in the manner or expected duration of use of a capital asset, such as closure of a school prior to the end of its useful life; and
- Construction stoppage, such as stoppage of construction of a building due to lack of funding.[2]

SLGs are not required to identify potential impairments beyond those that are discovered during the normal course of operations. Thus, any event or circumstance that potentially leads to impairment should be conspicuous and should prompt discussion by the governing board, management or the media. Governments are not obligated to search for hidden impairments.

Exhibit 1: Capital Asset Impairment Flowchart



Source: Adapted from GASB Statement No. 42, Appendix D, pp. 50–51.

Testing. Once identified, potentially impaired capital assets should be tested for impairment. Impairment exists when both of the following conditions are met:

1. The magnitude of the decline in service utility is significant; and
2. The decline in service utility is unexpected.[3]

The first criterion limits impairment testing to only those capital assets that have experienced events or changes in circumstances that significantly alter their state of being. The significance of decline in service utility is measured by comparing certain costs to the current service utility. The costs for continued operation and maintenance of the asset or restoration (the amount necessary to return the asset to its original condition, excluding improvements and additions) may be used for this comparison. The second criterion specifically excludes the normal decline in asset utility and limits impairment to events and circumstances that would not be part of the normal life cycle of the asset. Thus, unexpected declines in service utility are the result of events or circumstances that are not considered normal and ordinary.

Both criteria are necessary for an asset to be considered impaired. Governments are not required to report or disclose potentially impaired capital assets. However, a conservative approach may be to reevaluate the remaining estimated useful life and salvage value of the asset in question. Although an asset does not meet the current definition of "impaired," it may be prudent to write down the asset to reflect its useful value.

Measuring Impairment

The disposition of an impaired capital asset determines the method of measurement. That is, measurement of the impairment amount depends on whether the government will continue to use the capital asset. For capital assets that will no longer be used by the government and for assets impaired from construction stoppage, the lower of carrying value or fair value should be reported. For impaired capital assets that will continue to be used by the government, the most appropriate method for measuring impairment should be selected from the following three alternatives.[4]

The *restoration cost approach* is generally used for measuring impairments from physical damage. With this method, the cost necessary to restore the utility of the capital asset is multiplied by an appropriate cost index to derive the amount of impairment in terms of historical cost. Another way of deriving the portion of historical cost that should be written off is to multiply the carrying value of the capital asset by a ratio of the estimated restoration cost over estimated replacement cost.

A *service units approach* is typically used for measuring impairments resulting from environmental factors such as: enactment or approval of laws or regulations, other changes in environmental factors, technological development or evidence of obsolescence. This method of measuring impairment uses repeated measures of the service utility to isolate the historical cost that is to be written off. With this method, the amount of capital asset impairment is the difference between the total estimated service units before the event (or change in circumstances) and the estimated service units after the event or change in circumstances.

The *deflated depreciated replacement cost approach* is primarily used for impairments brought about by a change in manner or duration of use. However, these same impairments could alternatively be measured using a service units approach if deemed more appropriate. Under the deflated depreciated replacement cost approach, the estimated cost to replace the current level of service is first depreciated, and then the depreciated amount is multiplied by an appropriate index to deflate that amount to historical cost. The

Exhibit 2: Methods of Measuring Impairment

Indicators of Impairment	Measurement of Impairment	
	Continue Using Asset	*Stop Using Asset*
Evidence of physical damage	Restoration cost approach	For All Indicators: Lower of carrying value or fair value
Enactment or approval of laws or regulations or other changes in environmental factors	Service units approach	
Technological development or evidence of obsolescence	Service units approach	
Change in manner or duration of use	Deflated depreciated replacement cost or service units approach	
Construction stoppage	*Not applicable*	

Source: Adapted from GASB Statement No. 42, Appendix E, p. 53.

amount of impairment is finally derived by subtracting the deflated amount from the carrying value of the capital asset.

Reporting Impairments

One of the most important decisions to be made about impaired capital assets is the classification of the impairment as a permanent impairment or temporary impairment. Because Statement No. 42 utilizes a conservative approach, this statement only permits downward impairment adjustments. Statement No. 42 does not permit the reversal of a write-off, even if subsequent events or circumstances occur that would resurrect the asset.

Recognition. Generally, most capital asset impairments should be considered permanent[5] and recognized in the statement of activities. If appropriate, the impairment should be recognized in the statement of revenues, expenses and changes in fund net assets. Because of the various types of events and changes in circumstances that underlie impairment losses, it would be appropriate to report some impairment losses as program or operating expenses, while other losses may be reported as special or extraordinary items. Thus, proper recognition for an impairment loss depends on the specific details of the event or change in circumstances.

Recognized impairment losses should conform to the guidance provided in GASB Statement No. 34, *Basic Financial Statements – and Management's Discussion and Analysis – for State and Local Governments*, and APB Opinion No. 30, *Reporting the Results of Operations – Reporting the Effects of Disposal of a Segment of a Business and Extraordinary, Unusual and Infrequently Occurring Events and Transactions.*

Disclosure. Temporary impairments should not be recognized in the financial reports, but should be disclosed in the accompanying notes. Professional judgment should be used to determine the extent of impairment information provided in the notes to the financial statements. However, at a minimum, the description, amount and financial statement classification of impairment losses should be disclosed. Also, impaired capital assets that will no longer be used by the government (idle impaired capital assets) must be disclosed in the notes to the financial statements. In addition, whether the impairment is considered permanent or temporary, the carrying value of idle impaired capital assets should also be presented in the notes.

Insurance Recoveries

Generally, restoration or replacement costs should be recognized separately from capital asset losses and insurance recoveries. Losses should be recognized net of any associated insurance recovery if the recovery and loss occur in the same year. When the insurance recovery is received in a subsequent year to the loss, the amount of insurance recovery should be reported as a program revenue, non-operating revenue or extraordinary item, as appropriate. Only when the recovery amount is realized should the insurance recovery be recognized. Insurance recoveries should be disclosed in the notes if not otherwise apparent in the financial statements.

Because governmental funds do not report capital assets, only the insurance recovery and restoration or replacement costs should be reported. Insurance recoveries for impaired general capital assets are reported as other financing sources or extraordinary items, as appropriate. Restoration or replacement costs for an impaired general capital asset are reported as a separate transaction from any associated insurance recovery. Gains and losses associated with general capital asset should be reported in the government-wide statements and properly disclosed in the notes to the financial statements.

Guidance on insurance recoveries for government-wide and proprietary funds is provided in FASB Interpretation 30. Again, restoration or replacement costs should be reported separately from impaired capital asset losses and insurance recoveries. A capital asset loss should be reported net of any associated insurance recovery, when the loss and recovery occur in the same year.

The implementation of Statement No. 42 should improve the quality of information reported in SLG financial reports. The reporting of the effects of capital asset impairments will be much more timely. Furthermore, consistency among governmental units will be greatly improved in accounting for insurance recoveries. ■

Endnotes

1. *Governmental Accounting Standards Board, Statement No. 42,* Accounting and Financial Reporting for Impairment of Capital Assets and for Insurance Recoveries *(Norwalk, CT: GASB, 2003).*
2. *Ibid., par. 9.*
3. *Ibid., par. 11.*
4. *Ibid., par. 12.*
5. *Ibid., par. 18.*

About the Author

Dwayne N. McSwain, Ph.D., CPA, is an assistant professor of accounting at Middle Tennessee State University.