U.S. Department of Housing and Urban Development
Public and Indian Housing

Special Attention of:	**Notice PIH-2006 - 39 (TDHEs)**
ONAP Administrators, Tribes, and Tribally Designated Housing Entities (TDHEs)	Issued: October 19, 2006
	Expires: October 31, 2007
	Cross Reference: 24 CFR Part 1000, 24 CFR Part 85, and OMB Circular A-87

Subject: Accounting for Fixed Asset Depreciation and Related Issues

1. **Purpose:** This Notice and its attachment provide guidance on the fixed asset depreciation requirements and related issues for recipients of Indian Housing Block Grant (IHBG) Program funds administered by the Office of Native American Programs (ONAP). Specifically this Notice will clarify the differences between depreciation and capitalization requirements of Generally Accepted Accounting Principles (GAAP) and costs allowed under Federal grants by Office of Management and Budget (OMB) Circular A-87. The attachment provides information on depreciation and related issues in a question and answer format.

2. **Background:** The IHBG Program is authorized by the Native American Housing Assistance and Self-Determination Act of 1996 and the regulations governing the program are found at 24 CFR Part 1000. Title 24 CFR §1000.26(a) requires recipients, with specified exceptions (most notably self-governance Indian tribes), to comply with the requirements and standards of Office of Management and Budget (OMB) Circular A-87, *Cost Principles for State, Local and Indian Tribal Governments.* Pursuant to §1000.28, a self-governance Indian tribe shall certify that its administrative requirements, standards and systems meet or exceed the comparable requirements of §1000.26. The latest version of Circular A-87 was issued on May 10, 2004, with an effective date of June 9, 2004.

3. **Program Guidance:** OMB Circular A-87 provides that:

   a. Depreciation and use allowances are means of allocating the cost of fixed assets to periods benefiting from asset use. Compensation for the use of fixed assets on hand may be made through depreciation or use allowances. A combination of the two methods may not be used in connection with a single class of fixed assets (e.g., buildings, office equipment, computer equipment, etc.) except as provided for in subsection g. Except for enterprise funds and internal service funds that are included as part of a State/local cost allocation plan, classes of assets shall be determined on the same basis used for the government-wide financial statements.

b. The computation of depreciation or use allowances shall be based on the acquisition cost of the assets involved. Where actual cost records have not been maintained, a reasonable estimate of the original acquisition cost may be used. The value of an asset donated to the governmental unit by an unrelated third party shall be its fair market value at the time of donation. Governmental or quasi-governmental organizations located within the same State shall not be considered unrelated third parties for this purpose.

c. The computation of depreciation or use allowances will exclude:
   (1.) The cost of land;
   (2.) Any portion of the cost of buildings and equipment borne by or donated by the Federal Government irrespective of where title was originally vested or where it presently resides; and
   (3.) Any portion of the cost of buildings and equipment contributed by or for the governmental unit, or a related donor organization, in satisfaction of a matching requirement. (OMB Circular A-87, Attachment B, 11.)

If you have any questions regarding this policy, please contact your assigned Grants Evaluation Specialist in the local ONAP Area Office. For specific accounting questions, please contact your accounting professional.

/s/

Orlando J. Cabrera, Assistant Secretary for
Public and Indian Housing

QUESTIONS AND ANSWERS

FIXED ASSETS

1. **Question:** What is ***Depreciation***?

   Answer: Depreciation is a systematic and rational means of allocating the net cost of an asset over its useful life. Depreciation is a measure of the wearing out, consumption or other reduction in the useful economic life of an asset whether arising from use, influence of time, or obsolescence through technological or market changes.

2. **Question:** How can a Federal grant recipient meet the conflicting requirements of OMB Circular A-87 and Generally Accepted Accounting Principles (GAAP) regarding depreciation?

   Answer: There is no direct conflict between the requirements of GAAP and the Circular. GAAP provides for depreciation as it is presented in the financial statements of an organization. GAAP requires that all fixed assets, except for land, be depreciated for presentation in the financial statements.

   OMB Circular A-87 allows for recipients to be compensated for the use of fixed assets through depreciation, a use allowance, or an indirect rate. The Circular restricts the compensation by excluding from the depreciation computation land cost, building and equipment cost borne by the Federal government, and building and equipment cost used to meet a matching requirement of the Federal government.

3. ***Question:*** What assets should be depreciated?

   Answer: GAAP requires capital assets that gradually lose their value over time to be depreciated for financial statement presentation. Capital assets are tangible or intangible property items with an expected life of more than one year purchased for use within the organization's operation and not intended for resale. Examples include building structures, machinery, vehicles, fixtures and fittings, roads, bridges, dams, equipment, water and sewer systems, and patents and trademarks.

4. ***Question:*** How may depreciation be computed?

   Answer: There are several methods for computing depreciation under GAAP: straight-line depreciation, units-of-production and accelerated depreciation such as sum-of-the-years'-digits and double-declining balance methods. However, for purposes of charging or allocating these costs to Federal grants, OMB Circular A-87 provides that unless it can be proven by clear evidence that an item or class of items would deteriorate at a greater rate in the early years versus the later years, the straight-line method of depreciation shall be used (OMB Circular A-87 Attachment B, 11.d.).

5. ***Question:*** May a recipient change from one depreciation method for fixed assets, e.g. straight-line, units-of-production, sum-of-the-years'-digits and double-declining balance methods, to another method during the useful life of the asset?

   Answer: Program participants may not change the depreciation methods for fixed assets without the express approval of HUD or, if depreciation is charged through a cost allocation plan, the Federal cognizant or oversight agency (24 CFR §1000.26(b)(1)(i)). Please note: A combination of two depreciation methods may not be used in a single class of fixed assets (e.g., buildings, office equipment, computer equipment, etc) except when a reasonable use allowance has been negotiated for fully depreciated assets.

6. ***Question:*** Why is land not subject to depreciation?

   Answer: Land does not decline in economic value as a consequence of wear and tear, natural deterioration through interaction of the elements, or technical obsolescence. As a reflection of these characteristics, OMB Circular A-87 and GAAP specifically exclude land from computation of depreciation.

7. ***Question:*** Are there any circumstances or situations in which assets or portions of assets otherwise subject to depreciation are not depreciated for the purposes of Federal grants?

   Answer: Yes, OMB Circular A-87 provides that if any portion of the cost was paid or donated by the Federal government, those costs are excluded from the depreciation expense computation chargeable to a Federal grant. Also, if the recipient provided any portion of the cost because of a matching requirement of a Federal program, those costs are also excluded from depreciation chargeable to a Federal grant. (OMB Circular A-87, Attachment B.11.c.). For example, the Department of Defense surplus housing units that tribes or Tribally Designated Housing Entities (TDHEs) acquired through Operation Walking Shield would not be subject to depreciation expense charged to a Federal grant because the Federal government paid to construct those units.

   However, the costs of assets acquired through a Federal grant program or provided to match funds in a Federal grant program would be treated as other assets in the same classification category and would be depreciated according to GAAP for financial statement presentation purposes.

8. ***Question:*** What is the ***Depreciable Amount***?

Answer: The depreciable amount is the cost of an asset, or the fair market value at the time of acquisition if donated, less any residual value.

9. ***Question:*** What should be considered in determining the cost of an asset?

   Answer: Under GAAP only those costs actually relating to the purchase of a new asset or the construction or improvement of a project are to be included in the cost of an asset. Please note: If you have not converted to GAAP, the older property ledgers may include items that should not be capitalized, such as routine maintenance and repair costs. In consultation with your accounting professional, you should undertake an analysis to determine the actual cost of construction to be capitalized and then adjust your accounting records as appropriate.

10. ***Question:*** What is ***Residual Value***?

    Answer: The residual value of a depreciable asset is the estimated amount that should be received upon sale of the asset at the end of its useful life.

11. ***Question:*** What is ***Useful Life***?

    Answer: Buildings and equipment items have a limited useful life as a result of certain physical and functional factors. The physical factors that move a property item towards its ultimate retirement are (1) wear and tear, (2) deterioration and decay, and (3) damage or destruction. The useful life of an item may be expressed in terms of either an estimated time factor or an estimated use factor. The time factor may be a period of months or years; the use factor may be a number of hours of service or a number of units of output. Please note: Useful life should not be confused with the period of time that a recipient declares in its Indian Housing Plan (IHP) that housing is to remain affordable (24 CFR §1000.142).

12. ***Question:*** Are there any suggested useful life ranges that may be used to calculate depreciation?

    Answer: Useful lives in practice for both broad general categories and more specific items are as follows: Please note: These are suggestions only, and are not mandatory.

    - Buildings 20 to 40 years
    - Building improvements 10 to 40 years
    - Furniture and fixtures 5 to 10 years
    - Equipment 3 to 10 years
    - Telephones 5 years
    - Tools 5 years
    - Appliances 7 years

- Furniture 10 years
- Computers 3 years
- Roofs 10 years

13. ***Question:*** How are fixed assets reported under GAAP using the enterprise model?

    Answer: The value of a fixed asset is reported at the historical cost, which includes all expenditures relating to its acquisition and preparation for use. Donated assets would be reported at the estimated fair market value of the item on the donation date. Fixed assets are depreciated over the useful life of the item, except for land and land improvements.

14. ***Question:*** How are fixed assets reported under GAAP using the government fund model?

    Answer: The value of the fixed asset is reported as a capital expenditure at the historical cost, which includes all expenditures relating to its acquisition and preparation for use, and is not reported in the governmental fund financial statements but is noted in the General Fixed Asset Account Group. The fixed asset would be reported as a fixed asset in the government-wide financial statements.

15. ***Question:*** Are there any fixed asset management procedures that must be followed?

    Answer: Yes, recipients are required to meet the following requirements (24 CFR § 85.32(d)):

    a. Maintain property records that include physical description of the property, serial number or other identification number, source of property, identity of title holder, acquisition date, cost of the property, percentage of Federal fund participation in the acquisition of the property, location, use and condition of the property, and any disposition data including disposal date and sale price.
    b. Conduct a physical inventory at least once every two years and reconcile the results to the property records.
    c. Install a property control system that provides adequate safeguards to prevent loss, damage or theft of property. Any loss, damage or theft shall be investigated.
    d. Establish an adequate maintenance process that keeps the property in good usable condition.
    e. Establish adequate sales procedures that will ensure that if the property is sold, the highest possible return is realized.

LEASE-TO-OWN HOMEOWNERSHIP

1. ***Question***: What is a ***Capital Lease***?

   Answer: A capital lease is a transaction in which the lessee obtains significant property rights. Although *not* legally a purchase, *Theoretical Substance* governs over legal form and requires that the leased property be recorded as an asset on the lessee's books. A capital lease exists if any one of the following four criteria is met: (1) the lease transfers ownership of the property to the lessee at the end of the lease term; (2) a bargain purchase option exists; (3) the lease term is 75% or more of the life of the property; and (4) the present value of minimum lease payments equals or exceeds 90% of the fair value of the property.

2. ***Question***: What is a ***Sales Type Lease*** or ***Direct Financing Lease***?

   Answer: The sales type lease and the direct financing lease are methods the lessor uses to classify a capital lease. If the lessor is the manufacturer or dealer in the item, then the transaction is given the term "sales type lease." If the lessor is not the manufacturer or the dealer of the item, then the transaction is called a "direct financing lease".

   For the transaction to be termed either a sales type lease or direct financing lease the following criteria must be satisfied: (1) collectibility of minimum lease payments is predictable, and (2) no important uncertainties surround the amount of un-reimbursable costs yet to be incurred.

   The Mutual Help Homeownership Program as provided for under the 1937 Housing Act is very similar to a direct financing lease. However, the Mutual Help Program does not satisfy the criteria that the collectibility of minimum lease payments be predictable. Therefore, the Mutual Help lease-to-sell arrangement should not be classified as a direct financing lease.

3. ***Question***: Should a Mutual Help Homeownership unit be depreciated as you would a fixed asset?

   Answer: No. The Mutual Help Homeownership units do not meet the definition of a fixed asset. The Mutual Help Homeownership homes are not for use within the tribe's or TDHE's operation but were obtained or constructed for sale to eligible homebuyers. Therefore, the homes would not be subject to depreciation by the tribe or TDHE.

   In contrast, housing units in the Low Rent Program are subject to depreciation for financial statement purposes because these units do meet the definition of a fixed asset. The units would be excluded from the compensation computation because the Federal government has borne their construction cost.

4. ***Question****:* How should the lease-to-own arrangement of the Mutual Help Homeownership Program be valued on a tribe's or TDHE's financial books?

   Answer*:* A Mutual Help housing unit should be maintained on the financial records in the 'other assets' account until the housing unit is conveyed to the homebuyer. The value assigned to the housing unit in the 'other assets' account should be the current balance for the unit as shown on the amortization schedule as of the financial statements date. As noted above, the unit is not depreciated.

   The 'other assets' account is used to record miscellaneous assets that may not be readily classified within other asset accounts. Examples of items that can be classified in this account include long-term prepayments (e.g., rent, insurance), prepaid income taxes, bond issue costs, organization costs, idle fixed assets, cash from security deposits of customers on returnable containers, and assets leased to others.

5. ***Question****:* How should you account for the funds collected from a homebuyer in the financial records?

   Answer*:* The payments made by the homebuyer are comprised of two parts: one being an administrative fee portion and the other being the homebuyer's equity portion. The administrative fee is a reimbursement of the Mutual Help Program's operating expense; therefore these funds would be the tribe's or TDHE's operating income. The Mutual Help and Occupancy Agreement (MHOA) provides that when the homebuyer's monthly payment amount exceeds the administrative fee, the balance is transferred to the homebuyer's equity account. The homebuyer's equity funds may be used to pay several things: unpaid monthly charges; charges made by the housing entity for completed maintenance work (which, under the MHOA are stated as the responsibility of the homebuyer); charges for unit improvements requested by the homebuyer and approved by the housing entity; and the balance of the purchase price.

6. ***Question****:* What should you do with the homebuyer's equity fund balances when title to the housing unit is conveyed to the homebuyer?

   Answer*:* According to the MHOA the net balance of the homebuyer's equity accounts should be applied in the following manner (MHOA Article X, §10.5(d)):
   (a) For the initial payment for fire and extended coverage on the unit after conveyance, if the TDHE is financing the purchase of the housing unit;
   (b) For settlement costs, if the homebuyer so directs;
   (c) For the purchase price; and
   (d) The balance, if any, for refund to the homebuyer.

7. ***Question****:* How should you account in the financial records for a lease-to-purchase IHBG program established under the provisions and requirements of NAHASDA?

Answer: It depends on how the lease-to-purchase program is structured. If the program follows the structure of the Mutual Help Homeownership Program established under the '37 Housing Act, it may be accounted for in the manner previously described. The tribe or TDHE should consult with their accounting professional to determine the proper accounting procedure for their particular lease-to-purchase program if it does not follow the structure of the Mutual Help Homeownership Program.

8. ***Question:*** How should a lease-to-purchase program unit purchased or constructed under an IHBG program established under the provisions and requirements of NAHASDA be depreciated?

   Answer: Lease-to-purchase homes would not fit the definition of a fixed asset. Lease-to-purchase homes are not for use within the tribe's or TDHE's business operation but were purchased or constructed for sale to eligible homebuyers. The lease-to-purchase units would not be subject to depreciation by the tribe or TDHE. The lease-to-purchase homes should be maintained on the financial records in the 'other assets' account until the homes are conveyed to the homebuyer.