151477

GAO

United States
General Accounting Office
Washington, D.C. 20548

Accounting and Information
Management Division

B-256535

April 28, 1994

Mr. Stephen L. Lowry, Senior
Manager
KPMG Peat Marwick
9040 Executive Park Drive, Suite 301
Knoxville, TN 37923

Dear Mr. Lowry:

This letter is in response to your request that the General Accounting Office interpret the requirements in Title 2, "Accounting," of GAO's Policy and Procedures Manual for Guidance of Federal Agencies, regarding reporting losses from discontinued operations. KPMG Peat Marwick has completed the final audit of the financial statements of the Uranium Enrichment Activity (UEA) of the Department of Energy (DOE) for the 9 months ended June 30, 1993.

The issue of reporting leased property from discontinued operations arises due to the Energy Policy Act of 1992 (Public Law 102-486) which requires UEA to transfer all uranium enrichment activities to a newly created federal government Enrichment Corporation, effective July 1, 1993. The law also requires DOE to lease the uranium enrichment facilities containing UEA's property and equipment to the newly created Corporation without compensation, except for reimbursement for administrative expenses and other related charges. UEA follows Title 2 for purposes of accounting and financial reporting. Your request stems from the different positions initially taken by UEA and KPMG on the reporting of leased property and equipment in UEA's June 30, 1993, financial statements.

KPMG's position is that the net book value[1] of the property and equipment used in the uranium enrichment activity,

[1]Net book value is the cost of the property less related accumulated depreciation.

estimated at about $501 million at June 30, 1993, should be recognized as a loss in the Statement of Operations because these assets will no longer benefit UEA. However, UEA's position was that no loss on the leased property and equipment should be reported in its financial statements because the loss did not represent a cost that is recoverable by UEA.

UEA officials have stated that costs that are not controlled by management should not be recognized as such on the financial statements. The creation of the lease agreement and the terms of the agreement were beyond UEA's control and, therefore, should not be disclosed as a cost of operations. Under the terms of the lease, the new Corporation can continue to use the plant and equipment effectively for as long as it chooses[2] and is not required to make any payments, except for reimbusement for administrative expenses and related lease services. Since the lease is between DOE and the Corporation, UEA believes that any loss should be reported by DOE and not UEA.

KPMG believes that the property and equipment, from UEA's perspective, have become fully impaired as of July 1, 1993--the effective date of the lease. KPMG believes that, under the terms of the lease, it is very unlikely that UEA or DOE will ever again operate the facilities to enrich uranium; hence, it is unlikely that UEA will recover any portion of the cost of the property and equipment. Thus, KPMG believes such impairment to the property and equipment should be reported as a loss in the Statement of Operations.

Subsequent to KPMG's request to GAO, UEA changed its position and agreed to report the loss from discontinued operations, primarily to avoid a qualified opinion by KPMG on its financial statements. Although UEA agreed to report the loss, you requested our response for your records and for future reference should the same or similar issue arise.

---

[2]The Corporation entered into a 6-year lease with DOE to use the plant and equipment without charge, except for related administrative expenses and other lease service costs. The lease under similar payment terms is renewable at the Corporation's option.

UEA's original position was based on the premise that costs incurred outside the control of UEA were not costs to be recognized in the financial statements. However, the ability of management to control costs is not a valid criteria to report costs or exclude them from the financial statements, if the costs have been or will be borne by the entity.

Title 2 embodies three criteria for recognizing expenses, costs, or losses in the Statement of Operations of business-like activities. These criteria are to be applied sequentially until the applicable one is met, or none are met, in which case no recognition should occur. They are (1) associating cause and effect (matching costs to the revenues they generate), (2) systematic and rational allocation, such as recognizing depreciation expense, and (3) immediate recognition when an asset has been impaired or a liability incurred. In evaluating UEA's transfer of plant and equipment to the Corporation, the third criteria applies.

In applying the third criteria, Title 2 requires losses on the disposition of property in business-like activities to be reported in the Statement of Operations if the proceeds received from the disposition of the property are less than the net book value of the property. As required by the Energy Policy Act of 1992, the plant and equipment has been disposed of from UEA's perspective by a transfer under a nonreimbursable lease to the Corporation for an indefinite period of time. At the effective date of the lease, UEA also ceased to exist as a uranium enrichment activity. Because UEA will not receive any compensation under the lease nor is it likely to obtain any future benefit from the property and equipment conveyed under the lease, the amount of proceeds from the disposition of the plant and equipment is zero. Consequently, we agree with KPMG that the amount of loss to be recognized by UEA in its Statement of Operation is equivalent to the net book value of the property conveyed under the lease with the Corporation.

We have discussed our position regarding reporting losses from discontinued operations with you and UEA officials. We hope this response is helpful. Should you have any questions, please contact Bruce Michelson, Assistant Director, of my staff, at (202) 512-9366.

Sincerely yours,

John W. Hill, Jr.

John W. Hill, Jr.
Director, Audit Support and
Analysis Group

(922209)