Statutory Issue Paper No. 67

Depreciation of Property and Amortization of Leasehold Improvements

STATUS
Finalized March 16, 1998

Original SSAP and Current Authoritative Guidance: SSAP No. 19

Type of Issue:
Common Area

SUMMARY OF ISSUE

1. Current statutory guidance for accounting for the depreciation of property and the amortization of leasehold improvements is provided in Chapters 4 and 9 of the Accounting Practices and Procedures Manual for Property and Casualty Insurance Companies (P&C Accounting Practices and Procedures Manual) and Chapter 4 of the Accounting Practices and Procedures Manual for Life, Accident, and Health Insurance Companies (Life/A&H Accounting Practices and Procedures Manual). This guidance requires:

a. The cost of directly owned property (except land), occupied by the company or held for investment, to be allocated to expense (depreciated) over the property's estimated useful life in a systematic and rational manner.

b. The cost of nonadmitted furniture and equipment (including EDP equipment) to either be fully expensed when purchased or depreciated over the property's estimated useful life.

c. The cost of leasehold improvements to be allocated to expense (amortized) over the term of the lease.

2. GAAP guidance for accounting for depreciation is provided in *Accounting Research Bulletin No. 43*, *Restatement and Revision of Accounting Research Bulletins* (ARB 43*),* Chapter 9, *Depreciation*, and *Accounting Principles Board Opinion No. 12*, *Omnibus Opinion - 1967* (APB 12*)*. This guidance requires that the cost of depreciable assets, less salvage value (if any) be expensed over the estimated useful lives of the assets. GAAP guidance requires a leasehold improvement to be amortized over the remaining term of the lease or its estimated useful life, whichever is shorter.

3. The purpose of this issue paper is to establish statutory accounting principles for accounting for the depreciation of property and the amortization of leasehold improvements that are consistent with the Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy (Statement of Concepts).

4. *Issue Paper No. 16—Electronic Data Processing Equipment and Software* (Issue Paper No. 16), *Issue Paper No. 19—Furniture, Fixtures and Equipment* (Issue Paper No. 19), *Issue Paper No. 31—Leasehold Improvements Paid by the Reporting Entity as Lessee* (Issue Paper No. 31), and *Issue Paper No. 40—Real Estate Investments* (Issue Paper No. 40) each require the depreciation of these assets against net income as their estimated economic benefit expires.

SUMMARY CONCLUSION

5. The acquisition cost of all depreciable assets, net of salvage, shall be allocated to expense over the estimated useful lives of the assets in a systematic and rational manner. The acquisition cost of a leasehold improvement shall be allocated to expense over the shorter of its estimated useful life or the

original lease term excluding options or renewal periods. For leasehold improvements capitalized subsequent to inception of the lease, the cost shall be allocated to expense over the shorter of its estimated useful life or the remaining original lease term excluding options or renewal periods. Amounts capitalized for leasehold improvements in periods subsequent to the original lease term (i.e., during renewal periods), are amortized utilizing the shorter of the estimated useful life of the asset or the remaining term of the renewal period. In accordance with the reporting entity's capitalization policy, immaterial amounts incurred relative to leasehold improvements, can be expensed when purchased.

6. For the purposes of this issue paper, depreciable assets include all tangible capital assets classified as either admitted or nonadmitted in accordance with *Issue Paper No. 4—Definition of Assets and Nonadmitted Assets* (Issue Paper No. 4). Land shall not be considered a depreciable asset.

7. Depreciation and amortization expense shall be recorded in the statement of income in accordance with *Issue Paper No. 94—Allocation of Expenses* (Issue Paper No. 94).

8. A variety of systematic depreciation and amortization methods is available such as the straight-line method, the sum-of-the-years' digits method, and various declining balance methods. The depreciation or amortization method selected shall be that which most appropriately allocates the cost of the depreciable asset or leasehold improvement over its estimated useful life. The use of the sinking fund or constant yield method does not constitute acceptable statutory accounting practice.

9. Useful lives of depreciable assets and leasehold improvements can be obtained from contractors, appraisers, engineers, and manufacturers, or they may be based on prior experience. Estimates published by the Internal Revenue Service can be helpful in the selection of useful lives for specific assets.

10. The following disclosures shall be made in the financial statements or notes thereto:

a. Depreciation and amortization expense for the period.

b. A general description of the method or methods used in computing depreciation and amortization with respect to major classes of depreciable assets and leasehold improvements.

11. Changes in the estimated useful lives of depreciable assets or leasehold improvements from one period to another shall be considered a change in accounting estimate and shall be accounted for in accordance with *Issue Paper No. 3—Accounting Changes* (Issue Paper No. 3). Changes in depreciation or amortization methods from one period to another shall be considered a change in accounting principle and shall be accounted for in accordance with Issue Paper No. 3.

DISCUSSION

12. The statutory principles outlined in the conclusion above are consistent with current statutory guidance except as follows:

a. Paragraph 5 requires the acquisition cost of all depreciable nonadmitted assets to be allocated to expense over their estimated useful lives. Current guidance allows nonadmitted depreciable assets to either be expensed when purchased or depreciated.

b. Paragraph 5 requires a leasehold improvement to be amortized over the shorter of the remaining original term of the lease excluding renewal or option periods or its estimated useful life. Amounts capitalized subsequent to the original lease term (i.e., during a renewal period) are amortized over the shorter of the estimated useful life of the asset or the remaining renewal period. Current guidance requires amortization over the remaining term of the lease.

c. Paragraph 10 requires disclosures with respect to depreciable assets and depreciation and, leasehold improvements and amortization in the notes to the financial statements.

13. The statutory principles outlined in the conclusion above are consistent with the following issue papers:

a. Issue Paper No. 4 which requires that assets be depreciated or amortized against income as the economic benefit expires.

b. Issue Paper No. 16 which requires that the cost of electronic data processing equipment and software be depreciated against net income as the estimated economic benefit expires.

c. Issue Paper No. 19 which requires that the cost of furniture, fixtures and equipment be depreciated against net income as the estimated economic benefit expires.

d. Issue Paper No. 31 which requires that the cost of leasehold improvements be depreciated against net income as the estimated economic benefit expires.

e. Issue Paper No. 40 which requires that the cost of property included in real estate investment, other than land, be depreciated over the estimated useful life.

14. This issue paper rejects Chapter 9 of ARB 43 however, it is considered appropriate to use the concepts of depreciating assets discussed in the GAAP guidance, which requires that the acquisition cost less salvage value be recorded as an expense over the estimated useful life of the asset, as the basis for the statutory guidance codified in this issue paper. Additionally, this issue paper rejects APB 12 although the disclosures required by this issue paper are consistent with the disclosures required therein.

RELEVANT STATUTORY AND GAAP GUIDANCE

Statutory Accounting

15. The P&C Accounting Practices and Procedures Manual, Chapter 4, Real Estate, provides the following guidance:

> Depreciation and Amortization
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> The cost of property, other than land, should be depreciated over its estimated useful life. Useful lives for buildings and improvements can best be obtained from contractors, appraisers, engineers, and manufacturers. Estimates published by the Internal Revenue Service can be helpful in the selection of useful lives for specific assets. Depreciable life may at times be fixed by contract, such as in a leasehold investment.
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> A variety of depreciation methods is available, and a company should select the method that is most appropriate provided, however, that the method is both systematic and rational. Depreciation methods in use include the straight-line method and accelerated methods, such as sum-of-years' digits and various declining balance methods.
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> Because real estate leasehold improvements revert to the lessor at the end of the lease, and the lessee receives benefits from the improvements only during the life of the lease, a leasehold improvement is subject to amortization over the lease life.

The Accounting Practices and Procedures Manual for Life, Accident, and Heath Insurance Companies provides identical guidance.

16. The Life/A&H Accounting Practices and Procedures Manual, Chapter 9, Nonadmitted Assets, provides the following guidance:

> Equipment, Furniture, and Supplies: The company may record furniture and equipment as a ledger asset, depreciate it, and nonadmit it in the exhibit of assets in the statutory financial statements, or the company may expense the furniture and equipment when it is purchased. Supplies are normally expensed when purchased.

17. Emerging Accounting Issues Working Group of the Accounting Practices and Procedures (EX4) Task Force minutes 90-4 provide the following guidance:

> The Working Group concluded that the use of the sinking fund or constant yield method does not constitute acceptable statutory accounting practice and that the practice should not be applied to new properties acquired in the future nor if the company changes its existing properties' method of depreciation. This conclusion would not impact those properties currently being depreciated using the constant yield method.

Generally Accepted Accounting Principles

18. Chapter 9, Section C of ARB 43, provides the following guidance:

> 5. The cost of a productive facility is one of the costs of the services it renders during its useful economic life. Generally accepted accounting principles require that this cost be spread over the expected useful life of the facility in such a way as to allocate it as equitably as possible to the periods during which services are obtained from the use of the facility. This procedure is known as depreciation accounting, a system of accounting which aims to distribute the cost or other basic value of tangible capital assets, less salvage (if any), over the estimated useful life of the unit (which may be a group of assets) in a systematic and rational matter. It is a process of allocation, not of valuation.

19. *Accounting Principles Board Opinion No. 12*, *Omnibus Opinion - 1967,* provides the following guidance:

> DISCLOSURE OF DEPRECIABLE ASSETS AND DEPRECIATION
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> 4. Disclosure of the total amount of depreciation expense entering into the determination of results of operations has become a general practice. The balances of major classes of depreciable assets are also generally disclosed. Practice varies, however, with respect to disclosure of the depreciation method or methods used.
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> 5. Because of the significant effects on financial position and results of operations of the depreciation method or methods used, the following disclosures should be made in the financial statements or in notes thereto:
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> a. Depreciation expense for the period,
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> b. Balances of major classes of depreciable assets, by nature or function, at the balance-sheet date,
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> c. Accumulated depreciation, either by major classes of depreciable assets or in total, at the balance-sheet date, and
>
> d. A general description of the method or methods used in computing depreciation with respect to major classes of depreciable assets.

RELEVANT LITERATURE

Statutory Accounting

- Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy
- Accounting Practices and Procedures Manual for Property and Casualty Insurance Companies, Chapters 4 and 9
- Accounting Practices and Procedures Manual for Life, Accident and Health Insurance Companies, Chapter 4
- *Issue Paper No. 3—Accounting Changes*
- *Issue Paper No. 4—Definition of Assets and Nonadmitted Assets*
- *Issue Paper No. 16—Electronic Data Processing Equipment and Software*
- *Issue Paper No. 19—Furniture, Fixtures and Equipment*
- *Issue Paper No. 31—Leasehold Improvements Paid by the Reporting Entity as Lessee*
- *Issue Paper No. 40—Real Estate Investments*
- Emerging Accounting Issues Working Group of the Accounting Practices and Procedures (EX4) Task Force minutes 89-1
- Emerging Accounting Issues Working Group of the Accounting Practices and Procedures (EX4) Task Force minutes 89-2
- Emerging Accounting Issues Working Group of the Accounting Practices and Procedures (EX4) Task Force minutes 89-3
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- Emerging Accounting Issues Working Group of the Accounting Practices and Procedures (EX4) Task Force minutes 90-4

Generally Accepted Accounting Principles

- *Accounting Research Bulletin No. 43, Restatement and Revision of Accounting Research Bulletins, Chapter 9, Depreciation*
- *Accounting Principles Board Opinion No. 12, Omnibus Opinion - 1967*

State Regulations

- No additional guidance obtained from state statutes or regulations.

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