

7 Long lived assets

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Acquiring the asset - capitalization

What components of acquisition costs should be included in the capitalized cost ?
(interest during construction ?)

What type of costs merit capitalization ?
(software development costs)

What accounting methods should be used to determine the amount of costs capitalized ?
(oil & gas properties)

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Capitalization Vs. Expensing Conceptual Issues

Asset = probable future economic benefits (SFAC 6)

Effects of capitalization versus expensing choice: example

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Impact of capitalization decisions on FSA - 1

	Capitalize	Expense
Income variability	low variance	More variance
Assets	Higher	Lower
Income from operations	Higher if high growth	
Profitability (ROA)	Higher if high growth	Higher in steady state

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Impact of capitalization decisions on FSA - 2

	Capitalize	Expense
CFO	Higher	Lower
CFI	Lower	Higher
Cash Flow = CFO + CFI	same	
Leverage (debt to equity)	Lower (better)	Higher

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Capitalization of interest costs

SFAS 34: Cost of a self constructed asset should be identical to a purchased complete asset.

Jan 1,08	Jan 1,09
+	+
Pay \$1 mill here	Ready
	or Pay \$1.1 mill here

Capitalization rate: Use Weighted average interest rate
Reduce Interest expense by \$100,000 and increase Asset to \$1,100,000
But capitalized interest has to be < actual interest expense.
Calpine 2002 10-K (Look at pages 126, 142, 157 & 159)
What was the interest rate (expense) ?

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Capitalization of interest costs 2

- Adjustment for FSA: [Look at Weyerhaeuser, Calpine]
- » Capitalization of interest should be reversed
 - » Times Interest Earned ratio will be lower
 - » CFO overstated
 - » Net income overstated due to this period's capitalization; but previous period ?

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Goodwill

AOL - Time Warner 2002

(Look at pages 115 and 121)

How much goodwill was written off by Time Warner in 2003? Why?

Pfizer 2003 – Pharmacia Acquisition

(Look at the statements and note 2)

How much goodwill was created by Pharmacia acquisition?

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Intangible assets

Advertising Costs: Expensed
 Brand value assets

R & D 1975: SFAS 2 made all firms to expense R&D costs
 Did firms reduce R & D expenditures do the mandatory accounting change ? Box 7-4
 Analytic Adjustments for capitalization and expensing

Merck ROA overstated as R&D is not capitalized

	Expensed	Capitalize and amortize over		
		3	5	7
		years		
ROA	24.10%	22.20%	20.90%	20.00%

Positive theory Accounting method for R&D matters

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Software Development Costs

SFAS 86: From 1995, subsequent costs after economic feasibility of software has been established can be capitalized.

IBM: Depreciation and Amortization

Capitalized software costs incurred or acquired after technological feasibility are amortized over periods up to 3 years. See "Software Costs" below for additional information. Other intangible assets are amortized for periods up to 7 years. See "Standards Implemented" for additional information on goodwill.

1 \$billion capitalized

Microsoft? How much \$billion capitalized

Lucent? 1999 10k; How much Cap Software Dev Costs ? 249

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Accounting for Oil & Gas

Cost of drilling well \$1,000

Four wells drilled – one is productive, three are dry.

SFAS 19: In 1977, required all firms to use Successful Efforts (SE) accounting method that expenses all dry hole costs.

(SE) For the first three dry wells, expense of \$1,000 is recognized. The fourth producing well cost is \$

SFAS 25: In 1979, allowed all companies to use either SE or Full Cost (FC) method that creates assets out of dry holes.

(FC) For the first three dry wells, no expense is recognized. The fourth producing well cost is \$

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