THE JOURNEY FROM HISTORICAL COST ACCOUNTING TO FAIR VALUE ACCOUNTING: THE CASE OF ACQUISITION COSTS

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ABSTRACT

This paper discusses the evolution from historical cost accounting to fair value accounting and the corresponding change in the treatment of costs to acquire investment securities. The history of the movement from capitalizing acquisition costs to expensing these costs is documented. A discussion of the implications of these changes is also provided.

INTRODUCTION

For many years, U.S. generally accepted accounting principles (GAAP) placed more emphasis on historical cost accounting than on fair value accounting. However, there have been efforts over time to move toward some fair value reporting. In the last two decades, fair value accounting has made great strides in GAAP. In 1993, Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards (SFAS) No. 115 was issued which allowed for fair value accounting for certain investments in debt and equity securities. Any investments classified as either trading securities or available for sale securities are adjusted to fair value with a market adjustment at the end of each period. In 2007, SFAS No. 159 was issued. This statement allows reporting entities the option of measuring most financial assets and financial liabilities at fair value.

Traditionally, transaction costs paid in the acquisition of investment assets were capitalized as part of the investment cost. However, as recent movements toward fair value accounting have been made, a simultaneous movement toward expensing these costs has resulted. This paper presents some history and thoughts on the change from capitalizing these costs to expensing them. The next section of the paper addresses acquisition costs under historical cost accounting. The following section looks at the requirements for acquisition costs under the fair value option. Then a section describes the treatment of acquisition costs for other classifications such as trading securities, available-for-sale securities, held-to-maturity securities, and equity method investments. These sections are followed by a discussion section and a conclusion.

ACQUISITION COSTS–HISTORICAL COST ACCOUNTING

Accounting students are likely first introduced to the treatment of acquisition costs when they learn about the acquisition of property, plant, and equipment to be used as operating assets. In this context, students are taught that all costs necessary to acquire the asset and get it ready for its intended use are capitalized as part of the asset's original book value. For a piece of equipment, the acquisition cost would include not only the purchase price of the asset, but would also include any costs for taxes, shipping, insurance, installation, and testing. Interestingly, accounting standards do not seem to formalize the capitalization of these costs in any standard relating directly to the acquisition of fixed

assets. Instead, this concept seems to be formalized in SFAS No. 34 (issued in 1979) which discusses the capitalization of interest. Paragraph 6 of this statement says the following: "The historical cost of acquiring an asset includes the costs necessarily incurred to bring it to the condition and location necessary for its intended use" [5, para. 6].

The focus under historical cost accounting is to record assets at amounts that are verifiable and therefore reliable. An objective of historical cost accounting is to take all costs and split them between those that have future value and those that have no future value. Costs with future value will be capitalized, and as appropriate, written off as an expense over the time the periods when the value is provided. Costs with no future value will be immediately expensed.

One would assume the rational purchaser would only be willing to pay fair value for an asset and the rational seller would only be willing to sell an asset if the consideration received represents fair value. Therefore, the original purchase price, including the costs ready to get the asset ready for its intended use should be a close representation of the value of the asset on the acquisition date. However, traditional historical cost accounting makes no claim that book values track fair values after the acquisition date. Instead, an allocation of the cost over time through depreciation, amortization, or depletion, will systematically reduce the book value of the asset and result in an expense of the cost of the asset over its useful life. So instead of representing fair value at a balance sheet date subsequent to the acquisition of the asset, the historical cost accounting method presents the book value, the original costs less any portion which has been expensed systematically.

Although fixed asset values can become impaired and written down as a loss, unrealized gains are not recognized under the historical cost accounting model. Recognizing impairment losses that are unrealized but not unrealized gains seems to be a remnant of conservatism, which the FASB has now explicitly avoided in its concepts statements [4, paras. BC3.27 - BC3.29]. The realization process is very important in recognizing gains, so no gains are recorded until fixed asset are actually sold.

Under historical cost accounting, investments in debt and equity securities are recorded at cost, typically with the associated transaction costs capitalized as part of that cost. The arguments that these transaction costs are necessary to acquire the asset and get it ready for its intended use as an investment and that they should be capitalized follow from the traditional treatment of costs capitalized for fixed operating assets that are not part of the actual purchase price.

Over time, the investor will record interest or dividend revenues on these investments as the interest is earned or the dividends are declared by the investee. However, no unrealized gains or losses will be recorded as the value of the investment fluctuates. Instead, with the exception of an impairment loss, gains and losses will only be recognized when the investment is actually sold and the gain or loss is realized. Since transaction costs are capitalized as part of the investment asset, these costs will be part of the book value of the asset when it is sold and will affect the amount of realized gain or loss recorded at the time of the sale.

ACQUISITION COSTS–FAIR VALUE OPTION

Although International Financial Reporting Standards (IFRS) make some allowance for reporting fixed operating assets at fair value [2], U.S. GAAP still uses fairly traditional historical cost accounting for these fixed assets. However, U.S. GAAP has increasingly required or allowed the use of fair value accounting for investment assets. For 20 years, investments in trading and available for sale securities

have been adjusted to fair value at each balance sheet date. Market adjustments for the trading securities have been included in the income statement, while market adjustments for available for sale securities have bypassed the income statement and been directly included in stockholders' equity as part of accumulated other comprehensive income [6]. Since 2007, companies applying U.S. GAAP have been allowed to use the fair value option for most financial assets and financial liabilities [9]. Changes in fair value are included as a component of net income. When using the fair value option, realization of gains or losses is not considered to be important in the decision of recognizing them; instead, both realized and unrealized gains and losses are recognized in earnings.

The fair value option for financial assets and financial liabilities in SFAS No. 159 defines fair value as "The price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date" [9, para. 6]. Using this definition of exit value as the fair value makes sense in the case of financial assets and liabilities, as the ability/requirement to liquidate these assets/liabilities is the only ultimate way they have value to the firm.

Because the liquidation value of an investment asset will not include the amount of any transaction costs paid to acquire the security, even if these transaction costs were initially capitalized as part of the investment cost, they would be written off at the end of the year of acquisition when the asset is adjusted to fair value. Therefore, it makes no sense to capitalize these costs initially. It makes sense that "upfront costs and fees related to items for which the fair value option is elected shall be recognized in earnings as incurred and not deferred [9, para. 3].

ACQUISITION COSTS–SFAS NO. 115 AND NO. 141(R) AND APB NO. 18

Under SFAS No. 115 [6] a company classified its investment assets as held to maturity, available for sale, or trading. In addition, Accounting Principles Board (APB) Opinion No. 18 [1] provided that investments in common stock which resulted in significant influence or control be accounted for using the equity method. These categories still exist even though the fair value option has been added.

If an investment is classified as a trading security, the transaction costs would likely be expensed as incurred. Since trading securities are adjusted to fair value at the end of each period and the adjustment goes to the income statement, it makes no sense for the transaction costs to be capitalized. They would just be written off to the income statement at the end of the year of acquisition as part of the fair value adjustment. In fact, the fair value option essentially treats most financial assets using a method which mirrors the method used for trading securities.

In accounting for available-for-sale securities, even though the investments will be adjusted to fair value at the end of each year, the market adjustment does not go to the income statement. Therefore, the transaction costs for these investments can be capitalized as part of the investment cost without immediately being written off to the income statement in the same year as part of the market adjustment.

Since investments classified as held to maturity are not adjusted to fair value at the end of each period, the transaction costs to acquire these investments can be capitalized without immediately being written off at the end of the year. However, since these costs either reduce the discount or increase the premium for the transaction, they would also have the effect of adjusting the market rate of interest earned on the investment. The adjusted market rate would be used for calculating interest revenue over the life of the debt security.

Companies with significant influence over an investee company, usually evidenced by more than 20 percent ownership but less than 50 percent ownership, have the choice of using the equity method or the fair value option. If the equity method is chosen, a company can presumably capitalize the transaction costs as part of the initial investment. Even though the equity method is a modification of the cost method, with adjustments to the investment account for investee earnings and dividends and the investor amortization of differential, the transaction costs might be capitalized. If the fair value option is chosen, the transaction costs would be expensed. However, Stice and Stice [10] report that as of 2012 the FASB and the International Accounting Standards Board (IASB) were considering the elimination of the fair value option for investors using the equity method.

If a parent has control over the investee (greater than 50 percent ownership), the investor has to prepare consolidated financial statements. SFAS No. 159 specifically prohibits the election of the fair value option for "an investment in a subsidiary that the entity is required to consolidate" [9, para. 8a]. However, even though the fair value option is not a choice in this case, SFAS No. 141 (revised 2007) requires that most acquisition related costs be expensed:

> Acquisition-related costs are costs the acquirer incurs to effect a business combination. Those costs include finder's fees; advisory, legal, accounting, valuation, and other professional or consulting fees; general administrative costs, including the cost of maintaining an internal acquisitions department; and costs of registering and issuing debt and equity securities. The acquirer shall account for acquisition-related costs as expenses in the periods in which the costs are incurred and the services are received, with one exception. The costs to issue debt or equity securities shall be recognized in accordance with other applicable GAAP [7, para. 59].

Appendix B of SFAS No. 141(R) gives the basis for conclusions reached in the standard. Several paragraphs of this appendix provide a discussion about acquisition-related costs. While all of the discussion in these paragraphs is relevant, one paragraph in particular is extremely illuminating:

> The Boards concluded that acquisition-related costs are not part of the fair value exchange between the buyer and seller for the business. Rather, they are separate transactions in which the buyer pays for the fair value of services received. The Boards also observed that those costs, whether for services performed by external parties or internal staff of the acquirer, generally do not represent assets of the acquirer at the acquisition date because the benefits obtained are consumed as the services are received [7, para. B365].

It seems that with the movement toward fair value accounting, the FASB is transitioning away from capitalizing acquisition costs, instead arguing that these costs are not part of the exchange between the buyer and seller and that they should be expensed as part of a separate transaction.

DISCUSSION

The two primary qualitative characteristics of useful accounting information used to be relevance and reliability [3], but Statement of Financial Accounting Concepts (SFAC) No. 8 [4] has redefined the two fundamental qualitative characteristics of useful financial information as relevance and faithful representation. When reliability was one of the primary characteristics, it was sometimes used as an excuse to avoid fair value accounting, as historical costs were more reliable because they were verifiable. However, the change to faithful representation is perhaps a recognition that fair value accounting has received more emphasis in recent years.

SFAS No. 157 [8] gives specific guidance on how fair values are to be measured. This statement mentions three valuation techniques including the market approach, the income approach, and the cost approach. Inputs to these different valuation techniques can be either observable or unobservable and are classified in SFAS No. 157 as level 1 inputs, level 2 inputs, and level 3 inputs. In valuing assets, a valuation premise is used depending on whether "the highest and best use of the asset" is in-use or in-exchange. An in-exchange premise would likely be used for financial assets for which the value is best described in terms of exchange value. An in-use premise might be used for non-financial assets which are best used in combination with other assets rather than as separate items.

While historical costs are usually very reliable, fair values may be a more faithful representation of the measurement of the probable future economic benefit of an asset or the probable future sacrifice of economic benefits of a liability. As mentioned earlier, when assets are valued at fair value, it makes little sense to include the transaction/acquisition costs as part of the assets' value, as these costs are not part of the ongoing fair value of the asset. When assets are recorded at historical cost, it may make more sense to capitalize acquisition costs as part of the cost of the asset.

From a conceptual viewpoint, arguments can be made for both capitalizing or expensing acquisition costs. Assuming these costs are part of the normal and necessary costs of acquiring the asset, they can be thought of as costs necessary to have access and therefore as part of the value paid for the asset. From this viewpoint, the costs of acquiring an asset, even though they may be paid to a different party than the seller of the asset, are an inseparable part of the overall transaction to acquire the asset. You wouldn't pay for transportation costs for a piece of equipment if you were not buying the equipment. Likewise, you would not buy a piece of equipment without being willing to pay for the transportation costs to get the equipment to your place of business. Similarly, brokerage fees required to buy an investment asset are inseparable from the investment, as neither part of the transaction would occur without the other.

Another perspective is whether the costs are recoverable or not. Of course, if you pay costs to acquire an asset, these costs are not recoverable in an immediate resale of the asset to another party. Since they are not recoverable, perhaps they should be expensed. On the other hand, in any arms-length transaction, we would assume that the rational investor/purchaser would expect to recover the acquisition costs through the use of the operating asset or through revenues or gains from an investment asset. Otherwise, it would be unreasonable to pay these costs. Since these costs are not immediately recoverable but are theoretically recoverable over time, an argument exists for capitalizing these costs as having future benefit.

The FASB has been quite clear in recent years about its direction toward increasing the use of fair value accounting, especially for financial assets. It is obvious that the transaction costs for trading securities and for any securities using the fair value option will be expensed. In fact, since the FASB also requires the expensing of costs involved in a business combination through the purchase of a controlling interest in another company, it seems that the direction toward the expensing of acquisition costs has been set.

It will be interesting to see what will happen in the future with respect to fair value accounting for fixed assets. Whether or not accounting standards move that far, it seems clear that the FASB is setting standards that may lead to the expensing of acquisition costs regardless of the method of accounting for the specific asset. The argument made in SFAS 141(R) with respect to acquisition costs in a business combination could easily be applied to almost any situation in which an asset or asset group is acquired. This argument is that "acquisition-related costs are not part of the fair value exchange between the buyer

and seller. . . .Rather, they are separate transactions in which the buyer pays for the fair value of services received. . . . those costs. . .generally do not represent assets of the acquirer. . .because the benefits obtained are consumed as the services are received" [7, para. B365].

CONCLUSION

While it used to be quite common to capitalize transaction costs for the purchase of assets, it is becoming less common, especially with the increasing use of fair value accounting. In situations where fair value accounting is used (with changes in value going to the income statement), accounting standards now require the expensing of transaction costs. Even when the equity method is used for subsidiaries requiring consolidation, the acquisition costs are now expensed. At this point in time, fixed operating assets are still accounted for using historical cost accounting with all costs necessary to get the asset in place ready for its intended use being capitalized. However, it is possible that the trend to expense acquisition costs may change this traditional treatment in the future.

REFERENCES

[1] Accounting Principles Board Opinion No. 18, "The Equity Method of Accounting for Investments in Common Stock," American Institute of Certified Public Accountants, 1971.

[2] International Accounting Standard No. 16, "Property, Plant and Equipment," International Accounting Standards Board, 1993.

[3] Statement of Financial Accounting Concepts No. 2, "Qualitative Characteristics of Accounting Information," Financial Accounting Standards Board, 1980.

[4] Statement of Financial Accounting Concepts No. 8, "Conceptual Framework for Financial Reporting: Chapter 1, The Objective of General Purpose Financial Reporting, and Chapter 3, Qualitative Characteristics of Useful Financial Information," Financial Accounting Standards Board, 2010.

[5] Statement of Financial Accounting Standards No. 34, "Capitalization of Interest Cost," Financial Accounting Standards Board, 1979.

[6] Statement of Financial Accounting Standards No. 115, "Accounting for Certain Investments in Debt and Equity Securities," Financial Accounting Standards Board, 1993.

[7] Statement of Financial Accounting Standards No. 141 (revised 2007), "Business Combinations," Financial Accounting Standards Board, 2007.

[8] Statement of Financial Accounting Standards No. 157, "Fair Value Measurements," Financial Accounting Standards Board, 2006.

[9] Statement of Financial Accounting Standards No. 159, "The Fair Value Option for Financial Assets and Financial Liabilities Including an amendment of FASB Statement No. 115," Financial Accounting Standards Board, 2007.

[10] Stice, Earl K. and James D. Stice, *Intermediate Accounting*, 19th ed., Cengage Learning, 2014.