

LONG-LIVED ASSETS (PPE)

I. Overview and Financial Statements

Long-lived assets include land, buildings, equipment, natural resources, etc. These assets are acquired for use in operations and not for sale.

The amount you see on the balance sheet is net book value = cost - accumulated depreciation (or depletion for a natural resource). The current-period allocation of depreciation (or depletion) appears on the income statement. The cash paid to acquire new assets appears in the investing section of the SCF. Cash received for sales also appears in the investing section, if it is material.

II. Disclosures

A firm is required to supply certain information about its long-lived assets. The disclosures may be communicated in the body of balance sheet or in the footnotes to the financial statements.

1. Carrying value by major assets classes. Carrying value is the gross value, or original acquisition cost, of the asset.
2. Accumulated Depreciation (in total or by major classes)
3. Depreciation methods used and estimates of useful lives. Often the estimates of useful lives is given as a range. Rarely will you know exactly what useful life a firm assumes for each asset or even for each asset type.
4. Interest capitalization. (We will discuss what this is!) The disclosures vary. Some firms provide the amount of capitalized interest included in the book value of the asset. Other firms disclose the amount of interest capitalized during the period. Some firms disclose both.

Stop here and think about the information that is provided in the financial statements about a firm's PPE -- See Hilton Hotels. As an analyst, what are some significant questions you might have related to PPE? Do the accounting numbers provide useful information for answering these questions? Are there some industries where the reported amounts are particularly useless?

III. Acquisition of Long-lived assets

A. Purchased Assets

Acquisition cost = purchase price plus costs necessary to bring the asset to its location in working condition. Costs necessary to get the asset ready for use include transportation costs, installation costs, and specific employee training costs. For example, the cost of land includes cost of land surveys, legal fees, title fees, realtors' commissions, etc. The acquisition cost is also referred to as the "gross value" of the PPE.

B. Self-constructed assets

Under GAAP, interest costs are usually expensed when incurred. However, for a firm that constructs its own long-lived assets, interest costs can be capitalized as part of the “cost” of the asset being constructed.

The idea is that the “cost” basis of an asset (recall that this is the amount initially recorded on the balance sheet) should not depend on whether the firm buys it or builds it. If the firm were to purchase an asset, the cost of financing during the construction period would be passed from the construction company to the firm. Therefore, the purchase price would include such costs. For a self-constructed asset, the final acquisition cost = all construction costs (e.g., direct materials, direct labor and indirect manufacturing costs) plus interest costs incurred during construction.

See section VII of the notes for details on computing the amount of interest to be capitalized.

IV. Dispositions of Long-lived Assets

When the firm sells or otherwise disposes of a long-lived asset, it must remove the asset from the balance sheet and recognize any gain or loss on the disposal. Both the gross value and the accumulated depreciation associated with the asset are removed from the balance sheet.

Regular sale

Deberg company sells machinery (cost, \$100,000; accumulated depreciation, \$40,000) for \$50,000 in cash.

Donation

The donor should recognize the fair value as donation expense. A gain or loss on the donation equal to the difference between the asset’s book value and fair value should be recognized.

Kline Industries donates land that cost \$80,000 and has a fair market value of \$110,000 to the Memphis Industrial Development Corp. *Note: Land is a non-depreciable asset.*

Involuntary Conversion (e.g., due to flood, fire, theft, condemnation, etc.)

Camel was forced to sell a plant located on company property that stood directly in the path of an interstate highway. In settlement, Camel received \$500,000, which was substantially in excess of the \$200,000 book value of the plant and land (cost of \$400,000 less accumulated depreciation of \$200,000).

V. Asset Exchanges

Two firms exchange assets. Each will remove the old asset, and its related accumulated depreciation, from its books at book value on the date of the exchange. Each will record any *cash* received or paid. Each must record the new asset acquired in the exchange on its books. The significant accounting issue is how to value the “incoming” asset.

Each firm will *calculate* (BUT NOT NECESSARILY RECORD) a gain or loss on the exchange, which represents the difference between the fair value of the transaction and the book value of the assets given up. If the calculated amount is a loss, it is always recognized and the new asset is recorded at fair value. If the calculated amount is a gain, the rules below indicate how much, if any, of the calculated gain can be recognized. Any gain that is not recognized is treated as a reduction in the basis of the incoming asset.

If the cash exchanged/total boot $\geq 25\%$, the transaction is **not** a non-monetary exchange. Thus, the new asset acquired is recorded at fair value and all gain or loss is recognized.

If the asset is a non-monetary exchange, the treatment of the incoming asset and thus the gain/loss depends on whether the exchange has commercial substance. If it does, the firm recognizes all gains and losses. If not, the treatment of the incoming asset and thus the gain/loss depends on whether the exchange hypothetically results in a gain *or* loss. If it is a hypothetical loss, the firm recognizes it. If it is a gain, the treatment depends on the extent of cash received in the transaction.

In class, we will go over the examples on the next few pages of the notes to illustrate the accounting under different scenarios. Homework 4 asks you to characterize the process and to think about the financial statement implications of various types of transactions.

Examples of asset exchanges

For each of the following scenarios, consider the appropriate journal entry for Jayco:

1.1. Jayco exchanges a fleet of cars (cost, \$140,000; accumulated depreciation, \$60K) to Pitt Co. in exchange for land with a fair value of \$160,000. Jayco also pays \$50,000 to Pitt as part of the exchange.

1.2 Assume the same facts as in 1.1 except that the fair value of the land is \$110,000.

1.3. Assume the same facts as in 1.1 except that the fair value of the land is not readily determinable. Jayco also is unable to determine a reliable estimate of the fair value of the cars. They are customized vehicles designed specifically to deliver Jayco's products.

1.4. Jayco trades its machine which it carries on its books at a cost of \$4,000, accumulated depreciation of \$1,600, for a machine with a fair value of \$2,000. The machines are similar and the economic position of Jayco does not change.

1.5 Jayco Realty owns four acres of land, with a cost of \$100,000 on the west side of the city and Kaan Realty owns three acres, with a cost of \$90,000, on the east side of town. Both plots of land have a fair value of \$130,000. Economic development consultants hired by both firms recommend that a strip mall be built on the east side of town and apartments catering to young adults be built on the west side of the city. Because Jayco has more experience building strip malls and Kaan has more experience building apartments, they swap plots of land. Their economic positions remain the same and there should not be a significant change in cash flows.

1.6 Jayco exchanges a fleet of used cars plus cash (\$10,000) for land to be used as a future plant site. The cars have a cost of \$70,000 and accumulated depreciation of \$40,000. Jayco determines that the fair value of the *cars* is \$35,000 and that the transaction lacks commercial substance.

1.7 Jayco exchanges a used machine with a carrying value of \$60,000 (cost \$115,000 and accumulated depreciation of \$55,000) and a fair value of \$100,000 for another machine with a fair value of \$90,000. In addition, Jayco receives cash of \$10,000. Jayco determines that the transaction lacks commercial substance.

1.8. Five days after the exchange in 1.7, Jayco (unexpectedly) sells the new machine to an independent third party. The fair value of the machine has not changed, thus, the sale price is \$90,000. Because the sale is unexpected, this information does not affect the assessment of the commercial substance of the original transaction. Ignore depreciation for the 5-day period.

VI. Accounting for Changes in Asset Value Subsequent to Acquisition

A. Impairments

SFAS (Statements of Financial Accounting Standards) 144 requires a firm to reduce the value of long-lived assets when the carrying amount (net book value) is not recoverable. The key is the definition of “not recoverable.” Firms are required to perform a recoverability test whenever events or changes in circumstances indicate that impairment may have occurred.

Impairment (recoverability) test:

The firm must compare the net book value of the asset (cost – accumulated depreciation) to the sum of the expected undiscounted future cash flows from the asset.

Is this a “conservative” test? It doesn’t appear to be conservative – since the cash flows are undiscounted. But, determining recoverability is difficult and subject to significant estimation error. Thus, having a higher benchmark (undiscounted vs. discounted cash flows) effectively allows a cushion for estimation error. Following is a list of just some of the difficulties with measuring recoverability.

Complications:

How do you know the cash flows from any single asset...like a pizza oven in a restaurant (see the example below)?

Firms are allowed to group assets together for purposes of conducting the recoverability test and recording an impairment loss, if any. The standard requires that the firm group assets at the lowest possible level for which it can identify cash flows independent of the cash flows from other assets and liabilities.

What is meant by “expected” cash flows?

The FASB allows for two possibilities. One is a probability-weighted approach. The firm forecasts possible cash flows and assigns probability weights to the various scenarios. The sum of the probability-weighted cash flows = the expected cash flows. Two is a “best estimate” approach. As the name implies, the firm specifies the most likely amounts of future cash flows from the range of possible outcomes. The sum of those amounts is the expected future cash flows.

Over what period should the cash flows be accumulated: The life of the asset or the useful life of the asset to the entity?

The useful life of the asset to the entity. But what if the “asset” is a group of assets? Answer: Use the estimated useful life of the primary asset in the group.

Accounting for impairment:

If the asset value is impaired according to this test, the firm must reduce the book value of the asset on the balance sheet to its *fair value*. The “fair value” is the number computed according to the new rules on fair value measurement in SFAS 157. Thus, while the recoverability test is done from the perspective of the entity and its expected cash flows from using the asset, the fair value is based on the valuation from the perspective of market participants.

Once the loss has been determined:

Loss

Accumulated depreciation

The new book value of the asset = current market value.

The loss on impairment = net book value before impairment – current fair value.

SFAS 144 prohibits restoration of previous impairments.

KEY: Note that the recoverability test is based on undiscounted cash flows while the accounting is based on fair values or discounted cash flows.

B. Asset Revaluations

The recognition of increases in fixed asset values is generally not permitted under U.S. GAAP. Non-U.S. and IASC standards, however, permit such revaluations. IAS 16, Property, Plant, and Equipment, allows firms to report fixed assets at fair value less accumulated depreciation. Revaluations must be made with sufficient regularity to keep them current. All items in an asset class must be revalued if any are. Revaluation decreases that place the asset value below historical cost must be included in reported earnings.

Example:

Surprise Inc. owns a specialized oven to make pizzas. The oven's cost basis is \$18,000 and accumulated depreciation is \$4,000 at December 31, 2005.

Surprise's best estimate of the expected cash flows generated over each of the next four years (undiscounted) related to its oven are:

2004:	\$2,000
2005:	\$2,500
2006:	\$3,000
2007:	<u>\$3,500</u>
Total	\$11,000

The *fair value* of the oven is \$9,000. Surprise is preparing adjusting entries at December 31, 2005. Prepare the journal entry to record the impairment in value at December 31, 2005, if necessary.

Step 1. Recoverability test

Step 2. Record adjustment

Impairment Loss	5,000	
Accumulated depreciation		5,000

DUKE ENERGY CORPORATION
Notes To Consolidated Financial Statements
For the Years Ended December 31, 2002, 2001 and 2000

1. Summary of Significant Accounting Policies

Impairment of Long-Lived Assets. Duke Energy reviews the recoverability of long-lived and intangible assets, excluding goodwill, when circumstances indicate that the carrying amount of the asset may not be recoverable. This evaluation is based on various analyses, including undiscounted cash flow projections. The carrying amount is not recoverable if it exceeds the undiscounted sum of cash flows expected to result from the use and eventual disposition of the asset. If the carrying value is not recoverable, the impairment loss is measured as the excess of the asset's carrying value over its fair value. (See Note 9 for additional information.)

As of the acquisition date, Duke Energy allocates goodwill to a reporting unit. Duke Energy defines a reporting unit as an operating segment or one level below.

9. Asset Impairments and Other Charges

Duke Energy evaluates its long-lived assets, excluding goodwill, for impairment under SFAS No. 144 (see Note 1). SFAS No. 144 requires long-term assets to be reviewed for impairment whenever events or changes in circumstances indicate the carrying amount of the asset may not be recoverable. In 2002, the merchant energy portion of Duke Energy's business portfolio suffered from oversupply of merchant generation, low commodity pricing and volatility, and a steep decline in trading and marketing activity. These market challenges are continuing in 2003. As a result of the 2002 market conditions, Duke Energy suspended certain projects and abandoned others in this sector. The culmination of these events caused Duke Energy to evaluate the carrying values of certain of its long-lived assets at DENA and International Energy.

This analysis resulted in a \$31 million impairment charge at one of DENA's merchant power facilities. Additionally, charges of approximately \$242 million were also recorded in 2002 to write-off site development costs in California and Brazil and to partially write-down uninstalled turbines, as well as, the termination of other turbines on order. A two-step process was performed in testing the assets for impairment. The impairment loss recorded was equal to the amount by which the carrying value exceeded the fair value of the assets. Fair value was based on prices for similar assets and a discounted cash flow analysis.

In 2002, a decision was made to abandon an information technology system at DENA resulting in the write-off of approximately \$24 million of previously capitalized software and related costs.

During the fourth quarter of 2002, Field Services recorded impairments of approximately \$40 million (\$28 million at Duke Energy's 70% share) related to certain gas plants and gathering systems that have recently generated cash flow losses. Field Services determined that the carrying value of these assets was impaired and, accordingly, wrote them down to their fair value. Fair value was determined based on estimates of sales value and/or cash flow models.

Duke Energy evaluates its goodwill for impairment under SFAS No. 142 (see Note 1). In 2002, Duke Energy recorded a goodwill impairment loss of \$194 million related to International Energy's European trading and marketing business. Significant changes in the European market and recent operating results have adversely affected Duke Energy's outlook for this business unit. The exit of key market participants and a tightening of credit requirements are the primary drivers of this revised outlook. The fair value of the European reporting unit was estimated using the present value of expected future cash flows.

These impairments were recorded as charges to Operating Income in the Consolidated Statements of Income.

VII. Capitalized Interest

Firms are allowed to capitalize (treat as an asset) interest costs associated with financing construction of assets. Thus, instead of treating all interest costs as a period expense on the income statement in the period incurred, the interest cost is put in an *asset* account when incurred and (eventually) depreciated.

What assets qualify for interest capitalization?

Assets under construction for an enterprise's own use (including buildings, plants, and large machinery). Assets that will not be used in earning activities (e.g., excess capacity) do not qualify.

Start capitalizing interest when expenditure for the long-lived asset has been made and interest costs are incurred.

End capitalizing interest when construction is complete.

How much to capitalize?

Avoidable interest: Interest that could have been avoided if the asset had not been acquired. In other words, assume all construction costs are "financed", and calculate the interest on the financed amount. Call this "hypothetical" interest. Capitalize the minimum of the hypothetical interest or actual interest charges for the year. That is, the firm can only capitalize interest costs to the extent it has interest costs. If the firm has no interest costs, it cannot capitalize any.

Hypothetical capitalized interest costs

= "appropriate" interest rate * average amount of accumulated expenditure

where:

- average amount of accumulated expenditure is the average balance of the construction cost account during the year which = (the beginning balance of the construction cost account + the ending balance) / 2.
- appropriate interest rate is
 - the interest rate of a specific construction loan (if the average amount of accumulated expenditure is less than the construction loan), or
 - the interest rate of the construction loan (up to the total amount of the loan), and a weighted average of the interest rates on non-construction debt (for the remainder of the average amount of accumulated expenditure).

Example:

Average accumulated expenditure = 10,000,000

Construction loan = 6,000,000 @ 10%

Other loans = 5,000,000 @ 12% and 4,000,000 @ 9%

Thus, total interest charges for the year = 600,000 + 960,000 = 1,560,000.

Weighted average rate on other loans = 960,000/9,000,000 = 10.67%.

Capitalize: appropriate interest rate * 10,000,000.

For the first 6,000,000 of expenditures use 10%, so hypothetical interest = 600,000.

For the remaining 4,000,000 use 10.67%, so hypothetical interest = 426,800

Total hypothetical interest = 600,000 + 426,800 = 1,026,800 increases the “cost” basis of the firm’s assets.

Interest expense on the income statement will be 1,560,000 - 1,026,800 = 433,200.

VIII. The concept of depreciation

Depreciation is the allocation of the cost of an asset over its period of use. It is not a recognition of a decline in value of the asset. The value of the asset may actually increase over time.

Depreciation is an allocation process, not a valuation process.

Assets are depreciated as their service potential declines. Assets whose service potential does not decline are not depreciated (e.g., land and art). Service potential may decline because of physical factors (e.g., wear and tear) or functional factors (e.g., obsolescence).

Depreciation provides for the return of an asset's cost over its life. Annual depreciation is based on the historical cost of the asset, and not based on the current market value. Thus, in periods of inflation depreciation (based on acquisition cost) will not be sufficient to represent the annual "cost" to replace the firm's productive capacity.

Amortization, depletion, and depreciation are all terms used for the systematic allocation of the capitalized cost of an asset to income over its useful life. The term amortization is generally used for intangibles, depletion for natural resources, and depreciation for other tangible assets.

VIX. Determining the Periodic Depreciation Charge

Depreciable basis of an asset is acquisition cost less salvage value. **Salvage value** is the amount that the firm will receive on disposition of the asset. Salvage value may be a large portion of acquisition cost (e.g., rental cars).

The issue of whether salvage value may be negative usually comes up in class. Under current standards (SFAS 143, adopted in 2001), costs such as expected dismantling costs or restoration costs are recognized as a liability. Previously, firms included such costs in the computation of depreciation by establishing a negative salvage value. Other types of retirement obligations were recognized as a liability over the life of the PPE so that, at the retirement date, the full amount of the obligation was recorded on the firm's balance sheet. The new standard requires that firms record a liability for the fair value of retirement obligations when incurred (dr. PPE, cr. Retirement obligation). The increase in the value of the PPE is depreciated. The liability is at fair value (i.e., the discounted value of future cash flows). The firm will have to make adjustments to the liability through time to reflect the increase in the fair value (present value) of the liability as the balance sheet date approaches the asset's retirement date. This topic is not covered in your book, so I will not cover it in more detail than this here.

Net book value is the acquisition cost of the asset less the accumulated depreciation of the asset. Net book value is only equal to acquisition cost on the date of acquisition.

The depreciable basis is allocated as a "cost" over the useful service life of the asset. The useful service life is based primarily on experience. For tax purposes, companies follow IRS guidelines. Depreciation on the income statement and the tax return are different. The differential treatment of the expense means that the remaining basis of the asset is also different, which means that the gain or loss on sale will be different.

A. Straight Line Depreciation (time)

Annual depreciation expense = (cost – salvage) / estimated useful life in years

B. Production of Use Depreciation (straight line use)

Depreciation expense per unit = (cost – salvage) / estimated number of units

C. Declining Balance

Annual depreciation expense = BV at the beginning of the period x rate

where, BV = cost – accumulated depreciation as of the beginning of the period

The depreciation rate is based on some percent of the straight-line rate, where the straight-line rate is $1/(\text{estimated useful life})$. For example, with the 200% (double) declining balance method, the straight-line rate is multiplied by 200%, or 2.0 resulting in $2/(\text{estimated useful life})$.

Note 1: Firms usually switch to the straight-line method when the depreciation expense under the declining balance method drops below that for the straight-line method and depreciate the asset only down to its salvage value.

Note 2: The salvage value is not deducted when computing the depreciation expense. However, the asset is not depreciated below its salvage value.

D. Sum of the Years' Digits

Annual depreciation expense =

$$\frac{\text{the remaining life, in years, at the beginning of the year}}{\sum \text{number of years in the asset's useful life}} \times (\text{cost} - \text{salvage})$$

The denominator can be computed as $\{N*(N+1)\}/2$ where N = estimated asset's useful life.

E. MACRS (Modified Cost Recovery System)

MACRS is used for tax purposes. It is an accelerated method of depreciation. This method is typically faster than any method used for financial reporting purposes. The greater depreciation charges in the early years of the asset's life reduce the firm's taxable income, thereby reducing the amount of tax owed.

In total, for any given asset, the depreciation expense on the income statement plus (minus) any realized loss (gain) on the income statement at the time of sale = the depreciation charges taken on the tax return plus (minus) any realized loss (gain) reported on the tax return. The difference between the tax return and books is only in the timing. In present value terms, the firm is better

off paying less taxes in the current period and more later, relative to what it would pay if taxes were computed based on book income.

The tax code has long been used by governments to encourage investment, and this was the intent of the U.S. government when it first allowed accelerated depreciation methods for tax purposes in 1954.

F. Comparison of methods

Both the Declining Balance and Sum of the Years' Digits methods are accelerated methods. That is, the depreciable costs of the asset are expensed faster than under straight-line depreciation. Under accelerated methods, more depreciation is recognized in the early years of the asset's life than in the later years.

If a firm is growing and follows an accelerated method, it will have higher depreciation expense in all years. See the following example.

Example:

A firm purchases a machine on January 1, Year 1 for \$6,000. The machine is estimated to have a three year useful life and zero salvage value. Assume that the firm purchases a new machine (with the same cost, useful life and salvage value) every year. Compare the firm's annual depreciation expense under the straight-line and double declining balance depreciation methods.

Annual Straight Line Depreciation = $\$6,000/3 = \$2,000$

Year 1 DDB Depreciation = $\$6,000 * 2/3 = \$4,000$

Year 2 DDB Depreciation = $\$2,000 * 2/3 = \$1,333$

Year 3 DDB Depreciation = $\$667 (= \$6,000 - \$4,000 - \$1,333)$

First the case of no growth:

<u>Year</u>	<u>Machine</u>	<u>Straight Line Depreciation</u>	<u>DDB Depreciation</u>
Year 1	Machine 1 (1st Yr.)	\$2,000	\$4,000
	Total	<u>\$2,000</u>	<u>\$4,000</u>
Year 2	Machine 1 (2nd Yr.)	\$2,000	\$1,333
	Machine 2 (1st Yr.)	\$2,000	\$4,000
	Total	<u>\$4,000</u>	<u>\$5,333</u>
Year 3	Machine 1 (3rd Yr.)	\$2,000	\$667
	Machine 2 (2nd Yr.)	\$2,000	\$1,333
	Machine 3 (1st Yr.)	\$2,000	\$4,000
	Total	<u>\$6,000</u>	<u>\$6,000</u>
Year 4	Machine 1 (4th Yr.)	\$0	\$0
	Machine 2 (3rd Yr.)	\$2,000	\$667
	Machine 3 (2nd Yr.)	\$2,000	\$1,333
	Machine 4 (1st Yr.)	\$2,000	\$4,000
	Total	<u>\$6,000</u>	<u>\$6,000</u>

Now assume Machine 4 costs \$12,000 (inflation) or assume the firm buys two machines in year 4 at \$6,000 each (growth). Then depreciation for Year 4 would be as follows:

Year 4	Machine 1 (4th Yr.)	\$0	\$0
	Machine 2 (3rd Yr.)	\$2,000	\$667
	Machine 3 (2nd Yr.)	\$2,000	\$1,333
	Machine 4 (1st Yr.)	\$4,000	\$8,000
	Total	<u>\$8,000</u>	<u>\$10,000</u>

X. Depletion of Natural Resources

Natural resources (e.g., petroleum, minerals, and timber) are *depleted*, just as fixed assets are depreciated.

Units-of-Production (activity) Method:

$$\text{Depletion expense per unit} = \frac{\text{Depletion base}}{\text{Estimated recoverable units}}$$

Example:

Foster Corporation, a major copper producer, incurred costs of \$2 million in connection with property acquisition, exploration and development of an open-pit copper mine. Foster expects that the property can be sold for \$500,000 after it has depleted the copper and spends \$320,000 to restore the property. The fair value of the restoration obligation is \$300,000. The total estimated recoverable units in the property are 1 million tons of copper ore. Foster Corporation extracts 300,000 tons and sells 200,000 tons during the first year.

For year 1, compute (a) the per unit material cost, (b) Total material cost of End-Year-1 inventory, and (c) Total materials cost in COGS.

XI. Capitalization of Exploration Costs - An Industry-specific example

For oil and gas companies (and firms in extraction industries, in general), there is an important issue related to recording acquisition cost: What do you do with the cost of a project that turns out to be unsuccessful *ex post*. Should the firm consider the cost of unsuccessful drilling to be a part of doing business and allocate all drilling costs (whether successful or not) to its portfolio of oil well assets (i.e., do not expense unsuccessful drilling costs)? Or, should the firm consider an unsuccessful well to be worth zero and immediately expense the cost of drilling it?

Example:

Calaboga Oil paid \$50 million for a large oil field in Alaska. During 2004 Calaboga explored for oil throughout the field. Twenty wells were drilled at a total cost of \$200 million, or \$10 million per well. Nineteen of the wells proved to be unproductive dry holes, while one was found to contain a considerable amount of oil. What is the appropriate carrying amount of the producing well? How much is the depreciation expense in 2004?

Debate

Prior to 1977, firms could use either the full-cost or successful efforts method. In 1977, SFAS No. 19 eliminated the choice and mandated that all companies use successful-efforts accounting.

In 1978, in response to complaints by registrants, the SEC re-examined the issue and found **both** successful efforts and full cost accounting **inadequate** because neither reflects the economic substance of oil and gas exploration. Since 1978, both successful-efforts accounting and full-cost accounting have been allowed.

Hilton Hotels
CONSOLIDATED STATEMENTS OF INCOME
(IN MILLIONS, EXCEPT PER SHARE AMOUNTS)

YEAR ENDED DECEMBER 31,	1997	1998	1999
REVENUE			
Owned hotels	\$1,203	1,485	1,813
Leased hotels	--	--	26
Management and franchise fees	115	104	120
Other fees and income	157	180	191
	1,475	1,769	2,150
EXPENSES			
Owned hotels	820	964	1,196
Leased hotels	--	--	26
Depreciation and amortization	93	125	187
Other operating expenses	103	152	173
Corporate expense, net	64	64	73
	1,080	1,305	1,655
OPERATING INCOME			
Interest and dividend income	17	13	57
Interest expense	(90)	(137)	(237)
Interest expense, net, from unconsolidated affiliates	(8)	(4)	(2)
	314	336	313
INCOME BEFORE TAXES AND MINORITY INTEREST			
Provision for income taxes	(124)	(136)	(130)
Minority interest, net	(7)	(12)	(7)
	183	188	176
INCOME FROM CONTINUING OPERATIONS			
Income from discontinued gaming operations, net of tax provision of \$63 and \$111 in 1997 and 1998, respectively	67	109	--
Cumulative effect of acctg change, net of tax benefit of \$1 in 1999	--	--	(2)
NET INCOME	\$ 250	297	174
BASIC EARNINGS PER SHARE			
Income from continuing operations	\$.68	.71	.66
Discontinued gaming operations	.27	.44	--
Cumulative effect of accounting change	--	--	(.01)
Net income per share	\$.95	1.15	.65
DILUTED EARNINGS PER SHARE			
Income from continuing operations	\$.68	.71	.66
Discontinued gaming operations	.26	.41	--
Cumulative effect of accounting change	--	--	(.01)
Net income per share	\$.94	1.12	.65

See notes to consolidated financial statements.

CONSOLIDATED BALANCE SHEETS
(IN MILLIONS)

DECEMBER 31,	1998	1999
Assets		
CURRENT ASSETS		
Cash and equivalents	\$ 47	104
Accounts receivable, net of allowance of \$12 in 1998 and 1999	204	396
Receivable from discontinued gaming operations	73	--
Inventories	54	90
Deferred income taxes	48	15
Current portion of notes receivable	--	78
Other current assets	43	80
Total current assets	469	763
INVESTMENTS, PROPERTY AND OTHER ASSETS		
Investments and notes receivable	262	676
Long-term receivable	625	625
Property and equipment, net	2,483	3,892
Management and franchise contracts, net	--	647
Leases, net	--	216
Brands, net	--	1,048
Goodwill, net	36	1,277
Other assets	69	109
Total investments, property and other assets	3,475	8,490
TOTAL ASSETS	\$ 3,944	9,253
Liabilities and Stockholders' Equity		
CURRENT LIABILITIES		
Accounts payable and accrued expenses	\$ 410	615
Current maturities of long-term debt	62	9
Income taxes payable	34	5
Total current liabilities	506	629
Long-term debt	3,037	6,085
Deferred income taxes	65	879
Insurance reserves and other	149	245
Total liabilities	3,757	7,838
COMMITMENTS AND CONTINGENCIES		
STOCKHOLDERS' EQUITY		
Common stock, 261 and 368 shares outstanding, respectively	663	946
Additional paid-in capital	--	853
Retained deficit	(347)	(197)
Accumulated other comprehensive income	--	24
	316	1,626
Less treasury stock, at cost	129	211
Total stockholders' equity	187	1,415
TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY	\$ 3,944	9,253

See notes to consolidated financial statements.

CONSOLIDATED STATEMENTS OF CASH FLOW
(IN MILLIONS)

YEAR ENDED DECEMBER 31,	1997	1998	1999
OPERATING ACTIVITIES			
Net income	\$ 250	297	174
Adjustments to reconcile net income to net cash provided by operating activities:			
Income from discontinued gaming operations	(67)	(109)	--
Cumulative effect of accounting change	--	--	2
Depreciation and amortization	93	125	187
Amortization of loan costs	1	2	3
Change in working capital components:			
Inventories	10	(15)	(30)
Accounts receivable	5	(42)	(58)
Other current assets	(5)	(17)	15
Accounts payable and accrued expenses	4	124	16
Income taxes payable	4	25	(29)
Change in deferred income taxes	(63)	9	(5)
Change in other liabilities	(46)	5	4
Unconsol affiliates' distribs in excess of (less than) earnings	6	(17)	(7)
Other	37	3	7
Net cash provided by operating activities	229	390	279
INVESTING ACTIVITIES			
Capital expenditures	(93)	(171)	(254)
Additional investments	(97)	(98)	(102)
Change in temporary investments	25	--	--
Proceeds from asset sales	123	--	--
Payments on notes and other	49	49	78
Acquisitions, net of cash acquired	(67)	(842)	(2,036)
Net cash used in investing activities	(60)	(1,062)	(2,314)
FINANCING ACTIVITIES			
Change in commercial paper borrowings and revolving loans	(1,218)	355	2,264
Long-term borrowings	1,393	400	--
Reduction of long-term debt	(95)	(247)	(64)
Issuance of common stock	38	25	5
Purchase of common stock	(40)	(81)	(90)
Cash dividends	(93)	(90)	(23)
Net cash (used in) provided by financing activities	(15)	362	2,092
Net transfers (to) from discontinued gaming operations	(191)	352	--
(DECREASE) INCREASE IN CASH AND EQUIVALENTS	(37)	42	57
CASH AND EQUIVALENTS AT BEGINNING OF YEAR	42	5	47
CASH AND EQUIVALENTS AT END OF YEAR	\$ 5	47	104

See notes to consolidated financial statements.

PROPERTY AND EQUIPMENT

Property and equipment are stated at cost. Interest incurred during construction of facilities is capitalized and amortized over the life of the asset. Costs of improvements are capitalized. Costs of normal repairs and maintenance are charged to expense as incurred. Upon the sale or retirement of property and equipment, the cost and related accumulated depreciation are removed from the respective accounts, and the resulting gain or loss, if any, is included in income.

Depreciation is provided on a straight-line basis over the estimated useful life of the assets. Leasehold improvements are amortized over the shorter of the asset life or lease term. The service lives of assets are generally 40 years for buildings and eight years for building improvements and furniture and equipment.

PROPERTY AND EQUIPMENT

Property and equipment at December 31, 1998 and 1999 are as follows:

(IN MILLIONS)	1998	1999
Land	\$ 379	590
Buildings and leasehold improvements	2,296	3,256
Furniture and equipment	540	872
Property held for sale or development	37	22
Construction in progress	71	86
	<hr/>	<hr/>
	3,323	4,826
Less accumulated depreciation	840	934
	<hr/>	<hr/>
Total	<u>\$2,483</u>	<u>3,892</u>

LONG-TERM DEBT

Long-term debt at December 31, 1998 and 1999 is as follows:

(IN MILLIONS)	1998	1999
Industrial development revenue bonds at adjustable rates, due 2015	\$ 82	82
Senior notes, with an average rate of 7.7%, due 2001 to 2017	1,117	1,057
Senior notes, with an average rate of 7.2%, due 2002 to 2004	625	625
Mortgage notes, 6.0% to 8.6%, due 2000 to 2016	145	308
5% Convertible subordinated notes due 2006	492	494
Commercial paper	--	19
Revolving loans	635	3,506
Other	3	3
	<hr/>	<hr/>
	3,099	6,094
Less current maturities	62	9
	<hr/>	<hr/>
Net long-term debt	<u>\$3,037</u>	<u>6,085</u>

Interest paid, net of amounts capitalized, was \$74 million, \$130 million and \$187 million in 1997, 1998 and 1999, respectively. Capitalized interest amounted to \$2 million, \$4 million and \$7 million in 1997, 1998 and 1999, respectively.