

Does it Worth Capitalizing?

I.P.D. Chathuri & P.M.C. Thilakarathne
deshani.chathuri@gmail.com & lal@kln.ac.lk

Introduction

ABC Active (Pvt) LTD is a separate legal entity under Active cluster of ABC (Pvt) LTD. ABC (Pvt) LTD is a \$1.2 bn conglomerate and is positioned as one of the world's most recognized Design-to-Delivery Solution Providers in the realm of Apparel and Textile Manufacturing. Being one of the largest production plants in Sri Lanka, ABC Active (Pvt) LTD owns 03 plants of production comprised with Knitting, Dyeing & Sewing production floors.

ABC Active involves high technical knitting machines for their vibrant production process. Discrepancy identified here is that management recognizes total expense in the quotation as cost of a knitting machine although the payment of the asset is based on a deferred scheme.

Discussion of the Issue

ABC Active (Pvt) LTD owns a knitting machine which was acquired through a deferred payment. Typically, a knitting machine takes a substantial period of one month to get ready for its intended use. This period of one month involves assembling of the knitting machine up-to a usable condition. Thus during the first month of the acquisition pre-mentioned knitting machine becomes a qualifying asset.

Accounting treatment for the acquisition of the knitting machine according to ABC Active (Pvt) LTD is to capitalize the total of quotation price & recognize it as the cost of the knitting machine in SOFP. This may not be in compliance with LKAS 23 as elaborated below in paragraph 01 of the latter.

"An entity shall capitalize the borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset as part of the cost of the asset. An entity shall recognize other borrowing cost as an expense in the period in which it incurs them"

Implication of the Issue

Consequently, when ABC Active (Pvt) LTD capitalizes the total of quotation price as the cost which includes the interest portion of the deferred payment, this will violate the adherence to the Accounting Standard LKAS 23. It will lead to descent the reliability and relevance of the financial statements.

Conclusion & Recommendation

Since this knitting machine becomes a qualifying asset during the 1st month of the acquisition, relevant interest charge for that month need to be capitalized according to LKAS 23. This relevant interest charge is worth capitalizing since it represents significantly material amount from the cost of the knitting machine. From the quotation price, interest charge should be excluded & remained actual cost need to be capitalized as the cost in SOFP. Consequently, relevant interest expense for the year need to be charged to the Income Statement.