BDO

MAY 2012
www.bdo.com.au

ACCOUNTING NEWS

TEN WAYS TO MATERIALLY MISSTATE YOUR FINANCIAL STATEMENTS... The 'Blind Freddy' proposition continued - Part 7 – Capitalising items that fail the definition of an asset

A very simple and obvious way to materially misstate a set of financial statements is to capitalise expenditure as an asset which is required to be expensed under IFRS.

In this month's 'Blind Freddy' article we consider the key principles in determining whether expenditure qualifies for recognition as an asset.

Definition of an asset

'An asset is a resource:

a. Controlled by an entity as a result of past events
b. From which future economic benefits are expected to flow to the entity.'

It is imperative preparers and auditors understand the definition of an asset and the pitfalls in applying this definition.

Common mistakes in recognising an asset include:

- Capitalising marketing costs
- Capitalising research costs
- Capitalising operating losses/start up costs
- Capitalising items that you do not control
- Capitalising items that cannot be distinguished from costs of running the business
- Capitalising development costs if access to funds is not available
- Misunderstanding capitalisation of assets as it applies to assets acquired in business combinations vs. capitalisation of 'assets' developed in house
- Capitalising costs when a project is stalled/'mothballed'
- Capitalising acquisition costs of assets recognised at fair value
- Reversing decisions to previously expense development expenditure
- Capitalising non-eligible IPO costs.

The rules of capitalising assets are contained in AASB 102, AASB 111, AASB 116, and AASB 138. Many of the recognition rules are common across these standards, i.e. prohibition of capitalising marketing costs.

IN THIS EDITION

P1 Ten ways to materially misstate your financial statements...The 'Blind Freddy' proposition continued - Part 7 - Capitalising items that fail the definition of an asset

P3 IASB issues annual improvements Exposure Draft (2010-2012 cycle)

P4 No more non-reporting entities?

P5 MRRT update

P5 National Co-operatives law in the pipeline

P5 No reduction to company tax rate

P6 Carry back of tax losses may mean more tax assets

P7 Comments sought on exposure drafts

In this month's newsletter, we continue our 'Blind Freddy' series looking at common mistakes accountants make in capitalising items that do not meet the definition of an asset. We also look at the IASB's latest annual improvements proposals and a status update on differential reporting and the MRRT. The recent Federal Budget has introduced some measures which have accounting implications and last, but not least, we highlight the impacts of the proposed National Co-operatives law.

Capitalising marketing costs
A business spends billions on marketing and advertising. This spend is intended to build brands, develop customers and to sell specific assets or services. All of this spend is done with the intention that 'economic benefits' will flow to the entity.

AASB 102 and 111 specifically prohibit capitalising selling costs, whilst AASB 138 prohibits capitalising such costs as they cannot be distinguished from the general costs of running a business.

Example: Selling residential condominiums
In selling assets such as residential condominiums, it is likely that marketing expenditure will be incurred well in advance of recognising revenue. In the case of residential condominiums, effort to sell units off the plan usually involves newspaper and TV advertising, on site sales staff etc. Revenue will then not be recognised until legal title passes, usually years after the advertising activity. This advertising must be expensed when incurred and cannot be capitalised into WIP.

Example: Launch of a new resort/hotel
A similar issue arises when a new resort or hotel is launched. In order to attract the first visitors, extensive marketing spend is usually required well in advance of the hotel/resort opening for operation. This spend cannot be capitalised. Similarly, it is usual for resorts to be deliberately launched at below optimum operating levels to allow staff training and trial of equipment, systems and processes. IFRS prohibits capitalising these operating losses (see below).

Capitalising research costs
A key principal to be applied across AASB 102, 111, 116 and 138 is that research activities must be expensed. This includes researching how to satisfy a particular contract (unless expressly reimbursed for it) or researching the design of a new piece of equipment or the layout of a new building.

Capitalising operating losses/start up costs
Perhaps the most notorious example of capitalising losses as part of developing an asset was WorldCom, whereby the losses associated with running a network were capitalised. In many instances, for example, the launch of a new resort/hotel referred to above, assets run at only part capacity during the initial start up phase. This can arise deliberately to enable commissioning/testing of the new facility as a result of other components of the network being complete, or simply because it takes time to build up demand. No matter the reason, these start up costs must be expensed.

Capitalising items that you do not control
A key element of the definition of an asset is that the resource must be controlled. This prevents capitalising costs associated with building and up-skilling a work force (recruitment and training). It also prevents capitalising internally generated customer relationships or customer lists.

Capitalising items that cannot be distinguished from costs of running the business
Mastheads and brand names are commonly held out as the key examples of items that cannot be revalued because there is no active, homogeneous market available to determine valuation. However, it is often overlooked that these assets are also examples of assets that cannot be capitalised if they are generated internally because the spend on them cannot be distinguished from the spend on developing the overall business.

Capitalising development costs if access to funds is not available
Paragraph 57(e) of AASB 138 requires development costs to be capitalised only if there are adequate technical, financial and other resources available to complete the development.

If an item fails the recognition criteria on the grounds of having inadequate funding, but subsequently manages to secure funding, previously expensed development expenditure CANNOT be capitalised.

Misunderstanding capitalisation of assets as it applies to assets acquired in business combinations vs. capitalisation of 'assets' developed in house
Another common area of misunderstanding in applying the recognition criteria to internally generated assets is to wrongly apply the same tests to all assets, regardless of whether they are acquired by way of a business combination, separate acquisition or generated internally.

Intangible assets that can be acquired in a business combination include in-process R&D, customer lists, brands, mastheads etc. For the reasons stated previously, particularly in respect of being able to distinguish expenditure on these items from expenditure on the business as a whole, these items cannot be capitalised if generated internally.

Capitalising costs when a project is stalled/'mothballed'
A key principle for determining if expenditure can be capitalised is whether that expenditure adds value to the asset. Thus the costs of warehousing an asset cannot be capitalised. Similarly, interest cannot be capitalised when a project is 'mothballed' or delayed.

Capitalising acquisition costs of assets recognised at fair value
Another common mistake is to capitalise acquisition costs on assets to be measured at fair value. This is of particular relevance when acquiring investment property to be held at fair value under AASB 140 and any assets acquired in a business combination under AASB 3.

Reversing decisions to previously expense development expenditure
Determining whether a project will be commercially viable is a key recognition test within AASB 138. If a project becomes commercially viable, previous expensed spend cannot be capitalised. The test to capitalising expenditure is at a point in time.

Capitalising non-eligible IPO costs
Under AASB 132, the costs of raising equity can be 'capitalised' against the equity raised. There are two common mistakes that can be made, namely: (i) failing to split costs between existing shares and new shares; and (ii) capitalising ineligible expenditure that would have been incurred, regardless of the capital raise.

Example 1:
Company X lists on the ASX. It has 10,000,000 shares on issue at the time of the listing and raises 10,000,000 additional shares as part of the IPO. Costs of obtaining a listing are $500k. Only 50% of this listing expense can be offset against equity. The other $250k benefits existing shares and should be expensed.

Example 2:
Biotech Pty Ltd plans to go IPO in 12 months time. As part of this process, it appoints a very experienced CEO on a salary of $500k per year. His prime responsibility is to oversee the IPO, attend investor meetings etc. This expenditure cannot be offset against the equity raised. The entity had to employ a CEO, regardless of the IPO.

In next month's Blind Freddy article we will consider failing to recognise a reverse acquisition or fresh start accounting.