AFA 100: Expense vs Capitalization of Costs

Long-lived/term assets refers to property, plant, equipment, intangible assets held for production, as well as development, construction and maintenance or repair of other assets.

Under IFRS, the cost of property, plant, and equipment shall be recognised as an asset if, and only if the following conditions are met:

1. It is probable that the entity will benefit from the future economic benefits of the asset.
2. The cost of the item can be measured reliably.

This IFRS standard requires that entities must evaluate the costs incurred in acquiring a long-lived asset, placing it in an operational setting, and preparing it for use. If these costs meet the conditions mentioned above, they should be recorded in the designed asset account. This practice is called **capitalization.** If the conditions are not met, the cost will be expensed.

The tip to remember this is mentioned below:

If considered **repairs and maintenance** (after acquisition), then costs are expensed. Some characteristics are:

- Maintains normal operating condition of asset
- Does not increase productivity
- Does not extend useful life
- Recurring in nature

If considered **betterment of asset**, capitalize it. Some characteristics are:

- Major overhauls or partial replacement
- Usually occur infrequently
- Increases efficiency
- May extend useful life
- Involves large amounts of money

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Understanding the Impact of Each Method

Example 1

*You purchased a truck worth $5,000 to complete your deliveries for your restaurant. The journal entry you would record for the **purchase of the truck** would be:*

Dr. PPE (Truck) $5,000

Cr. Cash $5,000

2 years later, you realize there's an issue with the engine because of which your truck will only last another 2 months. However, you have an option to purchase a new engine worth $1,500. This would increase the useful life of your truck and you can use it for another 10 years. You decide to purchase the engine.

*The journal entry you would record for the **purchase of the engine** would be:*

Dr. PPE (Truck) $1,500

Cr. Cash $1,500

The purchase of the engine increases the useful life of the truck and would bring economic benefit to you. Therefore, this cost will be capitalized and the amount is debited to the asset account. Now, your asset account is worth $6,500 ($5,000 initial purchase + $1,500 engine purchase).

When you capitalize a cost, this decreases expenses and increases net earnings.

Example 2

Let's take a look at the same example again but with a few changes.

*You purchased a truck worth $5,000 to complete your deliveries for your restaurant. The journal entry you would record for the **purchase of the truck** would be:*

Dr. PPE (Truck) $5,000

Cr. Cash $5,000

6 months later, you see someone driving a similar truck as yours but it is painted red, while yours is black. You feel you are tired of the black truck and you want to switch things around. So, you decide to paint your truck red for $70.

The journal entry you would record for the ***paint job*** *would be:*

Dr. Repairs and Maintenance Expense $70
        Cr. Cash $70

The paint job does not bring any economic benefit to you in the future nor does it increase the useful life of your truck. Therefore, this cost will be expensed and is debited to an expense account. Your asset account is still $5,000 that you initially purchased it for. However, your expense account increased by $70.

When you expense a cost, this increases expenses and decreases net earnings.