Accounting for Software Development Cost

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Introduction

MDK Distributors (Pvt) Ltd is a limited liability company incorporated and domiciled in Sri Lanka under the Company Act No 07 of 2007. The principal activity of the company distributing biscuits (in wholesale) whole over the province. They aimed to lead the industry by utilizing software to collect orders from customers and management of the MDK Distributors (Pvt) Ltd decided to install tailor made software. Therefore, they gave contract to leading software development company in Sri Lanka to made stand-alone computer software. MDK Distributors (Pvt) Ltd incurred Rs.2 MN cost to develop and install the software. After installation process, MDK Distributors (Pvt) Ltd identified some error relating to the software and gave contract to redevelop the software to the same company. MDK distributors prepared annual financial statements on March, each year. The software development company was unable to furnished redevelopment process at the financial year end and according to their judgment they should have to incur some cost to redevelopment process.

Discussion of the Issue

After the financial year ended 2017, when preparing financial statements, the company has recorded the cost of Rs.2mn as an intangible asset.

According to the section 18 of SLFRS for SMEs, the entity shall recognize an intangible asset as an asset if and only if,

- It is probable that the expected future economic benefits that are attributable to the asset will flow to the enterprise; and
- The cost or value of the asset can be measured reliably.

In this case, by installing this software to the organization, it will get more benefits such as increase their sales, save time etc. Therefore it’s clear that the future economic benefit will flow to the entity and that will exist over the useful life of the assets. But cost or value can’t be measured reliably. Because after redevelopment process, the software development company will probably charge some cost. As well MDK Distributors should have to incur some cost of testing whether the software is functioning properly, and also should have incur
some installation cost. In this case even though the company has future economic benefits, this cost of Rs.2mn can't be treated as an intangible asset at the end of the financial year according to the standard. Therefore, it is required to identify this Rs.2mn as an advance payment.

**Implication**

The impact of this issue to the statement of comprehensive income and the statement of financial position are as follows;

a) Value of assets are overstated and advanced payment amount is included in the intangible assets. That presentation of statement of financial position gives wrong information to stakeholders from the Statement of financial position.

b) If company identifies this payment as an intangible asset, company should amortize this asset in current financial year (It’s not yet amortized). It lead to reduce profit of the company. That is affecting directly to the equity of the shareholders and to the tax portion of the company.

**Conclusion and Recommendation**

When analyzing this case, it was identified that the requirements of recognition of intangible assets have not been satisfied (section 18 of SLFRS for SMEs). Therefore recognizing this cash deposit as an intangible asset of the company is incorrect. Therefore company should consider this cash payment as an advanced payment until the completion of installation process.

*Following journal entries has to be passed by the company;*

<table>
<thead>
<tr>
<th>Account</th>
<th>Dr</th>
<th>Cr</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Advance payment account</td>
<td>2,000,000</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Intangible assets</td>
<td></td>
<td>2,000,000</td>
<td></td>
</tr>
</tbody>
</table>

MDK Distributors (Pvt) Ltd should disclose the amount of Rs.2mn as acquisition of intangible asset in the financial statements at the end of 2016/2017 financial year.