Selig Sporting Goods Inc. has been experiencing growth in the demand for its products over the last several years. The last two Olympic Games greatly increased the popularity of basketball around the world. As a result, a European sports retailing consortium entered in to an agreement with Selig’s Roundball Division to purchase basketballs and other accessories on an increasing basis over the next 5 years.

To be able to meet the quantity commitments of this agreement, Selig had to obtain additional manufacturing capacity. A real estate firm located an available factory in close proximity to Selig’s Roundball manufacturing facility, and Selig agreed to purchase the factory and used machinery from Starks Athletic Equipment Company on October 1, 2005. Renovations were necessary to convert the factory for Selig’s manufacturing use.

The terms of the agreement required Selig to pay $50,000 when renovations started on January 1, 2006, with the balance to be paid as renovations were completed. The overall purchase price for the factory and machinery was $ 400,000. The building renovations were contracted to Malone Construction at $100,000. The Payments made, as renovations progressed during 2006, are shown below. The factory was placed in service on January 1, 2007.

 1/1 4/1 10/1 12/31

Starks 50,000 100,000 100,000 150,000

Malone 30,000 30,000 40,000

On January 1, 2006, Selig secured a $500,000 line-of-credit with a 12% interest rate to finance the purchase cost of the factory and machinery, and the renovation costs. Selig drew down on the line-of-credit to meet the payment schedule shown above; this was Selig’s only outstanding loan during 2006.

Rob Stewart, Selig’s Controller, will capitalize the maximum allowable interest costs for this project. Selig’s policy regarding purchases of this nature is to use the appraisal value of the land for book purposes and prorate the balance of this purchase price over the remaining items. The building had originally cost Starks $300,000 and had a net book value of $ 50,000, while the machinery originally cost $125,000 and had a net book value $40,000 on the date of sale. The land was recorded on Starks books at $40,000. An appraisal, conducted by independent appraisers at the time of acquisition, valued the land at $280,000, the building at $105,000, and machinery at $45,000.

Linda Safford, Chief Engineer, estimated that the renovated plant would be used for 15 years, with an estimated salvage value of $30,000. Safford estimated that the productive machinery would have a remaining useful life of 5 years and a salvage value of $3,000. Selig’s depreciation policy specifies the 200% declining balance method for machinery and 150% declining-balance method for the plant. One half years depreciation is taken in the year the plant is placed in service and one half year is allowed when the property is disposed of or retired. Selig uses 360-day year for calculating interest costs.

Instructions;

1. Determine the amounts to be recorded on the books of Selig Sporting Goods Inc. as of December 31, 2006, for each of the following properties acquired from Starks Athletic Equipment Company. (1) Land. (2) Buildings. (3) Machinery.
2. Calculate Selig Sporting Goods Inc.’s 2007 depreciation expense, for book purposes, for each of the properties acquired from Starks Athletic Equipment Company.
3. Discuss the arguments for and against the Capitalization of interest’s costs.