UNIT 13 CAPITAL AND REVENUE

Structure

13.0 OBJECTIVES

After studying this unit you should be able to:

- explain the importance of distinction between capital and revenue
- distinguish between capital and revenue expenditure
- describe the circumstances under which a revenue expenditure is to be capitalised
- distinguish between capital receipt and revenue receipt, capital profit and capital loss
- identify correctly whether an item is of a capital or revenue nature

13.1 INTRODUCTION

In the preceding unit you learnt about the basic concepts followed in determining profit or loss and the financial position of a business. In this connection, it is equally necessary to understand the distinction between capital and revenue. Without such clarity you cannot ascertain the correct amount of profit or loss made during an accounting period. In this unit you will learn about the need for such distinction and study how to decide whether a particular expenditure or a receipt is of capital nature or of revenue nature.

13.2 NEED FOR DISTINCTION BETWEEN CAPITAL AND REVENUE

You know that the purpose of maintaining a detailed and systematic record of business transactions is two-fold i.e.,

i) to ascertain the net result of the trading activity for an accounting year, and

ii) to ascertain the financial position of the business as at the end of the accounting year.

Hence, we prepare an income statement called Profit and Loss Account for ascertaining the net result, and a position statement called Balance Sheet for determining the financial position. The Profit and Loss Account and Balance Sheet together are called Final Accounts. You also know that before preparing the final accounts, we prepare another statement called Trial Balance in order to check the arithmetical accuracy of the books of account. The Trial Balance also forms the basis for the preparation of the Final Accounts. All items appearing in the Trial Balance are transferred either to the Profit and Loss Account or to the Balance

Sheet. As per rules, items of revenue nature are shown in the Profit and Loss Account and items of capital nature in the Balance Sheet. In other words, whether an item will appear in Profit and Loss Account or in the Balance Sheet depends upon the revenue and capital nature of the item.

If any item is wrongly classified i.e., if any item of revenue nature is treated as a capital item or vice versa, the ascertainment of profit will be incorrect. For example, the revenues earned during an accounting year are Rs. 1,00,000 and the costs shown are Rs. 80,000. The profit will work out as Rs. 20,000. On rechecking you found that a revenue item of Rs. 5,000 (an expenditure on repairs of machinery) had been treated as a capital item (added to cost of machinery) and hence not included. It means the actual costs are Rs. 85,000 and not 80,000. So the correct profit is Rs. 15,000. In other words, the profit worked out earlier was overstated. Thus, it can also be stated that if any capital expenditure is wrongly classified as revenue expenditure, it would result in an understatement of profits. Let us also illustrate this. Assume that a purchase of furniture worth Rs. 10,000 was wrongly passed through the Purchases Book treating it as purchases of goods on credit. This would result in the boosting of costs by Rs. 10,000 leading to an understatement of profits by Rs. 10,000 and also to an understatement of assets. As such the final accounts will not reflect the true and fair view of the affairs of the business.

Thus you learn that wrong classification of items would lead to the wrong ascertainment of profit and also the financial position. Hence, it is necessary to determine correctly whether an item is of a capital or of a revenue nature. This distinction is also important from taxation point of view because capital profits are taxed differently from revenue profits.

13.3 CAPITAL AND REVENUE EXPENDITURES

You incur expenditure on various items every day. You buy food items, stationery, cosmetics, utensils, furniture, etc. Some of them are consumables and some are durables. The benefit of expenditure on consumables like stationery, cosmetics, etc. is derived over a short period. But in case of durables like furniture, utensils, etc., the benefit spreads over a number of years. Same thing is true of business also. In business you incur expenditure on two types of items: (i) routine items like stationery, postage, repairs, salaries, etc., where the benefit is available for a short period, and (ii) fixed assets like machinery, building, furniture, etc., whose benefit is available over a number of years. In accounting terminology the first category of expenditure is called revenue expenditure and the second one is called capital expenditure.

Let us now study the exact nature of capital and revenue expenditures.

13.3.1 Capital Expenditure

As stated above, when the benefit of an expenditure is not exhausted in the year in which it is incurred but is available over a number of years it is considered as capital expenditure. The following expenditures are usually treated as capital expenditures.

1 Any expenditure which results in the acquisition of fixed assets such as land, buildings, plant and machinery, furniture and fixtures, office equipment, copyright, etc. You should note that such capital expenditure includes not only the purchase price of the fixed asset but also various other expenses incurred in connection with their acquisition. So brokerage or commission paid in connection with the acquisition of an asset, freight and cartage paid for transportation of machinery, expenses incurred on its installation, legal fees and registration charges incurred in connection with purchase of land and buildings are also treated as capital expenditure.

2 Any expenditure incurred on a fixed asset which results in (a) its expansion, (b) substantial increase in its life, and (c) improvement in its revenue earning capacity. Improvement in the revenue earning capacity can be in the form of (i) increased production capacity, or (ii) reduced cost of production, or (iii) increased sales of the firm. Thus, cost of making additions to buildings and the amount spent on renovation of the old machinery are also regarded as capital expenditures. Sometimes, you buy a second hand machinery and incur heavy expenditure on reconditioning it. Such expenditure is also to be capitalised. Similarly, expenditure on structural improvements or alterations to existing fixed assets whereby their revenue earning capacity is increased, is also treated as capital expenditure.

3 Expenditure incurred, during the early years, on development of mines and land for plantations till they become operational.

4 Cost of experiments which ultimately result in the acquisition of a patent. However, the cost of experiments which are not successful is treated as a deferred revenue expenditure which is written off within two to three years.

5 Legal charges incurred in connection with acquiring or defending suits for protecting fixed assets, rights, etc.

13.3.2 Revenue Expenditure

When the benefit of an expenditure is not likely to be available for more than one year, it is treated as revenue expenditure. Thus all expenses which are incurred during the regular course of business are regarded as revenue expenditures. These may be as follows:

1 Expenses incurred in day-to-day conduct of the business such as wages, salaries, rent, postage, stationery, insurance, electricity, etc.

2 Expenditure incurred for buying goods for resale or raw materials for manufacturing.

3 Expenditure incurred for maintaining the fixed assets such as repairs and renewals of building, machinery, etc.

4 Depreciation on fixed assets. This can also be termed as revenue loss.

5 Interest on loans borrowed for running the business. You should note that any interest on loan paid during the initial period before production commences, is not treated as revenue expenditure. It is treated as capital expenditure.

6 Legal charges incurred during the regular course of business such as legal expenses incurred on collection from debtors, legal charges incurred on defending a suit for damages, etc.

13.3.3 Deferred Revenue Expenditure

Sometimes, certain expenditure which is normally treated as revenue may be unusually heavy. Its benefit is likely to be available in more than one year. It is considered appropriate to spread the cost of such expenditure over a number of accounting years. Hence, it is capitalised and only a portion of the total amount spent is charged to the Profit and Loss Account for the current year. The balance is shown as an asset which will be written off during the subsequent accounting years. Such expenditure is called a Deferred Revenue Expenditure because the charge to Profit and Loss Account is deferred to future years. Some examples of such expenditure are:

1 Expenditure incurred on advertising campaign to introduce a new product in the market.

2 Expenditure incurred on formation of a new company (preliminary expenses).

3 Brokerage charges, underwriting commission paid and other expenses incurred in connection with the issue of shares and debentures.

4 Cost of shifting the plant and machinery to a new site which may involve dismantling, removing and re-erection of the plant and machinery.

Let us take the case of expenditure on advertising campaign. It is not a routine advertisement and the amount involved is unusually heavy. Its benefit will not completely exhaust in one accounting year but will continue over two-three years. Hence, it is not proper to charge such expenditure to the Profit and Loss Account of one year. It is better to distribute it carefully over three years. So, in the first year we can charge one-third of the amount spent to the Profit and Loss Account and show the balance in the Balance Sheet as an asset. In the second year again we can charge a similar amount to the Profit and Loss Account and show the balance as an asset. In the third year, we may charge this balance to the Profit and Loss Account. Every expenditure which is regarded as deferred revenue is treated in this way in the final accounts.

Illustration 1

State whether the following items of expenditure would be treated as (a) capital expenditure or (b) revenue expenditure or (c) deferred revenue expenditure:

i) Carriage paid on goods purchased Rs. 25

ii) Rs. 2,000 spent on repairs of machinery

iii) Rs. 5,000 spent on white washing

iv) Rs. 8,000 paid for import duty and cartage on the purchase of machinery from West Germany

v) Rs. 25,000 spent on issue of equity shares

vi) Rs. 14,000 spent on spreading new tiles on factory floor

vii) Rs. 4,000 paid as brokerage in connection with the purchase of land

viii) Rs. 60,000 spent on construction of railway siding

ix) Rs. 1,55,000 spent on uniforms to staff

x) A second hand machine was bought for Rs. 10,000 and an amount of Rs. 6,000 was spent on its overhauling.

Solution

i) It is a revenue expenditure as it is related to the goods purchased for resale.

ii) It is a revenue expenditure as it relates to the maintenance of a fixed asset.

iii) Same as no. (ii)

iv) It is a capital expenditure as it is spent in connection with the purchase of a fixed asset.

v) It would be treated as deferred revenue expenditure. It is a heavy amount incurred in connection with raising of capital for the company and so capitalised. Even under the Indian Companies Act and the Indian Income Tax Act this expenditure is allowed to be written off over a number of years.

vi) It is a revenue expenditure as it is treated as a sort of repairs not leading to any increase in the earning capacity of a fixed asset.

vii) It is a capital expenditure as it is incurred in connection with the purchase of land.

viii) It is a capital expenditure as it is incurred on the construction of railway siding, a fixed asset.

ix) It is a revenue expenditure. But, if the uniforms are meant for use over two or more years (woollen uniform) this expenditure can be treated as deferred revenue.

x) It is a capital expenditure as it is incurred on making the newly bought second hand machinery operational.

Check Your Progress — A

1 Choose one of the alternatives given within brackets and fill in the blanks.

i) Proper allocation of expenditure between capital and revenue is necessary for ascertainment of .... (Profit or Loss/Cash in hand)

ii) All items of revenue nature are shown in the .... (Profit and Loss Account/Balance Sheet)

iii) If revenue expenditure is treated as a capital expenditure, it will result in .... of profits. (overstatement/understatement)

iv) Any expenditure where the benefit is spread over a number of years is .... expenditure. (capital/revenue)

v) When a revenue expenditure is capitalised, it is called .... expenditure. (capital/deferred revenue)

vi) Any expenditure incurred in acquiring a right like goodwill or patent is treated as .... expenditure. (capital/revenue)

2 State whether the following statements are True or False.

	True	False
i) Every expenditure of large amount is a capital expenditure.	☐	☐
ii) An expenditure incurred on acquisition of a fixed asset is a capital expenditure.	☐	☐
iii) Cartage paid on the new machine is a revenue expenditure.	☐	☐

iv) Depreciation on fixed assets is a capital expenditure. ☐ ☐

v) Cost of goods purchased for resale is a revenue expenditure. ☐ ☐

vi) Heavy expenditure on advertising campaign is a deferred revenue expenditure. ☐ ☐

vii) Deferred revenue expenditure is essentially an expenditure of capital nature. ☐ ☐

viii) Expenditure incurred as preliminary expenses is a capital expenditure. ☐ ☐

13.4 CAPITAL AND REVENUE RECEIPTS

Receipts refer to amounts received by a business i.e., cash inflows. Receipts may be classified as Capital Receipts and Revenue Receipts. It is necessary to note this distinction clearly because only the revenue receipts are taken to the Profit and Loss Account and not the capital receipts.

13.4.1 Capital Receipts

Capital receipts are the amounts received in the form of (a) additional capital introduced in the business, (b) loans received, and (c) sale proceeds of fixed assets. You are aware that a loan taken by the business is repayable sooner or later. Similarly, additional capital received represents an increase in the proprietor's claim over the business assets. Thus these two items represent increase in liabilities of the business and obviously are not incomes or revenues. These are capital receipts and should be treated as such. The sale proceeds of a fixed asset are also treated as a capital receipt because the amount received is not revenue earned in the normal course of business. The capital receipts increase the liabilities or reduce the assets. They do not affect the profit or loss.

13.4.2 Revenue Receipts

Revenue receipts are the amounts received in the normal and regular course of business. They take the form of (a) sale proceeds of goods, and (b) incomes such as interest earned, commission earned, rent received, etc. These receipts are on account of goods sold or some services rendered by the business and as such they are not repayable. All revenue receipts are treated as incomes and shown on the credit side of the Profit and Loss Account.

13.5 CAPITAL AND REVENUE PROFITS

Revenue profits are those profits that are earned in the normal and ordinary course of business i.e., through regular sales of goods or by way of income from investments. Capital profits, on the other hand, are those profits which are not earned in the course of regular trading. Such profits arise as a result of (i) selling some fixed assets at a profit or (ii) shares issued at a premium. The revenue profits are credited to Profit and Loss Account whereas the capital profits are transferred to capital reserve and shown in the Balance Sheet.

13.6 CAPITAL AND REVENUE LOSSES

Revenue losses are those losses that arise during the normal course of business. The capital losses are losses which arise on account of the sale of some fixed assets or on issue of shares at a discount. Capital losses are not shown in the Profit and Loss Account. They are generally set off against capital profits. However, if the amount of capital loss is heavy and capital profits are not available for writing it off, the same is spread over a number of years. It will be written off in instalments.

The purpose of this discussion is to highlight the importance of the distinction between capital and revenue items. Note that all revenue items are taken to the Profit and Loss

Account to determine the trading result while the capital items are shown in the Balance Sheet to assess the financial position of the business.

Check Your Progress — B

State whether the following statements are True or False.

	True	False
i) Expenditure is not the same thing as payment.	☐	☐
ii) Capital receipts are the amounts received in the normal course of the business.	☐	☐
iii) Capital profit is shown in the Profit and Loss Account.	☐	☐
iv) Capital receipt is different from capital income.	☐	☐
v) Revenue expenditure and revenue loss mean one and the same thing.	☐	☐
vi) Depreciation on fixed assets is an example of revenue loss.	☐	☐
vii) Money received from the sale of goods is a capital receipt.	☐	☐
viii) Money obtained by the issue of debentures is a capital receipt.	☐	☐

13.7 SOME PECULIAR ITEMS

The following items of expenditure need a special mention and a bit of clarification.

Replacement of an Old Asset

Quite often we sell an old asset and replace it by a new one involving heavy expenditure. For example, an old machine which originally cost Rs. 90,000 is replaced by a new and modern one costing Rs. 2,00,000. The old machine is sold for Rs. 15,000. The replacement cost thus amounts to Rs. 1,85,000. Now the question arises as to how much of this amount should be charged as capital expenditure and how much as revenue. For this purpose, you must know that the replacement involves two aspects: (a) cost of the new machine, and (b) loss on the sale of old machine. In this case the cost of the new machine is Rs. 2,00,000. This will be treated as capital expenditure because it results in the acquisition of a fixed asset. As for the loss on the sale of old machine, you have to first find out the depreciated value (book value) of the old machine. Assuming it to be Rs. 25,000, the loss on the sale of old machine works out to Rs. 10,000 (book value Rs. 25,000 — sale value Rs. 15,000). This will be treated as revenue loss and charged to Profit and Loss Account. However, if such loss is too heavy an amount, it can be treated as deferred revenue.

Let us take another case. An old machine which originally cost Rs. 90,000 is sold for Rs. 1,00,000 and replaced by a new machine costing Rs. 2,00,000. The book value of the old machine is Rs. 60,000. In this case, there is a profit of Rs. 40,000 (sale value Rs. 1,00,000 – book value Rs. 60,000). Will the whole amount of Rs. 40,000 be treated as revenue profit? No, the revenue profit in this case is only Rs. 30,000. Whatever amount is realised over and above the original cost is, as per rules, a capital profit. Thus we can say that (a) Rs. 2,00,000, being the cost of the new machine is a capital expenditure, (b) Rs. 30,000 is a revenue profit, and (c) Rs.10,000 is a capital profit.

Structural Alterations

Sometimes, a few alterations are made to a building involving heavy expenditure. To decide whether it is a capital expenditure or a revenue expenditure, we have to find out the nature and purpose of the alteration made. For instance, where structural alterations are made to a building just to satisfy the local by-laws (e.g., additional emergency exits in a cinema hall) and they do not in any way add to the revenue earning capacity of that building, the expenditure involved is treated as a revenue expenditure. Similarly, where alterations are made to an existing fixed asset so as to put it in proper condition (e.g., reinforcement of roofing to prevent leakage of rain water), the cost incurred should be treated as revenue expenditure. But where alterations are made on a building with a view to get more rent, such cost can be capitalised. For example, if a cinema hall or a restaurant is renovated whereby it becomes more attractive resulting in more customers, the expenditure involved will be treated as capital expenditure.

Sometimes, repairs to a machine or a building may not be of a routine type and the amount involved is heavy. In that case it may be treated as a deferred revenue item and thus written off over a period of two to three years.

Cost of Shifting to New Premises

Sometimes, the factory may be shifted to a more convenient location. This will involve dismantling the plant and machinery moving them to the new premises and re-erecting them. The expenditure so incurred does not result in the acquisition of any new asset and as such should be treated as revenue expenditure. But in view of the fact that the expenditure is of an unusual nature and the amount involved is heavy, it can be capitalised and thus treated as deferred revenue expenditure.

Illustration 2

Would you treat the following as a capital or a revenue expenditure? State your reasons in each case.

i) Rs. 7,500 spent on dismantling, moving and re-installing plant, machinery and fixtures.

ii) Rs. 800 spent on removal of stock from old factory.

iii) Some major alterations were made to a theatre at a cost of Rs. 3,00,000 which made it more comfortable and attractive.

iv) Rs. 20,000 spent by a large factory in overhauling its plant which resulted in adding three years to its working life.

v) For the purpose of constructing a factory building, some sheds costing Rs. 30,000 were built at site for the labour. They were demolished after completion of the construction work.

vi) An old machine, which stood in the books at Rs. 2,800 was found obsolete and hence sold for Rs. 800. A new machine was purchased at a cost of Rs. 10,000. Rs. 1,000 was spent on transportation and Rs. 800 on installation.

vii) Rs. 8,000 was spent on experimenting a new product which was not successful.

viii) Rs. 2,00,000 incurred in developing a new area for tea plantations.

Solution

i) Normally, expenses on transportation, etc. are revenue in nature. In view of the fact that expenditure incurred on shifting is of a non-recurring nature and involves a heavy amount, it can be treated as a deferred revenue expenditure.

ii) Although expenses on transportation are treated as revenue, but this expenditure relates to shifting of stock to new premises. So it will be treated in the same way as item (a).

iii) As the amount spent on alterations made the theatre more comfortable and attractive, it is likely to result in increased collections. Hence, it shall be treated as a capital expenditure.

iv) The amount spent on overhauling the plant has increased the life of the asset. Hence, it will be treated as capital expenditure.

v) Construction of temporary sheds for labour is necessary for the construction of the factory building and as such forms part of the cost of building. It shall be treated as capital expenditure.

vi) The loss of Rs. 2,000 (2,800 – 800) incurred on the sale of old machine shall be treated as a revenue loss. The cost of new machine, including transportation and installation costs, amounting to Rs. 11,800 shall be treated as a capital expenditure.

vii) If the experiment was successful it could be treated as capital expenditure. Since it was not successful, the amount spent should be treated as deferred revenue expenditure.

viii) It is a capital expenditure because it is incurred for the development of land for tea plantations.

13.8 LET US SUM UP

1 It is important to distinguish between capital and revenue because wrong classification of items leads to an incorrect ascertainment of profit and financial position of the business.

2 When the benefit of an expenditure is available for a number of years, such expenditure is treated as capital expenditure. When the benefit is limited to one year, such expenditure is treated as revenue expenditure.

3 Sometimes, a revenue expenditure may involve an unusually large amount and its benefit may extend to future accounting years. Such expenditure is treated as a deferred revenue expenditure.

4 Capital receipts are those receipts which either increase the liabilities of the business or represent sale proceeds of fixed assets. Revenue receipts, on the other hand, are those receipts which are received in the ordinary course of business.

5 Profits which are not earned in the regular course of business are capital profits while revenue profits represent the profits earned during the normal course of business.

6 Losses that arise during the regular course of business are treated as revenue losses, while those which do not arise in the normal course of business are treated as capital losses.

13.9 KEY WORDS

Capital Expenditure: An expenditure which results in the acquisition of a fixed asset or addition to a fixed asset, or improvement of the earning capacity of the asset.

Capital Losses: Losses which do not arise in the normal course of business.

Capital Profits: Profits not earned in the regular course of business.

Capital Receipts: Receipts in the form of additions to capital, liabilities or sale proceeds of fixed assets.

Deferred Revenue Expenditure: A revenue expenditure which involves a heavy amount and the benefit of which is likely to spread over a number of years.

Revenue Expenditure: An expenditure whose benefit is limited to one year.

Revenue Losses: Losses that occur in the regular course of business.

Revenue Profits: Profits earned in the normal course of business.

Revenue Receipts: Receipts arising out of services rendered or goods sold.

13.10 SOME USEFUL BOOKS

Batliboi Jamshed, R. *Advanced Accounting*, Standard Accountancy Publications Private Ltd.: Bombay. (Chapter III)

Frank Wood. 1986. *Book-keeping and Accounts*, Pitman: London. (Chapter 23)

Grewal, T.S. 1987. *Double Entry Book-keeping*, Sultan Chand & Sons: New Delhi. (Chapter 8)

Maheshwari, S.N. 1986. *Principles and Practice of Accountancy*, Arya Book Depot: Delhi. (Chapter 12)

13.11 ANSWERS TO CHECK YOUR PROGRESS

A1 i) Profit or Loss, ii) Profit and Loss Account, iii) Overstatement, iv) Capital, v) Deferred Revenue, vi) Capital.

2 i) False ii) True iii) False iv) False v) True vi) True vii) False viii) False.

B i) True ii) False iii) False iv) True v) False vi) True vii) False viii) True.

13.12 TERMINAL QUESTIONS/EXERCISES

Questions

1 Why is distinction between capital and revenue important? Give examples to show how wrong classification can affect the ascertainment of profit.

2 How would you determine whether a particular expenditure is capital or revenue? Give five examples of each.

3 What is deferred revenue expenditure? Give four examples.

4 Distinguish between (a) capital receipts and revenue receipts, (b) capital profits and revenue profits, and (c) capital losses and revenue losses.

Exercises

1 State with reasons whether the following expenditures are of capital or revenue nature.

a) A second hand machine was bought for Rs. 10,000 and Rs. 400 was spent on its carriage and installation.

b) Rs. 800 spent as carriage on goods purchased.

c) Rs. 2,000 spent on repairs to machinery.

d) Rs. 20,000 spent for constructing an additional hall.

e) Rs. 15,000 was spent for air-conditioning the office of the General Manager.

f) A second hand truck was purchased for Rs. 30,000 and Rs. 10,000 was spent on overhauling and converting it into a delivery van.

Answers: (a), (d), (e) and (f) are capital expenditures; (b) and (c) are revenue expenditures.

2 State whether the following expenditures are capital or revenue.

a) Legal expenses incurred in raising additional capital by way of shares and debentures.

b) Brokerage paid in connection with the purchase of land.

c) Taxes and insurance paid on factory premises.

d) Expenditure in development of land for rubber plantations.

e) Rs. 50,000 spent on an advertising campaign for a new product.

f) Wages paid to own workers for manufacturing loose tools for use in the factory.

Answers: (a), (b), (d) and (f) are capital expenditures; (c) revenue expenditure; and (e) deferred revenue expenditure.

3 Explain how would you deal with the following:

a) A sum of Rs. 25,000 was spent in overhauling the machinery. It increased the machine life by 5 years.

b) Rs. 2,000 was paid to an architect for drawing up the plans for the proposed building.

c) A sum of Rs. 800 was spent as legal charges for recovering dues from debtors.

d) Rs. 15,000 was spent on putting up a wooden partition in the existing building. It resulted in enhancing the rents realisable.

e) Rs. 500 was spent on shifting the office to new premises.

f) Old furniture was sold for Rs. 500. Its book value is Rs. 1,500. New furniture costing Rs. 3,000 was bought for replacement.

Answers: (a), (b) and (d) are capital expenditures, (c) is revenue expenditure, (e) is deferred revenue expenditure, (f) Rs. 3,000 being cost of new furniture is a capital expenditure and Rs. 1,000 is a revenue loss.

Note: These questions and exercises will help you to understand the unit better. Try to write answers for them. But do not send your answers to the university for evaluation. These are for your practice only.