

## UNIT 4 : CAPITAL AND REVENUE EXPENDITURES AND RECEIPTS

### LEARNING OUTCOMES

After studying this unit, you will be able to:

- ◆ Learn the criteria for identifying Revenue Expenditure and distinguishing from Capital Expenditure
- ◆ Learn the distinction between capital and revenue receipts.
- ◆ Understand the linkage of such distinction with the preparation of final accounts.

UNIT OVERVIEW 

**Capital**

- Payments
- Receipts

**Revenue**

- Payments
- Receipts

### 4.1 INTRODUCTION

Accounting aims in ascertaining and presenting the results of the business for an accounting period. For ascertaining the periodical business results, the nature of transactions should be analyzed whether they are of capital or revenue nature. The Revenue Expense relates to the operations of the business of an accounting period or to the revenue earned during the period or the items of expenditure, benefits of which do not extend beyond that period. Capital Expenditure, on the other hand, generates enduring benefits and helps in revenue generation over more than one accounting period. Revenue Expenses must be associated with a physical activity of the entity. Therefore, whereas production and sales generate revenue in the earning process, use of goods and services in support of those functions causes expenses to occur. Expenses are recognised in the Profit & Loss Account through matching principal which tells us when and how much of the expenses to be charged against revenue. A part of the expenditure can be capitalised only when these can be traced directly to definable streams of future benefits.

The distinction of transaction into revenue and capital is done for the purpose of placing them in Profit and Loss account or in the Balance Sheet. For example: revenue expenditures are shown in the profit and loss account as their benefits are for one accounting period i.e. in which they are incurred while capital expenditures are placed on the asset side of the balance sheet as they will generate benefits for more than one accounting period and will be transferred to profit and loss account of the year on the basis of utilisation of that benefit in particular accounting year. Hence, both capital and revenue expenditures are ultimately transferred to profit and loss account.

Revenue expenditures are transferred to profit and loss account in the year of spending while capital expenditures are transferred to profit and loss account of the year in which their benefits are utilised. Therefore we can conclude that it is the time factor, which is the main determinant for transferring the expenditure to profit and loss account. Also expenses are recognized in profit and loss account through matching concept which tells us when and how much of the expenses to be charged against revenue. However, distinction between capital and revenue creates a considerable difficulty. In many cases borderline between the two is very thin.

## 4.2 CONSIDERATIONS IN DETERMINING CAPITAL AND REVENUE EXPENDITURES

The basic considerations in distinction between capital and revenue expenditures are:

- (a) **Nature of business:** For a trader dealing in furniture, purchase of furniture is revenue expenditure but for any other trade, the purchase of furniture should be treated as capital expenditure and shown in the balance sheet as asset. Therefore, the nature of business is a very important criteria in separating an expenditure between capital and revenue.
- (b) **Recurring nature of expenditure:** If the frequency of an expense is quite often in an accounting year then it is said to be an expenditure of revenue nature while non-recurring expenditure is infrequent in nature and do not occur often in an accounting year. Monthly salary or rent is the example of revenue expenditure as they are incurred every month while purchase of assets is not the transaction done regularly therefore, classified as capital expenditure unless materiality criteria defines it as revenue expenditure.
- (c) **Purpose of expenses:** Expenses for repairs of machine may be incurred in course of normal maintenance of the asset. Such expenses are revenue in nature. On the other hand, expenditure incurred for major repair of the asset so as to increase its productive capacity is capital in nature. However, determination of the cost of maintenance and ordinary repairs which should be expensed, as opposed to a cost which ought to be capitalised, is not always simple.
- (d) **Effect on revenue generating capacity of business:** The expenses which help to generate income/revenue in the current period are revenue in nature and should be matched against the revenue earned in the current period. On the other hand, if expenditure helps to generate revenue over more than one accounting period, it is generally called capital expenditure.

When expenditure on improvements and repair of a fixed asset is done, it has to be charged to Profit and Loss Account if the expected future benefits from fixed assets do not change, and it will be included in book value of fixed asset, where the expected future benefits from assets increase.

- (e) **Materiality of the amount involved:** Relative proportion of the amount involved is another important consideration in distinction between revenue and capital.

## 4.3 CAPITAL EXPENDITURES AND REVENUE EXPENDITURES

As we have already discussed, capital expenditure contributes to the revenue earning capacity of a business over more than one accounting period whereas revenue expense is incurred to generate revenue for a particular accounting period. The revenue expenses either occur in direct relation with the revenue or in relation with accounting periods, for example cost of goods sold, salaries, rent, etc. Cost of goods sold is directly related to sales revenue whereas rent is related to the particular accounting period. Capital

expenditure may represent acquisition of any tangible or intangible fixed assets for enduring future benefits. Therefore, the benefits arising out of capital expenditure last for more than one accounting period whereas those arising out of revenue expenses expire in the same accounting period.

### ILLUSTRATION 1

State with reasons whether the following statements are 'True' or 'False'.

- (1) Overhaul expenses of second-hand machinery purchased are Revenue Expenditure.
- (2) Money spent to reduce working expenses is Revenue Expenditure.
- (3) Legal fees to acquire property is Capital Expenditure.
- (4) Amount spent as lawyer's fee to defend a suit claiming that the firm's factory site belonged to the plaintiff's land is Capital Expenditure.
- (5) Amount spent for replacement of worn out part of machine is Capital Expenditure.
- (6) Expense incurred on the repairs and white washing for the first time on purchase of an old building are Revenue Expenses.
- (7) Expenses in connection with obtaining a license for running the cinema is Capital Expenditure.
- (8) Amount spent for the construction of temporary huts, which were necessary for construction of the Cinema House and were demolished when the cinema house was ready, is Capital Expenditure.

### SOLUTION

- (1) **False:** Overhaul expenses are incurred to put second-hand machinery in working condition to derive enduring long-term advantage. So it should be capitalised.
- (2) **False:** It may be reasonably presumed that money spent for reducing revenue expenditure would have generated long-term benefits to the entity. It becomes part of intangible fixed assets if it is in the form of technical know-how and tangible fixed assets if it is in the form of additional replacement of any of the existing tangible fixed assets. So this is capital expenditure.
- (3) **True:** Legal fee paid to acquire any property is part of the cost of that property. It is incurred to possess the ownership right of the property and hence a capital expenditure.
- (4) **False:** Legal expenses incurred to defend a suit claiming that the firm's factory site belongs to the plaintiff is maintenance expenditure of the asset. By this expense, neither any enduring benefit can be obtained in future in addition to that what is presently available nor the capacity of the asset will be increased. Maintenance expenditure in relation to an asset is revenue expenditure.
- (5) **False:** Amount spent for replacement of any worn out part of a machine is revenue expense since it is part of its maintenance cost.
- (6) **False:** Repairing and white washing expenses for the first time of an old building are incurred to put the building in usable condition. These are the part of the cost of building. Accordingly, these are capital expenditure.
- (7) **True:** The Cinema Hall could not be started without license. Expenditure incurred to obtain the license is pre-operative expense which is capitalised. Such expenses are amortised over a period of time.
- (8) **True:** Cost of temporary huts constructed which were necessary for the construction of the cinema house is part of the construction cost of the cinema house. Therefore such costs are to be capitalised.

## ILLUSTRATION 2

State with reasons whether the following are Capital or Revenue Expenditure:

- (1) Expenses incurred in connection with obtaining a license for starting the factory for ₹ 10,000.
- (2) ₹ 1,000 paid for removal of Inventory to a new site.
- (3) Rings and Pistons of an engine were changed at a cost of ₹ 5,000 to get fuel efficiency.
- (4) Money paid to Mahanagar Telephone Nigam Ltd. (MTNL) ₹ 8,000 for installing telephone in the office.
- (5) A factory shed was constructed at a cost of ₹ 1,00,000. A sum of ₹ 5,000 had been incurred in the construction of temporary huts for storing building material.

## SOLUTION

- (1) Money paid ₹ 10,000 for obtaining license to start a factory is a capital expenditure. This is an item of expenditure incurred to acquire the right to carry on business.
- (2) ₹ 1,000 paid for removal of Inventory to a new site is revenue expenditure. This is neither bringing enduring benefit nor enhancing the value of the asset.
- (3) ₹ 5,000 spent in changing Rings and Pistons of an engine to get fuel efficiency is capital expenditure. This is an expenditure on improvement of a fixed asset. It results in increasing profit-earning capacity of the business by cost reduction.
- (4) Money deposited with MTNL for installation of telephone in office is not expenditure. This is treated as an asset and the same is adjusted over a period of time against actual telephone bills.
- (5) Cost of construction of building including cost of temporary huts is capital expenditure. Building is fixed asset which will generate enduring benefit to the business over more than one accounting period. Construction of temporary huts is incidental to the main construction. Such cost is also capitalised with the cost of building.

## 4.4 CAPITAL RECEIPTS AND REVENUE RECEIPTS

Just as a clear distinction between Capital and Revenue expenditure is necessary, in the same manner capital receipts must be distinguished from revenue receipts.

Receipts which are obtained in course of normal business activities are revenue receipts (e.g. receipts from sale of goods or services, interest income etc.). On the other hand, receipts which are not revenue in nature are capital receipts (e.g. receipts from sale of fixed assets or investments, secured or unsecured loans, owners' contributions etc.). Revenue and capital receipts are recognised on accrual basis as soon as the right of receipt is established. Revenue receipts should not be equated with the actual cash receipts. Revenue receipts are credited to the Profit and Loss Account.

On the other hand, Capital receipts are not directly credited to Profit and Loss Account. For example, when a fixed asset is sold for ₹ 92,000 (cost ₹ 90,000), the capital receipts ₹ 92,000 is not credited to Profit and Loss Account. Profit/Loss on sale of fixed assets is calculated and credited to Profit and Loss Account as follows:

|               |            |
|---------------|------------|
| Sale Proceeds | ₹ 92,000   |
| Cost          | (₹ 90,000) |
| Profit        | ₹ 2,000    |

### ILLUSTRATION 3

*Good Pictures Ltd., constructs a cinema house and incurs the following expenditure during the first year ending 31st March, 2016.*

- (i) *Second-hand furniture worth ₹ 9,000 was purchased; repainting of the furniture costs ₹ 1,000. The furniture was installed by own workmen, wages for this being ₹ 200.*
- (ii) *Expenses in connection with obtaining a license for running the cinema worth ₹ 20,000. During the course of the year the cinema company was fined ₹ 1,000, for contravening rules. Renewal fee ₹ 2,000 for next year also paid.*
- (iii) *Fire insurance, ₹ 1,000 was paid on 1st October, 2015 for one year.*
- (iv) *Temporary huts were constructed costing ₹ 1,200. They were necessary for the construction of the cinema. They were demolished when the cinema was ready.*

*Point out how you would classify the above items.*

### SOLUTION

1. The total cost of the furniture should be treated as ₹ 10,200 i.e., all the amounts mentioned should be capitalised since without such expenditure the furniture would not be available for use. If ₹ 1,000 and ₹ 200 have been respectively debited to the Repairs Account and the Wages Account, these accounts will be credited to the Furniture Account.
2. License for running the cinema house is necessary, hence its cost should be capitalised. But the fine of ₹ 1,000 is revenue expenditure. The renewal fee for the next year is also revenue expenditure but pertains to the next year; hence, it is a prepaid expense.
3. Half of the insurance premium pertains to the year beginning on 1st April, 2016. Hence such amount should be treated as prepaid expense. The remaining amount is revenue expense for the current year.
4. Since the temporary huts were necessary for the construction, their cost should be added to the cost of the cinema hall and thus capitalised.

### ILLUSTRATION 4

*State with reasons, how you would classify the following items of expenditure:*

1. *Overhauling expenses of ₹ 25,000 for the engine of a motor car to get better fuel efficiency.*
2. *Inauguration expenses of ₹ 25 lacs incurred on the opening of a new manufacturing unit in an existing business.*
3. *Compensation of ₹ 2.5 crores paid to workers, who opted for voluntary retirement.*

### SOLUTION

1. Overhauling expenses are incurred for the engine of a motor car to derive better fuel efficiency. These expenses will reduce the running cost in future and thus the benefit is in form of enduring long-term advantage. So this expenditure should be capitalised.

2. Inauguration expenses incurred on the opening of a new unit may help to explore more customers. This expenditure is in the nature of revenue expenditure, as the expenditure may not generate any enduring benefit to the business over more than one accounting period.
3. The amount paid to workers on voluntary retirement is in the nature of revenue expenditure. Since the magnitude of the amount of expenditure is very significant, it may be better to defer it over future years.

### ILLUSTRATION 5

*Classify the following expenditures and receipts as capital or revenue:*

- (i) ₹ 10,000 spent as travelling expenses of the directors on trips abroad for purchase of capital assets.
- (ii) Amount received from Trade receivables during the year.
- (iii) Amount spent on demolition of building to construct a bigger building on the same site.
- (iv) Insurance claim received on account of a machinery damaged by fire.

### SOLUTION

- (i) Capital expenditure.
- (ii) Revenue receipt.
- (iii) Capital expenditure.
- (iv) Capital receipt.

### ILLUSTRATION 6

*Are the following expenditures capital in nature?*

- (i) M/s ABC & Co. run a restaurant. They renovate some of the old cabins. Because of this renovation some space was made free and number of cabins was increased from 10 to 13. The total expenditure was ₹ 20,000.
- (ii) M/s New Delhi Financing Co. sold certain goods on installment payment basis. Five customers did not pay installments. To recover such outstanding installments, the firm spent ₹ 10,000 on account of legal expenses.
- (iii) M/s Ballav & Co. of Delhi purchased a machinery from M/s Shah & Co. of Ahmedabad. M/s Ballav & Co. spent ₹ 40,000 for transportation of such machinery. The year ending is 31st Dec, 2015.

### SOLUTION

- (i) Renovation of cabins increased the number of cabins. This has an effect on the future revenue generating capability of the business. Thus the renovation expense is capital expenditure in nature.
- (ii) Expense incurred to recover installments due from customer do not increase the revenue generating capability in future. It is a normal recurring expense of the business. Thus the legal expenses incurred in this case is revenue expenditure in nature.
- (iii) Expenses incurred on account of transportation of fixed asset is capital expenditure in nature.



## SUMMARY

- ◆ Revenue expenditures are shown in the profit and loss account while capital expenditures are placed on the asset side of the balance sheet since they generate benefits for more than one accounting period.
- ◆ Prepaid expenses are future expenses that have been paid in advance. These are shown in the balance sheet as an asset.
- ◆ Receipts obtained should be classified between revenue receipts and capital receipts.



## TEST YOUR KNOWLEDGE

### Multiple Choice Questions

1. Money spent ₹ 10,000 as traveling expenses of the directors on trips abroad for purchase of capital assets is
  - (a) Capital expenditures
  - (b) Revenue expenditures
  - (c) Prepaid revenue expenditures
2. Amount of ₹ 5,000 spent as lawyers' fee to defend a suit claiming that the firm's factory site belonged to the plaintiff's land is
  - (a) Capital expenditures
  - (b) Revenue expenditures
  - (c) Prepaid revenue expenditures
3. Entrance fee of ₹ 2,000 received by Ram and Shyam Social Club is
  - (a) Capital receipt
  - (b) Revenue receipt
  - (c) Capital expenditures
4. Subsidy of ₹ 40,000 received from the government for working capital by a manufacturing concern is
  - (a) Capital receipt
  - (b) Revenue receipt
  - (c) Capital expenditures
5. Insurance claim received on account of machinery damaged completely by fire is
  - (a) Capital receipt
  - (b) Revenue receipt
  - (c) Capital expenditures
6. Interest on investments received from UTI is
  - (a) Capital receipt
  - (b) Revenue receipt
  - (c) Capital expenditures
7. Amount received from IDBI as a medium term loan for augmenting working capital is
  - (a) Capital expenditures
  - (b) Revenue expenditures
  - (c) Capital receipt

8. Revenue from sale of products, ordinarily, is reported as part of the earning in the period in which
- (a) The sale is made.
  - (b) The cash is collected.
  - (c) The products are manufactured.
9. If repair cost is ₹ 25,000, whitewash expenses are ₹ 5,000, (both these expenses relate to presently used building) cost of extension of building is ₹ 2,50,000 and cost of improvement in electrical wiring system is ₹ 19,000; the amount to be expensed is
- (a) ₹ 2,99,000.
  - (b) ₹ 44,000.
  - (c) ₹ 30,000.

### Theory Questions

1. What are the basic considerations in distinguishing between capital and revenue expenditures?
2. Define revenue receipts and give examples. How are these receipts treated?

### ANSWERS/HINTS

#### MCQs

- 1: (a), 2 (b), 3 (a), 4(b), 5(a), 6 (b), 7(c), 8 (a), 9 (c)

### Theoretical Questions

1. The basic considerations in distinction between capital and revenue expenditures are:
  - (a) Nature of business.
  - (b) Recurring nature of expenditure.
  - (c) Purpose of expenses.
  - (d) Effect on revenue generating capacity of business.
  - (e) Materiality of the amount involved.
2. Receipts which are obtained in course of normal business activities are revenue receipts (e.g. receipts from sale of goods or services, interest income etc.).

Revenue receipts should not be equated with the actual cash receipts. Revenue receipts are credited to the Profit and Loss Account.