Capital & Revenue Expenditure/Income

Capital and Revenue- Meaning and Distinction

Objectives

After going through this lesson, you shall be able to understand the following concepts.

- Capital and Revenue Items and need for their Classification
  - Capital and Revenue Expenditure
- Difference between Capital and Revenue Expenditure
- Capital and Revenue Receipts
  - Difference between Capital and Revenue Receipts
  - Deferred Revenue Expenditure
  - Capital and Revenue Profits
  - Difference between Capital and Revenue Profits
  - Capital and Revenue Losses
  - Difference between Capital and Revenue Losses
  - Capital and Revenue Income
  - Difference between Capital and Revenue Income

Capital and Revenue Items and need for their Classification

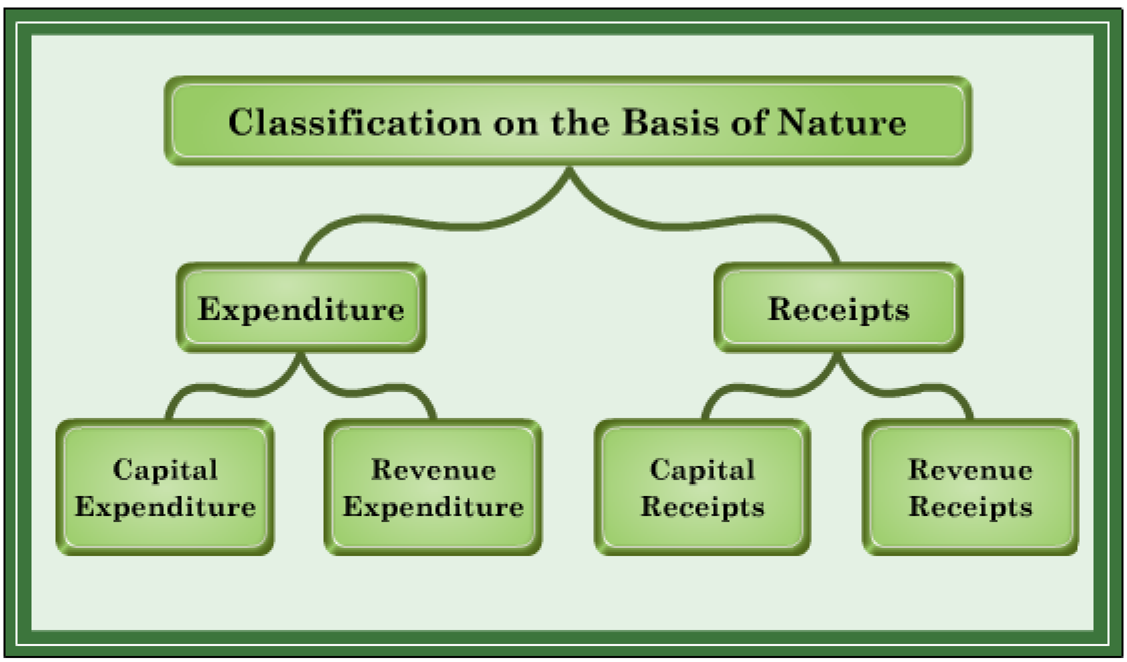
Every business organisation incurs various expenses and earns various incomes during the year for carrying the business activities. Some of these expenditure and incomes may involve huge amounts while some of them are of small amounts.

This is the main basis to distinguish a transaction or an item into capital and revenue. From the financial point of view, there is a difference between capital and revenue items. All the items which results in profits or benefits for more than a year are categorised as ***Capital items***. While on the other hand, the items which results in profits or benefits only for the related year are categorised as ***Revenue items***.

We know that financial statements i.e. Trading and Profit and Loss Account and Balance Sheet of an organisation are prepared on the basis of Trial Balance. Trading and Profit and Loss Account records all the revenue nature items appearing in the Trial Balance. However, the capital nature items appearing in the Trial Balance are recorded in the Balance Sheet.

In other words, we can say that the transfer of items from the Trial Balance to the Trading and Profit and Loss Account depends on the nature of item. In case the transactions are not properly recorded from the Trial Balance to the Trading and Profit and Loss Account and in the Balance Sheet i.e. an item of revenue nature is wrongly treated as capital item or vice-versa while transferring from the Trial Balance, then in this case the financial statements fails to reveal the correct profit or loss and also fail to exhibit the true financial position of the firm.

Therefore, it becomes necessary to classify the items on the basis of their nature. This helps in transferring the items from the Trial Balance to the financial statements correctly. On the basis of nature the classification of capital and revenue expenditure and receipts are discussed below in detail.



Expenditure

Capital Expenditure

Capital Expenditures are those expenditures that are incurred to acquire fixed assets or to increase or to add the value to an existing fixed asset. Fixed assets include both tangible as well as intangible assets.These assets are not meant for the purpose of resale and are used in the business to generate the revenues. Capital expenditure is not incurred on regular basis and the amount of this expenditure is relatively higher than the revenue expenditure.

The capital expenditure results in an income or benefits for a longer period that extends for period of more than a year. This expenditure is shown in the Balance Sheet on the Assets Side. Some of the examples of such expenditures are purchase of plant, furniture, vehicles, goodwill, wages paid for extension of land, wages paid for constructing additional rooms in a building, etc.

Capital Expenditure

Some examples of a capital expenditure are as follows:

a) When a fixed asset is acquired by the firm like furniture, machinery, land & building, motor vehicles, etc.

b) When expenditure is incurred on making a fixed asset operational like installation charges on the machinery, freight and carriage paid on the fixed asset, etc.

c) When any modification is made to an existing fixed asset like adding a floor to the building or construction of offices, etc.

d) When any intangible asset is purchased like patents, trademarks, copyrights, Goodwill, etc.

Features of Capital Expenditure

The given below are some features of capital expenditure.

i. This is incurred to purchase the fixed assets or to add the value to an existing fixed asset. Fixed assets includes both tangible assets such building, plant, etc. and intangible assets such as patents, goodwill, copyrights, etc.

ii. It results in improving the working capacity and also increases the earning capacity of an organisation.

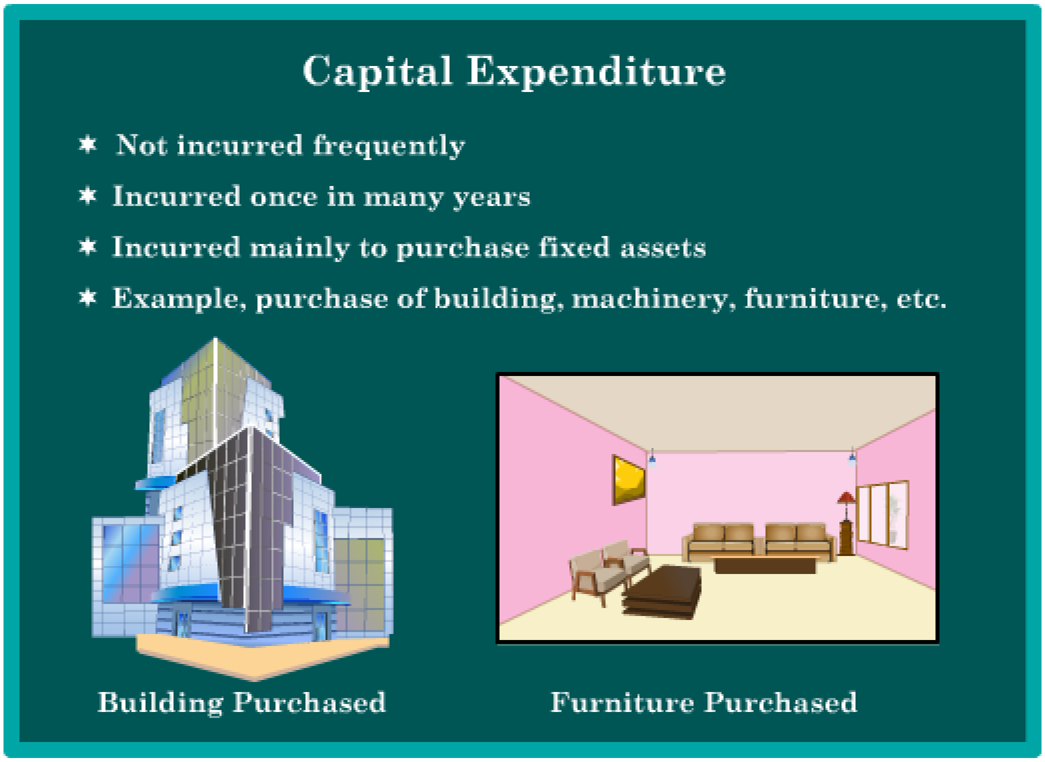
iii. Assets purchased are not meant for resale in the business.

iv. It is non-recurring in nature i.e. it is not incurred on regular basis.

v. The benefits from this expenditure are availed for a period more than an accounting year.

vi. This expenditure includes all the expenses that are incurred at the time of purchase of assets or to make the asset in ready to use condition. Some of the examples are cost of installation of assets, erection charges, overhauling of existing or second-hand assets, legal expenses/registration, interest on loan taken to acquire fixed assets, carriage, preliminary expenses for obtaining license, etc.

vii. It is shown on the Assets Side of the Balance Sheet.



Revenue Expenditure Revenue Expenditure is the expenditure that is incurred to earn or to generate revenue during an accounting year. This expenditure is incurred for normal operating activities of business and for its efficient or smooth working. In other words, this expenditure does not help in increasing the earning capacity, rather it helps to earn and generate the income from the business.

The benefits of this expenditure can be availed for period of only one year in which such expenditure is incurred. These expenditures are incurred frequently by an organisation and also include the decrease in the value of an asset in form of depreciation. This expenditure is shown on the debit side of the Trading and Profit and Loss Account. Some of the examples of such expenditure are rent, repairs, depreciation, loss on sale of fixed assets, etc.

Features of Revenue Expenditure
The given below are some features of revenue expenditure.

i. It is incurred to carry on day-to-day business activities.

ii. It does not result in increasing the earning capacity of an organisation.

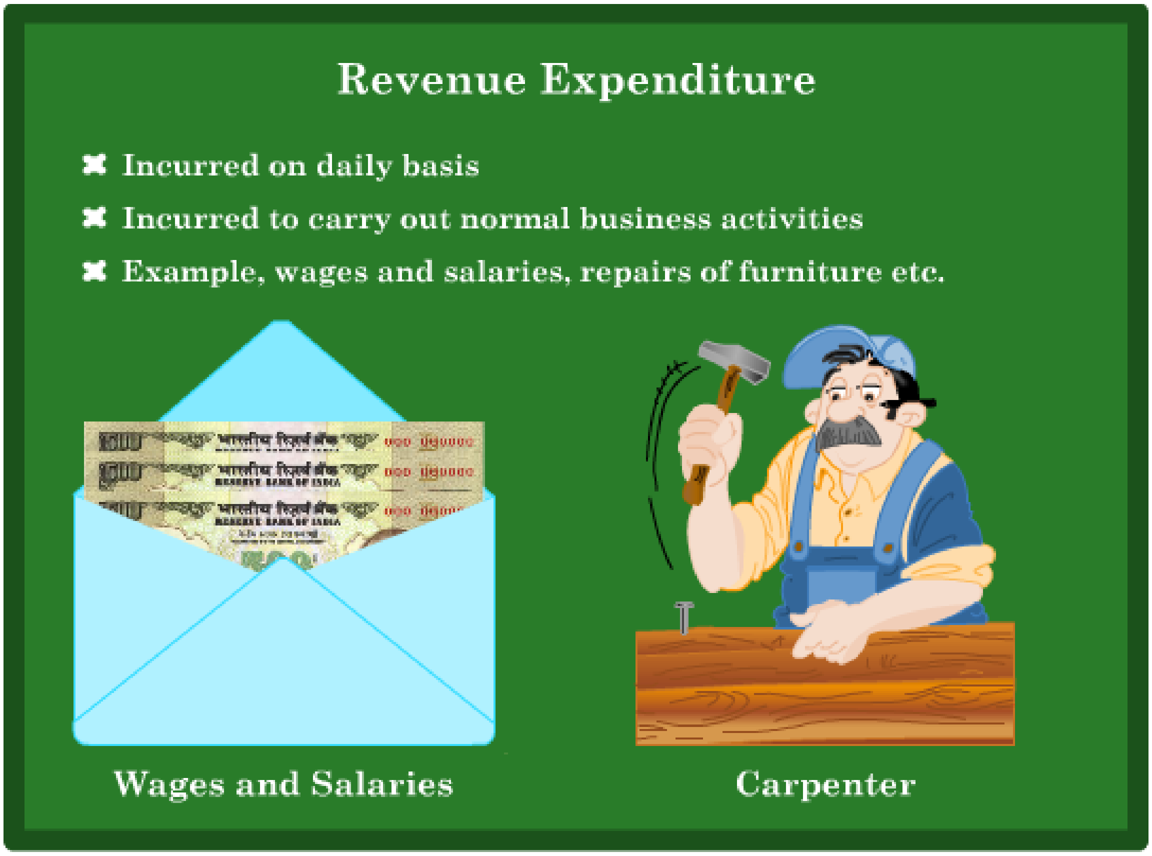
iii. It helps to maintain and improve the working capacity of the fixed assets but does not increase their value.

iv. The benefits from this expenditure are availed for a period of an accounting year in which it is incurred.

v. It is recurring in nature. That is, it is incurred on regular basis.

vi. It includes the decrease or fall in the value of an asset.

vii. It is shown on the debit side of Trading and Profit and Loss Account.



Difference between Capital Expenditure and Revenue Expenditure
The points of difference between Capital and Revenue expenditure are given below.

Basis of Difference	Capital Expenditure	Revenue Expenditure
Meaning	It is incurred to increase the earning capacity of a business.	It is incurred to maintain the earning capacity of a business.
Purpose	It is incurred to acquire fixed assets.	It is incurred to carry day-to-day business activities.

Benefits	The benefits of such expenditure can be availed for a period of more than an accounting year.	The benefits of such expenditure can be availed only for a period of one accounting year.
Nature	It is non-recurring in nature.	It is recurring in nature.
Shown	It is shown on the Assets side of the Balance Sheet.	It is shown on the debit side of the Trading and Profit and Loss Account.
Examples	Purchase of Building, Purchase of Patents or Trade Marks, etc.	Depreciation on Building, Rent paid, Loss on Sale of Furniture, etc.

Points to be taken into consideration for the classification of expenditure as Capital or Revenue

1) Benefit derived: Normally, the benefit of a capital expenditure is derived for a longer period of time i.e. exceeding a financial year or so as against Revenue Expenditure. For example: When you purchase a computer is usually lasts for 4 to 5 years and hence is a capital expenditure by you.

2) Consideration: The amount incurred on a capital expenditure far exceeds that of revenue expenditure and is usually a big amount. For example: When you purchase a house, the amount paid to acquire it is greater than the amount you pay for buying food to eat.

3) Frequency of Payments: A capital expenditure is incurred once or in lump sum mostly as against revenue expenditure which is periodic in nature. For example: You frequently purchase fruits to eat hence it is a revenue expenditure but land is purchased once in a while.

4) Source of making the payments: As a general rule, the capital expenditure is paid out of capital owing to its large amount and the revenue expenditure is paid out of revenue receipts like sales, etc. However, it is not a mandatory rule.

Example:

State with the reasons whether the following items of expenditure are of capital or revenue nature.

i. Goodwill purchased for Rs 19,000.

ii. Repairs paid for machinery Rs 5,000

iii. Fees paid for obtaining license to start business.

iv. Duty paid for importing a new machine.

v. Agriculture Land purchased for Rs 1,10,000, Also paid Rs 5,000 for land revenue.

vi. Fees paid for renewal of license Rs 1,000.

Solution

i. *Capital Expenditure*- It is a capital expenditure because it is related to the purchase of an intangible asset.

ii. *Revenue Expenditure*- It is revenue expenditure because it is incurred under normal course of business for the maintenance of machinery.

iii. *Capital Expenditure*- It is a capital expenditure because it is an initial expenditure incurred for starting a new business.

iv. *Capital Expenditure*- It is a capital expenditure because it is paid for acquiring a new asset.

v. *Agriculture Land purchased* for Rs 1,10,000 is a capital expenditure as it is related to the purchase of an asset and *land revenue* of Rs 5,000 is a revenue expenditure.

vi. *Revenue Expenditure*- It is revenue expenditure because it is paid for renewal of license and not for obtaining a new license.

Receipts

Capital Receipts

Capital receipts are those receipts that are received from disposal or sale of an asset or received in form of additional capital introduced. It also includes the receipts in form of loan taken by a business organisation. These are non-recurring in nature i.e. these are not frequently received. Capital receipts are shown on the Liabilities Side of the Balance Sheet. When the assets of a firm are sold it decreases the fixed assets and when the loan is taken or additional capital is introduced it increases the liability. In both the cases the amount so received is regarded as capital receipts. From this discussion it can be stated that capital receipts reduce the fixed assets and increases the liabilities of the business organisation. Some of the examples of such receipts are sale of plant, loan from bank, etc.

Features of Capital Receipts

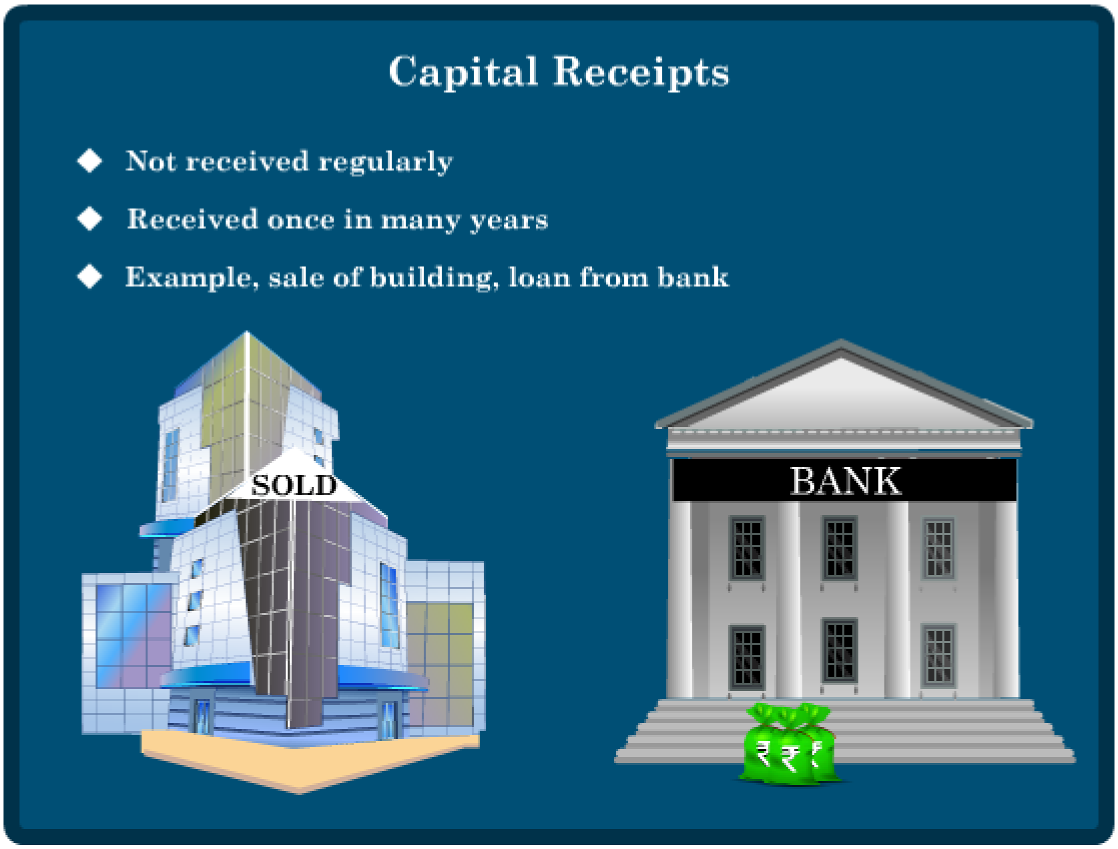
The given below are some of the features of capital receipts.

i. It is received from sale of fixed assets.

ii. It also consists of amount of loan taken and additional capital introduced.

iii. It is non-recurring in nature.

iv. It is shown on the Liabilities Side of the Balance Sheet.



Revenue Receipts
Revenue receipts are those receipts that are received in conduct of ordinary and day to day business activities. The sale of goods and services are the main source of revenue receipts. These receipts or incomes are received frequently in the normal course of business operations. Revenue receipts are shown on the credit side of the Trading and Profit and Loss Account.

Features of Revenue Receipts
The given below are some features of revenue receipts.

i. It is received from sale of goods and services.

ii. It is recurring in nature i.e. it is received on regular basis.

iii. It is shown on the Credit Side of the Trading and Profit and Loss Account.

Difference between Capital Receipts and Revenue Receipts
The points of difference between Capital and Revenue receipts are given below.

Basis of Difference	Capital Receipts	Revenue Receipts
Meaning	It is the amount received from the sale of fixed assets, loan taken or additional capital introduced.	It is the amount received from sale of goods and services.
Activities	These are not received from the ordinary business activities.	These are received from the ordinary business activities.
Nature	It is non-recurring in nature.	It is recurring in nature.
Shown	It is shown on the Liabilities Side of Balance Sheet.	It is shown on the Credit Side of Trading and Profit and Loss Account.
Examples	Sale of Furniture, Loan from Bank, etc.	Sale of Goods, Rent Received, Profit on Sale of Machinery, etc.

Example:

State with the reasons whether the following items of receipts are of capital or revenue in nature.

i. Amount received from sale of goods worth Rs 7,500.

ii. Started business with cash Rs 15,000.

iii. Sale of Old Machine Rs 19,500.

iv. Dividend received from investment of shares.

v. Amount received from sale of old newspapers Rs 2,300.

Solution:

i. *Revenue Receipt*- It is a revenue receipt because it is earned from normal business activity i.e. sale of goods.

ii. *Capital Receipt*- It is a capital receipt because it is introduced or invested in the business for its commencement and non-recurring in nature.

iii. *Capital Receipt*- It is a capital receipt because it is received from sale of fixed assets (old machine) and not from the normal activity of business.

iv. *Revenue Receipts*- It is a revenue receipt because it is a regular income for an investor.

v. *Revenue Receipts*- It is a revenue receipt because sale of newspapers is routine in nature.

Deferred Revenue Expenditure

Sometimes, the benefits from revenue expenditure are not restricted to only one year but are extended over many years. Such class of revenue expenditure is regarded as deferred revenue expenditure. Such revenue expenditure involves the payment of huge amount. Therefore, instead of charging the total amount of expenditure from Profit and Loss Account the expenditure is written-off over certain years.

The expenditure written-off in the current accounting year is shown on the debit side of the Profit and Loss Account and the remaining expenditure is shown on the Assets Side of the Balance Sheet as deferred revenue expenditure.

For example, heavy expenditure of say Rs 90,000 is incurred on an advertisement campaign the benefit of which is likely to be availed for a period of five years. In this case, the whole amount of Rs 90,000 is not charged from the profits of the current accounting year. Rather, expenditure will be spread over the period of 5 years. This implies that, Rs 18,000 $\left(\frac{90,000}{5}\right)$ will be charged each year as revenue expenditure for a period of 5 years. Thus, Rs 18,000 will be recorded as an advertisement expense on the debit side of the Profit and Loss Account and the remaining portion of expenditure i.e. Rs 72,000 (90,000 – 18,000) will be shown as Deferred Revenue expenditure on the Assets Side of the Balance Sheet.

It should be noted that deferred revenue expenditure is a fictitious asset. Some of the examples of such expenditure are preliminary expenses, huge advertisement expenditure, underwriting commission, etc.

Features of Deferred Revenue Expenditure

The given below are some features of deferred revenue expenditure.

i. The benefit of this expenditure continues for more than one year.

ii. Amount of this expenditure is huge.

iii. Total expenditure is spread over certain years.

iv. It is a fictitious asset and shown in the Balance Sheet on the Assets Side.

Profits

Capital Profits
Capital profits are those profits that are earned from the disposal or sale of an asset and redemption of debentures. These are not earned in the course of normal business operations and are non-recurring in nature i.e. these are not frequently earned. Capital profits are transferred to Capital Reserve and are shown on the Liabilities Side of the Balance Sheet. When the assets of a firm are sold at a price above their book values, then the amount realised in excess of the book value is regarded as capital profit.

Revenue Profits
Revenue profits are those profits that are earned in conduct of ordinary and day to day business activities. The sale of goods and services at a price above their cost price, results in revenue profits. These profits are received frequently in the normal course of business operations. Revenue profits are shown on the credit side of the Profit and Loss Account.

Difference between Capital Profits and Revenue Profits
The points of difference between Capital and Revenue profits are given below.

Basis of Difference	Capital Profits	Revenue Profits
Meaning	It is the amount earned from the disposal or sale of an asset and redemption of debentures.	It is the amount earned from the sale of goods and services at a price above their cost price.
Activities	These are not earned from the ordinary business activities.	These are earned from the ordinary business activities.
Nature	It is non-recurring in nature.	It is recurring in nature.
Shown	It is shown on the Liabilities Side of Balance Sheet.	It is shown on the Credit Side of Profit and Loss Account.
Source	Creation of Capital Reserves	Creation of Revenue Reserves

Losses

Capital Loss
Capital losses are those losses that are incurred from the disposal or sale of an asset and redemption of debentures. These are not incurred in the course of normal business operations and are non-recurring in nature i.e. these are not frequently incurred. Capital losses are made good or settled against the capital profits.

In case the amount of capital losses is more than the capital profit, then the excess amount is shown on the Assets Side of the Balance Sheet. When the assets of a firm are sold at a price lesser than their book values, then the amount lost in excess of the book value is regarded as capital loss.

Revenue Loss
Revenue losses are those losses that are incurred in conduct of ordinary and day to day business activities. The sale of goods and services at a price lesser than their cost price, results in revenue losses. These losses are incurred frequently in the normal course of business operations. Revenue losses are shown on the debit side of the Profit and Loss Account.

Difference between Capital Loss and Revenue Loss

The points of difference between Capital and Revenue loss are given below.

Basis of Difference	Capital Loss	Revenue Loss
Meaning	It is the loss incurred from the disposal or sale of an asset and redemption of debentures.	It is the loss incurred from the sale of goods and services at a price lesser than their cost price.

Activities	These are not incurred from the ordinary business activities.	These are incurred from the ordinary business activities.
Nature	It is non-recurring in nature.	It is recurring in nature.
Shown	It is shown on the Assets Side of Balance Sheet.	It is shown on the Debit Side of Profit and Loss Account.
Set-off	It can be set-off against capital profits	It cannot be set-off against capital profits.

Incomes

Capital Income

Capital incomes are those incomes that do not arise in the normal course of business operations. Such incomes arise from the capital itself, without involving any production work. For example, premium received from the issue of shares or debentures.

Revenue Income

Revenue incomes are those incomes that are earned in the conduct of ordinary and day to day business activities. Such incomes are earned frequently. For example, profit earned from the sale of goods, commission earned etc.

Difference between Capital Income and Revenue Income

The points of difference between Capital and Revenue income are given below.

Basis of Difference	**Capital Income**	**Revenue Income**
Meaning	Incomes arising from the capital itself, without involving any production work	Incomes earned in conduct of ordinary and day to day business activities
Activities	These are not earned from the ordinary business activities.	These are earned from the ordinary business activities.
Nature	It is non-recurring in nature.	It is recurring in nature.
Shown	It is shown on the Liabilities Side of Balance Sheet.	It is shown on the Credit Side of Profit and Loss Account.