Unit 11

CAPITAL AND REVENUE TRANSACTIONS

Contents

Points to recall

The following points are to be recalled before learning capital and revenue transactions:

- Matching concept
- Periodicity concept
- Income and expenditure

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Learning Objectives

To enable the students to

- Understand the meaning of capital and revenue expenditure and capital and revenue receipts
- Understand the meaning of deferred revenue expenditure
- Analyse the transactions to classify into capital and revenue items

Key terms to know

- Capital expenditure
- Revenue expenditure
- Deferred revenue expenditure
- Capital receipts
- Revenue receipts

11.1 Introduction

Student activity

Think: How often the business entities buy stationery items? How often they buy machinery? Is it fair if the business entity treats both these type of expenditure the same?

The main objective of accounting of business transactions is to ascertain the results of operations and the financial position of the business concern. The transactions carried on may yield benefit only for the current accounting period or they may yield benefit for more than one accounting period. According to matching principle, the expenses incurred in the current accounting period must be matched with the revenues earned during that period.

In case of certain expences, the benefit accrues only in the relevant accounting period. They are called revenue expenditrues. For example, salaries, rent, etc. But in case of certain expenditrues benefit extends beyond one accounting period. They are called capital expenditrues.

To exhibit a true and fair view of profitability and state of affairs, proper allocation of capital and revenue items is required. The revenue items are to be shown in the trading and profit and loss account and capital items are to be shown in the balance sheet.

11.2 Considerations in determining capital and revenue expenditures

The basic considerations to differentiate between capital and revenue expenditures are:

(i) Nature of business

Expenditure on purchase of goods is revenue expenditure. Expenditure on purchase of asset is capital expenditure. Whether an item of expenditure is goods or asset depends on the nature of business. Goods include articles or commodities in which the business is dealing with. For example, 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 very important criteria in classifying expenditure between capital and revenue.

(ii) Effect on revenue generating capacity of business

If expenditure helps to generate income or revenue in the current accounting period, it is revenue expenditure. On the other hand, if expenditure helps to generate revenue for more than one accounting period, it is capital expenditure.

(iii) Purpose of expenditure

If expenditure is incurred in the normal course of maintenance of an asset, it is revenue expenditure. On the other hand, if expenditure is incurred for major repair of an asset which increases its productive capacity, it is capital expenditure.

(iv) Materiality of the amount involved

Relative proportion of the amount involved is considered in distinguishing between revenue expenditure and capital expenditure. If the amount of expenditure is material, it is treated as capital expenditure even if the expenditure does not increase the productive capacity of the asset. On the other hand, when the amount of expenditure is immaterial, it is treated as revenue even if the benefit of the expenditure extends beyond one accounting period. For example cost of waste basket is treated as revenue expenditure.

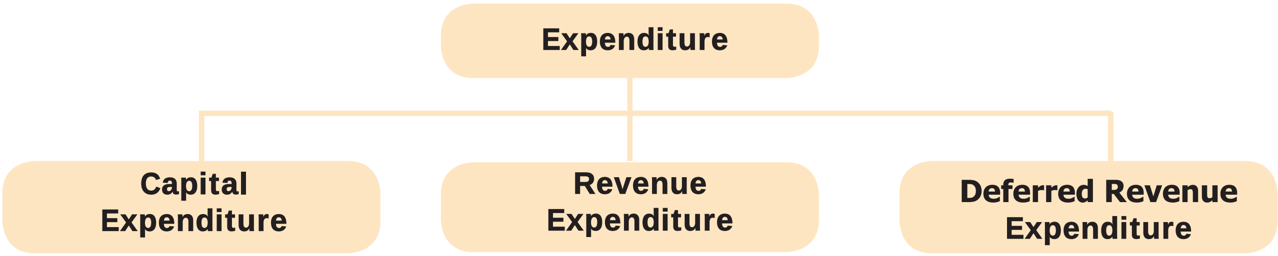
11.3 Classification of expenditure

Expenditures may be classified into the following three categories:

(i) Capital expenditure

(ii) Revenue expenditure

(iii) Deferred revenue expenditure.



11.4 Capital expenditure

It is an expenditure incurred during an accounting period, the benefits of which will be available for more than one accounting period. It includes any expenditure resulting in the acquisition of any fixed asset or contributes to the revenue earning capacity of the business. It is non- recurring in nature.

11.4.1 Features of capital expenditure

Following are the features of capital expenditure:

(i) It gives benefit for more than one accounting period.

(ii) It includes acquisition of fixed assets and all expenditure incurred upto the point an asset is ready for use.

(iii) It contributes to the revenue earning capacity of the business.

(iv) It is non-recurring in nature.

(v) It is shown on the assets side of the balance sheet.

Examples

- Cost of acquisition of land and building.
- Cost of acquisition of office equipment, computer and air-conditioner.
- Cost of acquisition of plant and machinery including installation charges and trial run.

11.5 Revenue expenditure

The expenditure incurred for day to day running of the business or for maintaining the earning capacity of the business is known as revenue expenditure. It is recurring in nature. It is incurred to generate revenue for a particular accounting period. The revenue expenditure may be incurred in relation with revenue or in relation with a particular accounting period. For example, cost of purchases is a revenue expenditure related to sales revenue. Rent and salaries are related to a particular accounting period.

11.5.1 Features of revenue expenditure

Following are the features of revenue expenditure:

(i) It is recurring in nature.

(ii) It is incurred for maintaining the earning capacity of the business.
(iii) Its benefit expires in the same accounting period.
(iv) It is shown on the debit side of the trading and profit and loss account.

Examples

- Purchase of goods for resale.
- Administrative, selling and distribution expenses.
- Manufacturing expenses.

Student activity

Think: Identify and list down capital and revenue expenditures at home and at school.

11.6 Deferred revenue expenditure

An expenditure, which is revenue expenditure in nature, the benefit of which is to be derived over a subsequent period or periods is known as deferred revenue expenditure. The benefit usually accrues for a period of two or more years. It is for the time being, deferred from being charged against income. It is charged against income over a period of certain years.

11.6.1 Features of deferred revenue expenditure

Following are the features of deferred revenue expenditure:

(a) It is a revenue expenditure, the benefit of which is to be derived over a subsequent period or periods.
(b) It is not fully written off in the year of actual expenditure. It is written off over a period of certain years.
(c) The balance available after writing off (i.e., Actual expenditure - Amount written off) is shown on the assets side balance sheet.

Examples

- Considerable amount spent on advertising
- Major repairs to plant and machinery

11.7 Comparison of capital, revenue and deferred revenue expenditure

Following are the points of comparison among capital, revenue and deferred revenue expenditure:

Basis	Capital expenditure	Revenue expenditure	Deferred revenue expenditure
i) Nature	It is non – recurring in nature.	It is recurring in nature.	It is non- recurring in nature.
ii) Purpose	To contribute to the revenue earning capacity of the business.	To carry on the day to day activities of the business.	To get benefit for certain years.
iii) Period of benefits	Its benefit is available for a longer period.	Its benefit is obtained within one accounting period.	Its benefit is available for more than one accounting period.

iv) Effect on profit earning capacity	It increases the profit earning capacity of the business.	It maintains the profit earning capacity of the business.	It is of benefit to the business for certain years.
v) Accounting treatment	It will appear on the assets side of the balance sheet.	It will be shown on the debit side of the trading and profit and loss account depending on whether direct or indirect in nature.	The amount written off during the year is shown on the debit side of profit and loss account and the unwritten off portion is shown on the asset side.

11.8 Capital and revenue receipts

Student activity

Think: A textile business sells some part of its unused land and receives the amount. Can it be considered as normal sale? Can it be shown in the trading account?

11.8.1 Capital receipt

Receipt which is not revenue in nature is called capital receipt. It is non-recurring in nature. The amount received is normally substantial. It is shown on the liabilities side of the balance sheet.

Examples

- Proceeds from issue of shares and debentures
- Long term loan raised from bank and other financial institutions
- Proceeds of sale of fixed assets
- Proceeds of sale of long-term investments
- Receipt of special donations

11.8.2 Revenue receipt

Receipts which are obtained in the normal course of business are called revenue receipts. It is recurring in nature. The amount received is generally small.

Examples

- Proceeds from sale of goods
- Interest on investments received
- Rent received
- Dividend from investment in shares.

11.9 Distinction between capital and revenue receipts

Following are the main differences between capital and revenue receipts:

Basis	Capital receipts	Revenue receipts
i) Nature	Non-recurring in nature.	Recurring in nature.
ii) Size	Amount is generally substantial.	Amount is generally smaller.
iii) Distribution	These amounts are not available for distribution as profits.	The excess of revenue receipts over the revenue expenses can be used for distribution as profits.

Examples of capital and revenue items

Capital expenditure	Revenue expenditure	Deferred revenue expenditure	Capital receipts	Revenue receipts
i) Purchase cost of fixed assets ii) Purchase cost of long term investments iii) Expenses to increase the earning capacity of fixed assets iv) Loan given to outsiders v) Cost of acquisition of goodwill, copyright, trademark, etc. vi) Installation expenditure of fixed assets vii) Expenses incurred for trial run of a machinery	i) Maintenance expenses of fixed assets ii) Insurance premium iii) Postage and stationery iv) Administrative, selling and distribution expenditure v)Advertisement expenditure, the benefit of which will accrue for one accounting period vi) Payment of honorarium vii) Annual subscription vii) Entertainment expenses	i) Heavy amount on advertisement. ii) Cost of major repairs on fixed assets	i) Life membership fees ii) Special donations received iii) Loan borrowed iv) Sale of fixed assets v) Contribution towards capital fund vi) Long term investment sold vii) Government grants. (specific purpose) viii) Amount received not in normal course of business	i) Sale proceeds of goods ii) Commission received iii) Sale of old news paper iv) Rent received v) Interest on investments vi) Government grants (general purpose) vii) Bad debts recovered

Illustration 1

State with reasons whether the following are capital or revenue expenditure:

(i) Expenses incurred in connection with obtaining a licence for starting the factory for ₹ 25,000.

(ii) A factory shed was constructed at a cost of ₹ 2,00,000. A sum of ₹ 10,000 had been incurred in the construction of temporary huts for storing building material.

(iii) Overhaul expenses of second-hand machinery purchased amounted to₹ 5,000.

Solution

(i) It is a capital expenditure since it is incurred to acquire the right to carry on business.

(ii) Cost of construction of building including cost of temporary huts is capital expenditure.

(iii) It is a capital expenditure because overhaul expenses are incurred to put second-hand machinery in working condition to get long-term advantage.

Illustration 2

State with reasons whether the following are capital or revenue or deferred revenue expenditure:

(i) Advertisement expenses amounted to ₹ 10 crores to introduce a new product.

(ii) Expenses on freight for purchasing new machinery.

(iii) Freight and insurance on the new machinery and cartage paid to bring the new machinery to the factory.

Solution

(i) The effect of heavy advertisement expenses will extend to more than one accounting period, but it does not create any property of tangible or intangible nature and hence it is deferred revenue expenditure.

(ii) It is a capital expenditure since it is incurred up to the point the machine is ready for use.

(iii) These are capital expenditures since they are incurred up to the point the machine is ready for use.

Illustration 3

State whether the following are capital, revenue or deferred revenue expenditure.

(i) Carriage of ₹ 1,000 spent on machinery purchased and installed.

(ii) Office rent paid ₹ 2,000.

(iii) Wages of ₹ 5,000 paid to machine operators.

(iv) Hire charges for the use of motor vehicle, hired for five years, but paid yearly.

Solution

(i) Carriage of ₹ 1,000 spent on machinery purchased and installed is capital expenditure.

(ii) Office rent paid ₹ 2,000 is revenue expenditure.

(iii) Wages of ₹ 5,000 paid to machine operators is revenue expenditure.

(iv) Hire charges for the use of motor vehicle, hired for five years, but paid yearly is revenue expenditure.

Illustration 4

State whether the following are capital or revenue items.

(i) ₹ 5,000 spent towards additions to buildings.

(ii) Second-hand motor car purchased for ₹30,000 and paid ₹2,000 as repairs immediately.

(iii) ₹ 10,000 was spent on painting the new factory.

(iv) Freight and cartage on the new machine ₹ 150, erection charges ₹ 200.

(v) ₹ 150 spent on repairs before using a second hand car purchased recently.

Solution

(i) ₹ 5,000 spent towards additions to buildings is capital expenditure.

(ii) The entire amount of ₹ 32,000 should be treated as capital expenditure.

(iii) ₹ 10,000 spent on painting the new factory should be treated as capital expenditure.

(iv) Freight, cartage and erection charges are capital expenditures.

(v) ₹ 150 being expense to bring the asset in usable condition, is a capital expenditure.

Illustration 5

Classify the following expenses as capital or revenue.

(i) The sum of ₹ 3,200 has been spent on a machine as follows:

a) ₹ 2,000 for additions to double the output.

b) ₹ 1,200 for repairs necessitated by negligence.

(ii) Overhauling expenses of ₹ 25,000 for the engine of a motor car to get better fuel efficiency.

Solution

(i) a) ₹ 2,000 spent on additions should be treated as capital expenditure

b) ₹ 1200 spent on repairs should be treated as revenue expenditure.

(ii) Overhauling expenses are incurred for the engine of a motor car to get better fuel efficiency. So this expenditure should be treated as capital expenditure.

Illustration 6

Classify the following expenditures and receipts as capital or revenue:

(i) ₹ 10,000 spent as travelling expenses of the directors on trips abroad for the purchase of fixed assets.

(ii) Amount received from trade receivables during the year.

(iii) Amount spent on demolition of building to construct a large 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.

Points to remember

- Expenditures of a business can be classified into capital, revenue and differred revenue expenditure.
- Capital expenditure is an expenditure incurred during an accounting period, the benefits of which will be available for more than one accounting period.
- Revenue expenditure is the expenditure incurred for day today running of the business or for maintaining the earning capacity of the business.
- Deferred revenue expenditure is expenditure of revenue nature incurred for getting benefits which extends to two or more years.
- Revenue receipts are incomes derived from the normal activities of the business. Capital receipts are derived from transactions that are not the usual activities of the business.

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Self–examination questions

I Multiple choice questions

Choose the correct answer

1. Amount spent on increasing the seating capacity in a cinema hall is

    (a) Capital expenditure (b) Revenue expenditure

    (c) Deferred revenue expenditure (d) None of the above.

2. Expenditure incurred ₹ 20,000 for trial run of a newly installed machinery will be

    (a) Preliminary expense (b) Revenue expenditure

    (c) Capital expenditure (d) Deferred revenue expenditure

3. Interest on bank deposits is

    (a) Capital receipt (b) Revenue receipt

    (c) Capital expenditures (d) Revenue expenditures

4. Amount received from IDBI as a medium term loan for augmenting working capital

    (a) Capital expenditures (b) Revenue expenditures

    (c) Revenue receipts (d) Capital receipt

5. Revenue expenditure is intended to benefit

    (a) Past period (b) Future period

    (c) Current period (d) Any period

6. Pre-operative expenses are

    (a) Revenue expenditure (b) Prepaid revenue expenditure

    (c) Deferred revenue expenditure (d) Capital expenditure

Answer

1 (a)	2 (c)	3 (b)	4 (d)	5 (c)	6 (d)

II Very short answer questions

1. What is meant by revenue expenditure?
2. What is capital expenditure?
3. What is capital profit?
4. Write a short note on revenue receipt.
5. What is meant by deferred revenue expenditure?

III Short answer questions

1. Distinguish between capital expenditure and revenue expenditure.
2. Distinguish between capital receipt and revenue receipt.
3. What is deferred revenue expenditure? Give two examples.

IV Exercises

1. State whether the following expenditures are capital, revenue or deferred revenue.
   (i) Advertising expenditure, the benefits of which will last for three years.
   (ii) Registration fees paid at the time of registration of a building.
   (iii) Expenditure incurred on repairs and whitewashing at the time of purchase of an old building in order to make it usable.

(**Answer**: Capital Expenditure: ii , iii Deferred revenue expenditure: i)

2. Classify the following items into capital and revenue.
   (i) Registration expenses incurred for the purchase of land.
   (ii) Repairing charges paid for remodelling the old building purchased.
   (iii) Carriage paid on goods purchased.
   (iv) Legal expenses paid for raising of loans

(**Answer**: Capital : i, ii, iv Revenue: iii)

3. State whether they are capital and revenue.
   (i) Construction of building ₹ 10,00,000.
   (ii) Repairs to furniture ₹ 50,000.
   (iii) White-washing the building ₹ 80,000
   (iv) Pulling down the old building and rebuilding ₹ 4,00,000

(**Answer**: Capital: i, iv. Revenue: ii, iii)

4. Classify the following items into capital and revenue.
   (i) ₹ 50,000 spent for railway siding.
   (ii) Loss on sale of old furniture
   (iii) Carriage paid on goods sold.

(**Answer**: Capital: i, Revenue: ii, iii)

5. State whether the following are capital, revenue and deferred revenue.
   (i) Legal fees paid to the lawyer for acquiring a land ₹ 20,000.
   (ii) Heavy advertising cost of ₹ 12,00,000 spent on introducing a new product.
   (iii) Renewal of factory licence ₹ 12,000.
   (iv) A sum of ₹ 4,000 was spent on painting the factory.

(**Answer**: Capital: i, Revenue: iii, iv Deferred revenue: ii)

6. Classify the following receipts into capital and revenue.
   (i) Sale proceeds of goods ₹ 75,000.
   (ii) Loan borrowed from bank ₹ 2,50,000
   (iii) Sale of investment ₹ 1,20,000.
   (iv) Commission received ₹ 30,000.
   (v) ₹ 1,400 wages paid in connection with the erection of new machinery.

(**Answer**: Capital: ii, iii, v Revenue: i, iv)

7. Identify the following items into capital or revenue.

(i) Audit fees paid ₹ 10,000.
(ii) Labour welfare expenses ₹ 5,000.
(iii) ₹ 2,000 paid for servicing the company vehicle.
(iv) Repair to furniture purchased second hand ₹ 3,000.
(v) Rent paid for the factory ₹ 12,000

(**Answer**: Capital: iv Revenue: i, ii, iii, v)

CASE STUDY

Sadhana decides to start a business of selling air-conditioners. She buys different brands of air-conditioners. She also buys a delivery van, some furniture and some tools to fix air-conditioners. She buys some stationery items and cleaning liquid. She spends some amount on advertising her shop. She records the entire amount spent in the trading account.

Now, discuss on the following points:

- Is it correct to record the entire amount spent in the first year of trading in the trading account? What impact will it have on the profit for the year?
- What are her fixed assets?
- Does she apply accounting concepts? If not which is the concept she does not apply?
- Can you help Sadhana to classify the expenditure?
- What other capital, revenue and deferred revenue expenditure her business may incur in the future?

To explore further

Do you think that the amount of the expenditure determines whether it is capital or revenue in nature? Justify.

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