CAPITAL AND REVENUE TRANSACTIONS

17

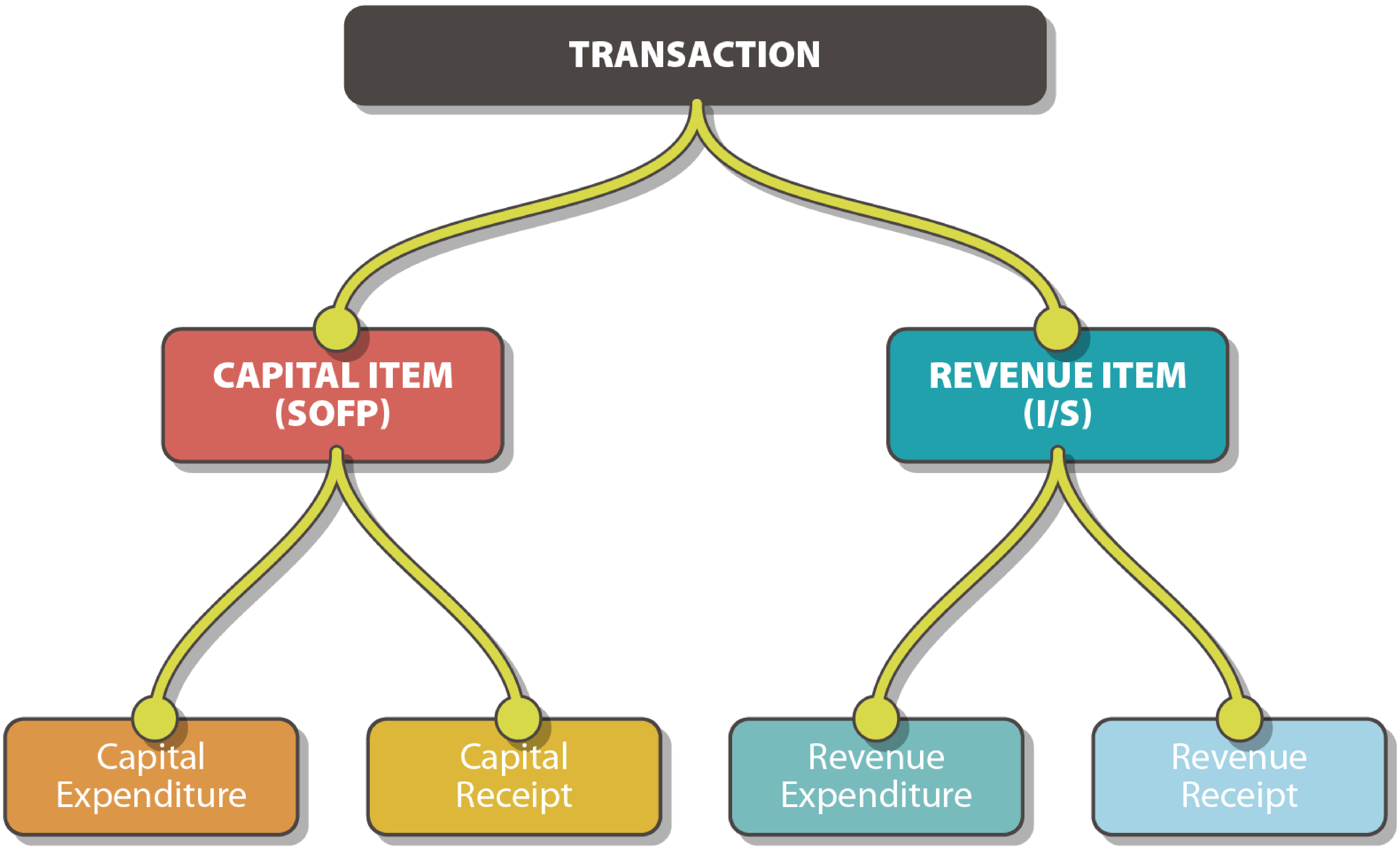
LEVEL OF CHAPTER

EASY

MEDIUM

HARD

Capital & Revenue Transactions



Transaction:

It is an event which involves transfer of money, goods and services and can be classified into cash or credit transactions. Cash transaction is the one where cash receipt or payment is involved and a credit transaction is one where cash is not involved immediately but will be paid or received later.

The main functions of accounting include the ascertainment of profit/loss for an accounting period and financial position as at the end of that period. The distinction between capital and revenue items is important both from the Income Statement (Profit and Loss Account) as well as the Position Statement (Balance Sheet) point of view.

For example, if a depreciable asset is purchased, the depreciation on that asset is charged to the Profit and Loss Account, and the written down value of the asset (or original cost of the asset less accumulated depreciation) is shown in the Balance Sheet. If the purchase of a depreciable asset, which is a capital expenditure, is treated as revenue expenditure it will understate the profit of the current year and overstate the profits of the subsequent years. Similarly, the Balance Sheet will not give a true and fair view of the assets and equity of the enterprise till the useful life of the asset is over assuming that the asset is not sold earlier.

Expenditure: It is the amount spent or liability incurred for acquiring assets, goods or services. These expenditures are further classified as follows:

Capital Expenditure

Expenditure that acquires a capital asset is capital expenditure. If it acquires stock-in-trade, then it is revenue expenditure.
A capital asset is one that is used in or for the purposes of the business and not meant for sale in the ordinary course of business of the enterprise.
Purchase of stock-in-trade is not capital expenditure as it is sold in the ordinary course of business.
Expenditure on the purchase and installation of machinery is a capital expenditure. Further when an expenditure is made with a view to bringing into existence an asset or advantage for the enduring benefit of trade is a capital expenditure in the absence of special circumstances leading to the opposite conclusion.

Asset or advantage of enduring nature means that it must not be fully consumed or used up in the accounting period in which it is incurred. Capital expenditure increases the earning capacity or reduces the operating expenses of a business.

According to Kohler the term capital expenditure is "generally restricted to expenditures that add fixed asset units or that have the effect of increasing the capacity, efficiency, life span, or economy of operation of an existing fixed asset."

The following are the examples of capital expenditure :

1. Expenditure incurred for acquisition of fixed tangible assets such as land, building, machinery, furniture, motor vehicle etc.

2. Expenditure incurred for improvement or extension of fixed assets such as increasing the seating capacity of a theatre.

3. Expenditure incurred to bring the fixed assets to the place of their use and expenditure incurred on their installation or erection such as freight on fixed assets, wages paid for installation.

4. Expenditure incurred for the purchase of intangible assets such as goodwill, patent rights, and trademarks, copyright, etc.

5. Expenditure incurred for reconditioning of old fixed assets such as expenditure incurred on repairing or overhaling of secondhand machinery.

6. Major repairs and replacement of plant which increase the efficiency of the plant.

7. The cost of shifting a plant to another place is a capital expenditure.

Treatment of Capital Expenditure.

Capital expenditure is capitalised. It is written off over the estimated useful life of the asset. For example, when machinery is purchased, Machinery Account is debited at the price paid for it and later shown in the Balance Sheet as an asset after deducting depreciation. Similarly, wages paid for the installation of machinery is capitalised by debiting the Machinery Account.

Rules for Determining Capital Expenditure.

The following are the rules for determining capital expenditure :

1. An expenditure is capital expenditure, if it is incurred for acquiring a long term asset (having a useful life of more than one year) for use in the business to earn revenue and not meant for sale.

2. An expenditure is capital expenditure, if it is incurred to put an asset into working condition. For example, the transportation and installation charges are added to the cost of machine. Similarly, the legal charges like registration and stamp duty is added to the cost of land and building. Again, architect fee paid for supervising construction of building is capitalised.

3. An expenditure incurred for putting an old asset into working condition is treated as capital expenditure and added to the cost of the asset.

4. An expenditure incurred to increase the earning capacity of a business is treated as capital expenditure. For example, expenditure incurred for shifting the factory to convenient site is a capital expenditure.

5. Borrowing costs (e., interest and other costs incurred by an enterprise in connection with the borrowing of funds) that are directly attributable to the acquisition, construction or production of a qualifying asset should be capitalised as part of the cost of that asset till the asset is ready for its intended use or sale as per AS-16 : Borrowing costs.

Revenue Expenditure

If an expenditure is made not for the purpose of bringing into existence any capital asset or advantage of enduring nature but for running the business or working it with a view to produce the profits is revenue expenditure. Such expenditure benefits the current period only. It is incurred to maintain the existing earning capacity of the business. For example, the amount spent on purchase of stock-in-trade is of revenue nature. Administrative expenses and selling and distribution expenses are other examples of revenue expenditure.

Rules for Determining Revenue Expenditure.

The following are the rules for determining revenue expenditure :

1. An expenditure incurred for the purpose of acquiring goods purchased for resale, consumable items, etc. is a revenue expenditure. For example, purchase of raw material in the case of manufacturing unit and purchase of merchandise meant for the purpose of resale. At the end of the year, closing stock and opening stock of these items adjusted to match cost with revenue for calculating profit.
2. Expenditures incurred on other direct expenses, e., expenses on production and purchase of goods such as wages, power, freight etc. are revenue expenditure.
3. Expenditure incurred for maintaining fixed assets in working order is revenue expenditure. For example, amount spent on repairs and renewals is revenue expenditure.
4. Depreciation on fixed assets is revenue expenditure.
5. Expenditures incurred on office and administrative and selling and distribution departments (not covered above) in the normal course of business are revenue expenditures. These include salaries, rent, telephone expenses, electricity, postage, advertisement, travelling expenses, commission to salesmen.
6. Expenditures incurred on non-operating expenses and losses are revenue expenditures. For example, interest on loan taken after commencement of commercial production, loss on sale of a long term asset, loss by theft, loss by fire are revenue expenditures.
7. Expenditure incurred by an enterprise to discharge itself from recurring liability is of revenue nature. For example, a lump sum amount paid to a pensioner by the employer is revenue expenditure.
8. Expenditure incurred for protecting the business is a revenue expenditure. For example, the amount spent on propaganda campaign to oppose the threatened nationalisation of industry is of revenue nature.
9. Expenditure incurred to maintain the existing efficiency or the earning capacity is of revenue type.

Deferred Revenue Expenditure

Deferred revenue expenditure is a revenue expenditure by nature but it is not treated as revenue expenditure on the ground that its benefit is not fully exhausted in the accounting period in which it is incurred. The Guidance Note on 'Terms used in Financial Statement', issued by the Institute of Chartered Accountant of India, states that "Deferred revenue expenditure is that expenditure for which payment has been made or a liability incurred but which is carried forward on the presumption that it will benefit over a subsequent period or periods."

Deferred revenue expenditure is, for the time being, deferred from being charged against revenue. The unwritten off portion of the deferred revenue expenditure is shown on the asset side of the Balance Sheet. A portion of the total deferred revenue expenditure is charged as revenue expenditure. Deferred revenue expenditure should be written off over a certain number of years.

- **AS-26 "Intangible Assets" has diluted the concept of deferred revenue expenditure. According to it, if expenditure is incurred to provide future economic benefits to an enterprise, but no intangible asset or other asset is acquired that can be recognised, then expenditure should be recognised when it is incurred. For example, preliminary expenses in establishing a legal entity, expenditure on training activities and expenditure on relocating or reorganising an enterprise, expenditure on launching of new products, expenditure on advertising and promotional activities should be recognised as expenses in the year in which these are incurred. However, share issue expenses and discount on issue of shares/debentures can be written off over a certain number of years.**

Deferred revenue expenditure should be distinguished from prepaid expenses. In case of deferred revenue expenditure the benefits available cannot be precisely estimated but in case of prepaid expenses, like payment of insurance in advance, benefits available can be precisely estimated. In case of prepaid insurance, insurance protection will be available for a definite period after close of the financial year.

Capital and Revenue Receipts

The distinction between capital receipt and revenue receipt is important because capital receipt is taken to the Balance Sheet and revenue receipt is taken to the Trading and Profit and Loss Account.

Capital receipts are the receipts which are not obtained in course of normal business activities of the enterprise. The examples of capital receipts are :
1. **capital contributed by the owner(s),**
2. **secured or unsecured loans taken,**
3. **receipts from sale of fixed assets and non-current investments.**

In case of not for profit organisation, legacy and life membership are capital receipts.
Revenue receipts are the receipts which are obtained in course of normal business activities. They include proceeds from sale of goods, fee received from the services rendered in the ordinary course of business, receipts.
The nature of receipt is decided from the point of view of the person receiving it.

The following broad principles may be laid down as guide for determining whether a particular receipt is of capital nature or of revenue nature :

1. **A receipt on account of fixed assets is a capital receipt whereas a receipt on account of current assets or circulating capital is a revenue receipt. For example, sale proceeds from sale of fixed assets is a capital receipt while proceeds from sale of stock-in-trade is a revenue receipt. Capital profit from sale of fixed asset is to be shown in Profit and Loss Accounts.**

2. A receipt in substitution of source of income is a capital receipt whereas a receipt in substitution of income alone is a revenue receipt. For example, compensation for loss of employment or agency is a capital receipt (though taxable) whereas damages for breach of business contract is a revenue receipt.

3. An amount received for surrender of certain right under an agreement is a capital receipt whereas amount received by way of compensation of loss of future profits is a revenue receipt. For example, pension is a revenue receipt whereas lump sum received in commutation of pension is a capital receipt (though taxable).

4. The nature of a receipt is determined exclusively by its character in the hands of the receiver.

5. Where an asset is held as an investment, the sale proceeds of such asset is a capital receipt. But where an asset is held as stock-in-trade, the sale proceeds of such asset is a revenue receipt. For example, profit on sale of shares to a dealer in shares is a revenue receipt.