Chapter 2F

Accounting Process – Capital vs Revenue Distinction

CHAPTER OVERVIEW

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- ***While recording transactions, it is essential to differentiate between capital and revenue transactions. Because, the nature of transaction has a bearing on the profits / losses of the entity. Capital transactions do not directly affect the profit, whereas revenue transactions have a direct impact on profits.***
- ***Classification of Revenue vs Capital Expenditure is based on the facts of case and cannot be generalized.***
- ***Students are advised not to confuse the term "Capital" used in this Chapter with the "Capital" brought in by the Owner.***

GLOSSARY OF SIGNIFICANT TERMS USED

Term	Meaning
Recurring	If a transaction regularly happens, it is referred as "Recurring Transaction", e.g. Rent paid every month
Non–Recurring	Transactions which are not expected to occur regularly are called "Non Recurring Transactions", e.g. Purchase of Building, Losses due to fire / accidents, etc.

1.1 Capital Expenditure vs Revenue Expenditure

Particulars	Capital Expenditure	Revenue Expenditure
1. **Meaning**	It is an expenditure incurred for the purpose of – (a) Purchase / Creation / Improvement of Fixed Assets or (b) Expenses necessary for the above purchase / Creation (c) Increasing the earning capacity of the business.	It is an expenditure, the benefit of which is **immediately (normally within one year) exhausted** in the process of earning revenue.
2. **Purpose**	(a) Acquiring Fixed Assets, which are held not for resale, but for use with a view to earn profits. (b) Making additions to the existing Fixed Assets. (c) Increasing earning capacity of the business by improved facilities and equipments. (d) Reducing the cost of production. (e) Acquiring benefit of enduring nature or valuable right.	(a) Actual day–to–day running of the business, (b) Maintaining the capital assets in an efficient manner. (c) Cost of Material & Stores (d) Salary and Wages of employees, (e) Administrative Exp. Like Stationery, Rent, Telephone and Insurance.
3. **Treatment in Fin. Stmts**	• Capital Expenditure is **displayed as asset** in Balance Sheet. Only depreciation portion is debited to P&L A/c. • It is **NOT directly reduced** from Incomes.	• Expenditure is charged fully in the Profit and Loss Account. • It is **fully REDUCED** from income

Particulars	Capital Expenditure	Revenue Expenditure
4. **Wrong treatment**	If wrongly treated as revenue, profits will be **understated or reduced.**	If wrongly capitalized, profits will be **inflated or overstated.**
5. **Matching**	Capital Expenditure is **not matched** with Capital Receipts.	Revenue Expenditure is matched with Revenue Receipts.
6. **Time of incurrence**	Capital Expenditure may be incurred before or after the commencement of the business.	It is incurred after the commencement of the business.
7. **Recurring Nature**	Normally Capital Expenditure is generally non–recurring in nature. However, certain Capital Expenditure is required once in 2–5 years, e.g. modernization of Machinery, etc.	Revenue Expenditure is of recurring / repetitive nature. It is incurred every year by the business.
8. **Interest on borrowing**	If Interest on Borrowings is payable for the period prior to the commencement of the Business / Production	If interest on borrowings is payable for the period on or after commencement of business / production
Note: Amount involved in a transaction is not relevant for Capital vs Revenue distinction. Hence, even a transaction involving a huge amount say ₹ 5 Crores, may be considered as Revenue Expenditure.		

1.2 Deferred Revenue Expenditure

Particulars	Deferred Revenue Expenditure
1. **Meaning**	It is an expenditure **primarily of revenue nature**, but the benefit whereof extends to periods more than the year of incurrence.
2. **Inclusion**	It also includes expenditure which gives benefits for 2 / 3 years, but does not result in creation or improvement of Fixed Assets. **Example:** Shifting of business from one location to a convenient location. This results in increase in benefits for many years, but do not result in creation of any Fixed Asset.
3. **Examples**	(a) Expenditure on an Advertisement Campaign to introduce a product in the market, (b) Discount allowed on issue of Debentures, (c) Development Expenses in the case of Mines and Plantations. (d) Cost of construction / extension to a leased building (Since the building has to be returned after the lease period is over, its benefits are for only a limited period.)
4. **Time**	Benefit of such expenditure relates to many years, i.e. relating to the future period.
5. **Treatment**	Even if the benefits from these Expenditures arise over a period of 2 or 3 years, in accordance with applicable Accounting Standards, these Expenditures are **fully written off** in P&L n the year of incurrence. They are **not "Assets"** and hence should not be carried forward. **[Note: Hence, the concept of "Deferral" of Revenue Expenditure is no longer relevant.]**

Notes:

- **DRE ≠ Losses or Exceptional Items:** Exceptional losses suffered due to natural calamity, political or other social disturbances, etc. are **not** Deferred Revenue Expenditures. They constitute **"Losses"** / **"Exceptional Items"**, since there is no corresponding benefit, either current or future.
- **DRE ≠ Prepaid Expenses:** The benefits available from Prepaid Expenses can be precisely estimated (e.g. Prepaid Insurance), but such precise estimation is **not** possible in the case of Deferred Revenue Expenditure (e.g. substantial Advertisement Campaign).

1.3 Capital Expenditure vs Deferred Revenue Expenditure

Particulars	Capital Expenditure	Deferred Revenue Expenditure
1. **Meaning**	It is an expenditure incurred for the purpose of – (a) acquiring, extending or improving assets of a permanent nature for carrying on the business, or (b) increasing the earning capacity of the business.	It is an expenditure primarily of revenue nature, but the benefit whereof extends to periods more than the year of incurrence.
2. **Treatment**	Asset is displayed in the Balance Sheet. Only Depreciation portion thereon is debited to P&L A/c.	These Expenditures are fully written off in P&L in the year of incurrence. They are not "Assets" and hence should not be carried forward.
3. **Example**	Purchase of Factory Building for use in the business	Substantial Advertisement Expenditure.

1.4 Criteria / Considerations for Capital vs Revenue

Whether an expenditure is Capital or Revenue in nature, depends upon the following factors –

Factor	Capital Expenditure if	Revenue Expenditure if ....
1. Nature of Business	Expenditure relates to purchase of a Fixed Asset (e.g. Land purchased by a Manufacturing Firm).	Expenditure relates to purchase of a Current Asset (e.g. Land purchased by a Construction Company).
2. Recurring Nature	Expenditure is incurred infrequently, or once in 2–5 years (e.g. purchase of assets.)	Expenditure is incurred frequently / regularly, in the normal course of business (e.g. Salary, Rent, etc.)
3. Purpose of Expenses	Expenditure is for acquiring / creating capital assets or increasing their productive capacity.	Expenditure is for maintaining the capital assets in an efficient manner.
4. Period of Benefit	Expenditure helps to generate revenue over more than one accounting period	Expenditure helps to generate income / revenue in the current period only.
5. Materiality	Expenditure is material / significant.	Expenditure is not material, i.e. insignificant.

1.5 Examples for Capital and Revenue Expenditures

Capital Expenditure	Revenue Expenditure
1. Purchase of Fixed Asset (Land, Building, etc.) 2. Purchase of Second–hand Asset (e.g. Vehicle, Furniture, etc.) 3. Overhaul Expenses to put second–hand machinery in working condition. 4. Repairing & Painting of Old Building purchased recently by the Firm. 5. Expenditure incurred to reduce working expenses / operating expenses. 6. Legal Fee paid to acquire new property. 7. Licence Fee paid by Cinema Theatre to commence its business. 8. Cost of constructing Temporary Huts which were necessary for Factory Building Construction, which were demolished when the Factory was ready.	1. Expenditure for replacement of worn–out part of an existing asset. 2. Regular Advertisement Expenses in respect of products and services. 3. Expenditure on removal of stock to new site. 4. Legal Fees incurred to file suit against a Customer from whom money is due.

1.6 Capital vs Revenue Receipts

Particulars	Capital Receipt	Revenue Receipt
1. **Meaning**	Capital Receipts refer to receipts other than Revenue Receipts.	Revenue Receipts are moneys received in the course of normal business activities, and are recurring in nature.
2. **Example**	Capital contribution by Owner, Issue of Shares / Debentures, Sale Proceeds of Fixed Assets, etc.	Sales, Interest and Other Income Received, Bad Debts Recovered, etc.
3. **Purpose**	Capital Receipts relate to specific purpose, e.g. Capital Contribution for commencing business or expanding business, Loans taken for acquiring Fixed Assets, etc.	Revenue Receipts relate to general business purpose, and are not specifically identifiable to any purpose as such.
4. **Effect on Profit**	Capital Receipts do not affect profit.	Revenue Receipts have a direct impact on the profits.
5. **Disclosure**	They are shown as Liability or Reduction from the Asset in the Balance Sheet.	They are shown on the Credit Side of the Profit and Loss Account.
6. **Matching**	Capital Receipts are **not** matched with Capital Expenditure, in all cases.	Revenue Receipts is generally matched with Revenue Expenditure.

1. **Revenue Receipts ≠ Cash Receipts.** "Revenue Receipts" refers to Total Income in the period (e.g. Total Sales on Cash & Credit) while "Cash Receipts" refers to Cash Collections (i.e. Cash Sales + Collection from Debtors) in the period.
2. **Deposit of Money with other persons ≠ Expenditure:**
   - **Deposit of money** is **not considered as an expenditure** as the money is just kept with another person and it is to be recovered from that person.
   - Expenditure refers to the amount spent to earn benefit. Deposit is **not considered as amount spent**

1.7 Capital vs Revenue Profits

Particulars	Capital Profits	Revenue Profits
1. **Meaning**	Profits arising on issue / repayment of capital, borrowings or sale of fixed assets	Profits arising out of the regular operations of the business
2. **Examples**	(a) Premium on issue of shares / debentures (b) Discount on redemption of shares (c) Profits on sale of Fixed Assets (exceeding cost)	(a) Profits arising out of normal trading operations (b) Profits on sale of Fixed Assets (exceeding Book Value but less than cost)
3. **Treatment**	Taken to **Capital Reserve or under any other head** in Balance Sheet (unless realized in cash)	Revenue Profits taken to **Profit & Loss Account**

1.8 Capital vs Revenue Losses

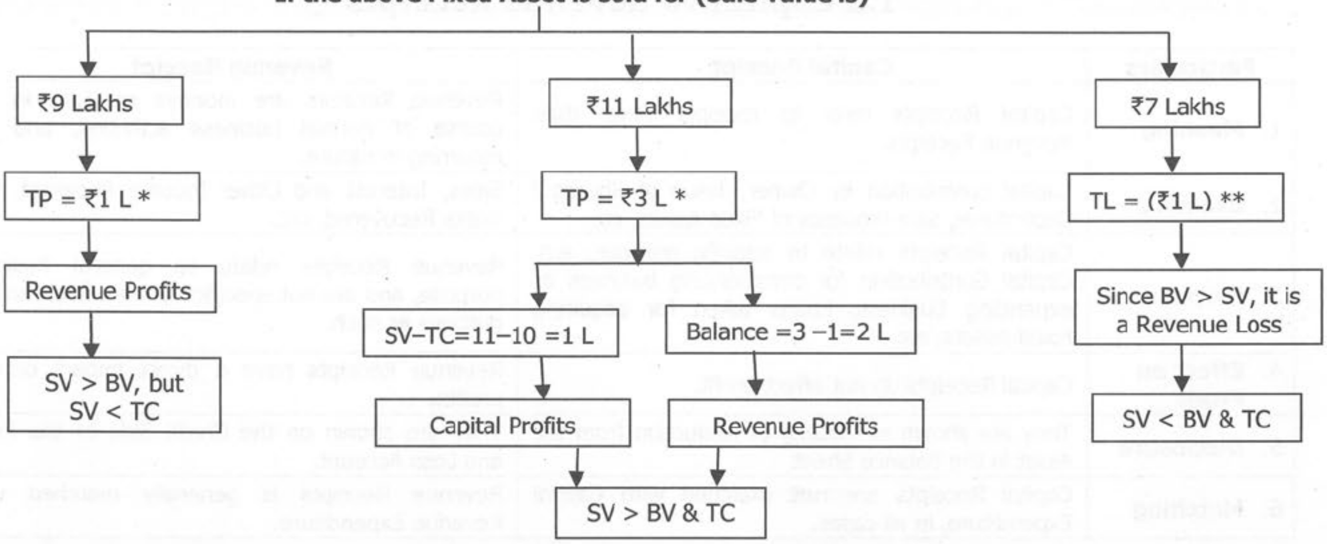
Particulars	Capital Losses	Revenue Losses
1. **Meaning**	Loss on issue / repayment of capital, borrowings, Loss of Fixed Assets due to fire / accidents	Losses arising out of the regular operations of the business
2. **Examples**	(a) Discount on issue of shares / debentures (b) Premium on redemption of shares (c) Loss of Fixed Assets	(a) Losses on normal trading operations (b) Bad Debts (c) Losses on sale of Fixed Assets (S.V. < B.V.)
3. **Treatment**	**Taken to Profit and Loss Account.** However, a specific note shall be given that the profits / losses are arrived after considering the capital loss	**Taken to Profit and Loss Account.**

Profits / Losses on Sale of a Fixed Asset – Capital vs Revenue Profits:

Consider the following question for treatment of Profits / Losses on sale of a Fixed Asset. For the meaning of the terms used herein, Students are advised to refer chapter on "Depreciation"

Cost of Fixed Asset – Purchase Value	₹10,00,000
Book Value of Fixed Asset	₹8,00,000

If the above Fixed Asset is sold for (Sale Value is)



Notes:

1. SV = Sale Value; TC = Total Cost; BV = Book Value (TC less depreciation), TP = Total Profits.
2. **Profit / Losses = SV – BV**; If SV > BV = Profits; If SV < BV = Losses
3. If **SV > TC**, then Capital Profits = SV – TC and Revenue Profits = Balance amount
4. If **SV < TC**, but SV > BV, then **Revenue Profits alone** = SV – BV (No Capital Profits)
5. If **SV < TC and SV < BV**, then Revenue losses = BV – SV (No Capital Losses)

State with reasons, whether the following statements are True or False

Statements	T/F	Reasoning
1. Pre–operative expenses are Revenue Expenses.	False	Pre–Operative Expenses are incurred prior to commercial production and are generally capitalized.
2. Expense incurred to keep the Machine in working condition is a Capital Expenditure.	False	It is a Revenue Expenditure as it is not increasing the benefits but only keeping the Machine in working condition.
3. An expenditure intended to benefit the current period is a Revenue Expenditure.	True	Revenue Expenditure is that expenditure the benefit of which does not extend beyond the current accounting period.
4. Amounts written off from the Cost of Fixed Assets is Capital Expenditure.	False	Amount written off from the Cost of Fixed Assets is treated as Revenue Expenditure and charged to Profit and Loss account. **Example:** Depreciation.
5. Wages paid to Workers to produce a tool to be captively consumed is Capital Expenditure.	True	Wages paid to workers for the creation of an Asset to be used in the business is Capital Expenditure.
6. Expenditure which result in acquisition of a permanent asset is a Capital Expenditure.	True	Such Expenditure is a Capital Expenditure since it will generate enduring benefits and help in Revenue Generation over more than one accounting period.
7. Amount paid for acquiring Goodwill is Deferred Revenue Expenditure.	False	Amount paid for acquiring Goodwill is Capital Expenditure since it involves acquisition of an Intangible Asset which is classified as Fixed Asset.
8. Overhaul Expenses of a second–hand Machinery purchased are Revenue Expenditure.	False	Overhaul Expenses are incurred to put a second–hand Machinery in good/working condition to derive long term benefits of enduring nature. So, it is a Capital Expenditure.
9. Amount spent for replacement of worn–out parts of a Machine is a Capital Expenditure.	False	Such Expenditure is Revenue Expenditure, since it is part of its Maintenance Cost.
10. Expenditure incurred on white washing of Factory Building done after every six months is Revenue Expenditure.	True	These expenses are incurred in the course of normal maintenance of the Asset and are, therefore Revenue Expenditure.
11. Temporary Shed put up at Project Site to Store materials is a Capital Expenditure.	True	Temporary Shed is incidental to the main Construction and the Expenditure on it, is a part of Construction Cost. Therefore, it is a Capital Expenditure.
12. Legal Fees paid to acquire a Property is Capital Expenditure.	True	Legal Fees paid to acquire a Property is a part of the Cost of that Property. Hence, it is taken as Capital Expenditure.
13. Expenditure on Renovation of a Theatre which has increased the seating capacity by 10% is Deferred Revenue Expenditure.	False	It is a Capital Expenditure, since it has contributed to the Revenue Earning Capacity of the business over more than one accounting period.
14. 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. **[M 19]**	True	Temporary Huts is incidental to the main Construction and the Expenditure on it, is a part of Construction Cost. Therefore, it is a Capital Expenditure.
15. Overhauling Expenses for the Engine of Motor Car to get better fuel efficiency is Revenue Expenditure. **[N 18]**	False	**Refer Principles in Page 2.61, Para 1.4** **Hint:** Since Efficiency of the Asset is increased, it is Capital Expenditure.
16. Fees received for Life Membership is a Revenue Receipt as it is of recurring nature. **[N 18]**	False	**Refer Principles in Page 2.61, Para 1.4** **Hint:** It is of Non–recurring nature and hence, it is Capital Receipt.

Statements	T/F	Reasoning
17. M/s. XYZ & Co. runs a café. They renovated some of the old cabins. Because of this renovation some space was made free and number of cabins was increased from 15 to 18. The total expenditure incurred was ₹ 30,000 and was treated as a revenue expenditure. **[N19]**	False	It is a Capital Expenditure, since it has contributed to the Revenue Earning Capacity of the business over more than one accounting period.