Lesson 14
CAPITAL AND REVENUE EXPENDITURE

14.1 Capital & Revenue Expenditure

It is Very important to know and understanding the distinction between “capital” and “revenue”. It is important because after the trial balance is prepared. The final account can be prepared. The final account can be prepared in such a way that all the account is appearing in the trial balance are either transferred to the “P and L” account or “Balance Sheet”.

Generally, all the nominal accounts or revenue accounts are transferred to the P and L account, while all the real and personal accounts (capital accounts) are to transfer to balance sheet. Here one point arises which cause a lot of importance- it is whenever an expenditure is incurred, it may be treated as an expense (and transferred to as an asset(transferred to balance sheet)

The correct identification of revenue expenditure and capital expenditure is very necessary because wrong allocation of a revenue item to capital item (and vice versa) can create wrong financial statements.

For example a computer is purchased for Rs. 40,000 and is debited to office expenses and transferred to P and L account, instead of debiting it to an appropriate computer account and transferred computer account to the balance sheet as an asset(capital expenditure). It is clearly an error of principle, how a “capital expenditure” item is wrongly treated as “revenue expenditure”. It leads to incorrect P and L account and incorrect balance sheet.

14.2 Capital Expenditure

It is an expenditure which provides benefits to the company for several future years (or several future accounting periods).

Generally, capital expenditure refers to expenditure involving purchase of plant, machinery, assets, land, vehicles, patents, copy rights etc whose benefits are received for more than one year by the firm.

Expenditure may be identified as a capital expenditure →

1. Expenditure incurred for fixed assets land, building, plant, machinery, cost of installation of lights, fans, cost of erection of plant and machinery.
2. When expenditure, incurred in one year, gives benefit for a number of accounting years.
3. When expenditure is incurred to increase the earning capacity of a business.

4. When expenditure is incurred to improve the present condition of a machine or putting an old asset into working condition.
5. All preliminary expenses incurred before the commencement of the business.
6. Expenditure for the extension of improvement in fixed assets. If due to such expenditure the profit earning capacity of firm increases, the expenditure should be capitalized.
7. Any expenditure which have the effect of increasing "fixed assets" of the company or which have the effect of increasing the capacity, efficiency, life span or economy of operation of an existing fixed assets.

Examples of Capital Expenditure

1. Cost of land, building, plant and machinery.
2. Cost of manufacture, purchase of furniture etc.
3. Purchase of vehicle, cars, vans etc.
4. Cost of good will, trademark, copyrights etc.
5. Preliminary expenses.

14.3 Revenue Expenditure

Revenue expenditure is that expenditure which is not a capital expenditure. According to Kohler "it is an expenditure charged against operation; a term used to contrast with capital expenditure". Revenue expenditure is incurred in the current period or in one period of account. The benefit of the revenue expenditure is utilized in that period itself. Revenue expenditure is incurred for the following purpose:

a) All establishment and other expenses incurred in the normal course of business. For instance, administration expenses of a business, expenses incurred in manufacturing and selling products.
b) Expenses incidental to the carrying of a business, the benefit of which is consumed within the accounting period. For instance, Rent, Wages, Salaries, Advertising, Taxes, Insurance etc.
c) Expenditure on goods purchased for resale. For instance, cost of goods purchased or cost of raw materials etc.
d) For maintaining fixed assets in working order. For instance, repairs, renewals and replacement of existing assets, depreciation etc.

These revenue expenditure items appear in Trading and Profit and Loss Account.

Items of Revenue Expenditure

1. Expenditure on rent, wages, carriage, salaries, postage, insurance, advertising etc.
2. Interest on loan borrowed for running business.
3. Cost of goods bought for resale.
4. Cost of raw materials consumed in the course of manufacturing.

5. Expenses incurred for maintenance of various assets by way of repairs, renewals and replacement on building, plant, machinery, tools, fixtures, van, car etc. To keep them in the good condition.
6. Depreciation of fixed assets.
7. Taxes and legal expenses.
8. Loss arising from sale of fixed assets.
9. Maintenances of lights and fans.
10. All expenses incurred in the manufacturing and distribution of the products handled.
11. Wages paid for sale of goods.
12. Loss of goods by fire or other reasons.
13. Discounts and allowances.

14.4. Definitions of Depreciation

“Depreciation may be defined as the permanent decrease in the value of an asset through wear and tear in use or the passage of time.”

“The Primary meaning of the word depreciation is loss of the value through wear and tear or some other form of material deterioration. The secondary sense of depreciation is the operation of adjusting the book values of assets. As the machines or other assets get old, it is the practice of the Accountant to reduce their values in the books of accounts and it is usual to call this as depreciation.”

Depreciation is an expense or loss involved in using machinery, motor vehicles, tools and other fixed assets in the process of production and has to be provided for; this is done estimating the amount to be written off the value of a particular asset each year and setting this amount against the profits for that year.”

14.5 Causes of Depreciation

1. Wear and Tear

Some assets physically deteriorate due to wear and tear in use. When an asset is constantly used for production, the asset wears out. More and more use of an asset, the greater would be the wear and tear. Physical deterioration of an asset is caused from movement, strain, friction, erosion, etc. For instance, building, machineries, furniture, vehicles, plant etc. The wear is general but primary cause of depreciation.

2. Lapse of time

There are certain assets like leasehold property, patents, copy-right etc. That are acquired for a particular period. After expire of the period, they are rendered useless i.e. their value ceases to exist. Thus their cost is written off over their legal life.

3. Obsolescence

Appearance of new and improved machines results in discarding of old machines. Thus New inventions, change in fashion and taste, market condition, Government policies etc., are the causes to discard the value of an asset. But this is not the cause of depreciation and not depreciation in the real sense. A new machine performs the same function more quickly and cheaply than the existing machine. As such, existing machine may become out of date or outmoded or obsolete.

4. Exhaustion

Some assets are of wasting nature. For instance, quarries, mines, oil-well etc. It is reduction in the value of natural deposits as resource, have been extracted year after year. As such these assets are known as wasting sheets. The coalmine or oil well gets physically exhausted by the removal of its content.

5. Non-use

Machines which are idly lying, becomes less useful with the passage of time. Certain types of machines exposed to weather conditions, may have more depreciation from not using it then from its use.

6. Non-Maintenance

A good maintenance of machines will naturally increase its life. When there is no maintenance, there is more depreciated value. When there is good maintenance, there is longer life to the machines. The long life of machine depends upon good and skilled maintenance.

7. Market Trend

The market price may fluctuate in case of certain assets, for instance, investments in gilt-edged securities. When the prices go down, the concerned assets may depreciate its value. In certain cases, accident causes diminution in the value of assets.

14.6 Need for Depreciation

Depreciation is provided for the assets with a view to achieve the following results:

1. To ascertain the true Working Result

Asset is an important tool on earning revenues. Huge amount are spent for acquisition of assets which are worn out in the process of earning income. Thus, the assets get depreciated in their values, over a period of time due to many reasons explained above. When the values of assets decreases, this loss must be brought into account; otherwise a true working result cannot be considered in arriving the true profit earned during each year.

The basic need of depreciation is to ascertain the true income. If depreciation is ignored, the loss that is occurred on respect of fixed assets will be ignored. So, depreciation should be debited to profit and loss account before profit is ascertained.

2. To Ascertain the True Value of Asset

The function of Balance sheet is to show the true and correct view of the state of affairs of a business. If no depreciation is charged and when assets are shown at the original cost year after year, Balance Sheet will not disclose the correct state or affairs of a business.

3. To Retain Funds for Replacement

Assets used in the business need replacement after expiry of their service. It is always not possible to determine the useful life of assets. But, in certain cases, machine often becomes, obsolete long before it wears out because of rapid changes in tastes and technology. It is permanent loss in value of asset. When an asset is continuously used, a time will come when the asset is to be given up and hence its replacement is essential. Therefore, if no depreciation is charged against the profit, during the life time of the asset, it will be very difficult to find cash to replace the asset and if replaced it may cripple resources. Therefore, it is necessary to make provision and create funds to replace such assets, in proper time.

4. To Reduce Tax Liability

Depreciation is a tax deductible expenses. As such, it is permitted by the prevailing taxation laws to be deducted from profit. Consequently, the owner of a business may avail himself of this benefit by charging depreciation to his profit and reducing his tax liability.

5. To present True Position

Financial Position can be studied from the Balance Sheet and for the preparation of the Balance sheet fixed assets are required to be shown at their true value. If assets are shown in the Balance Sheet without any charge made for their use, (that is, depreciation) then their value must have been overstated in the Balance sheet and will not reflect the true financial position of the business. Therefore, for the purpose of reflecting true financial position, it is necessary that depreciation must be deducted from the asset and then at such reduced value may be shown in the Balance sheet.

If depreciation is not accounted for, the profit of the company is overstated, in turn; it is distributed among the shareholders. Thus there is no provision for replacement machine. It must be pointed out that depreciation by itself does not create funds; it merely draws attention to the fact that out of gross revenue receipts a certain amount should be retained to replace the asset used for carrying on activities. The companies Act of 1956 now makes it compulsory to write off depreciation on fixed assets before declaring dividend.

14.7 Consequences of not Providing for Depreciation

If depreciation is not provided for, the Income Statement and Balance Sheet will not exhibit a true or fair View of the business. Ultimately, it affects the following:

1. Profit will be overstated.
2. Capital employed will be incorrect.
3. Valuation of assets will be understated.
4. Cost of production will be understated.
5. Periodic expenses will be understated.
6. Capital depletion will take place.
7. Net worth will be overstated.

8. Correct sale price of price of products cannot be fixed.
9. No provision for replacement of assets.
10. A true working result cannot be known.

Illustration:

Bright paints company purchased a machinery on 1st January 2000 for Rs. 2000. The rate of depreciation for the machinery is 10% per annum. On 1st July 2002 the machinery was sold for Rs. 1200/-. Prepare the machinery account.

First method

Dr. MACHINERY ACCOUNT Cr.							
Year 2000			**Rs.**	**Year 2000**			**Rs.**
Jan-01	To Bank Account		2000	Dec-31	By Depreciation Account 10 % on Rs. 2000		200
				Dec-31	By Balance c/d		1800
			2000				2000
2001				**2001**			
Jan-01	To Balance b/d		1800	Dec-31	By Depreciation Account 10 % on Rs. 2000		200
				Dec-31	By Balance c/d		1600
			1800				1800
2002				**2002**			
Jan-01	To Balance b/d		1600	Jul-01	By Depreciation Account for 6 months		100
				Jul-01	By Bank Account		1200
				Jul-01	By Profit and Loss Account--loss written off		300
			1600				1600

Second method

If a machinery account and a provision for depreciation account are maintained then the solution is as shown below

YEAR				**YEAR**			
2000			Rs.	2000			Rs.
Jan-01	To Bank Account		2000	Dec-31	By balance c/d		2000
2001				2001			
Jan-01	To Balance b/d		2000	Dec-31	By balance c/d		2000
2002				2002			
Jan-01	To Balance b/d		2000	Jul-01	By provision for depreciation account		500
				Jul-01	By bank a/c		1200
				Jul-01	By profit and loss a/c		300
			2000				2000

Provision for Depreciation account

Dr. Cr.

YEAR				**YEAR**			
2000			Rs.	2000			Rs.
Dec-31	To Balance c/d		200	Dec-31	By depreciation a/c @ 10% of Rs.2000		200
2001				2001			
Dec-31	To Balance c/d		400	Jan-01	To Balance b/d		200
				Dec-31	By balance c/d		200
2002				2002			
				Jan-01	To Balance b/d		400
Jul-01				Jul-01	By depreciation a/c @ 10% on Rs. 2000 for half year		100
	To Machinery a/c Transferred.		500				

			500				500