5.1 Introduction

Final accounts prepared at the end of the year consists of trading and profit and loss account and balance sheet. All accounts appearing in the trial balance are taken to either trading and profit and loss account or balance sheet. In order to decide as to which item will be taken to which place the following accounting principle is applied. All revenue expenditures and receipts are taken to trading and profit and loss account and all capital expenditures and receipts are taken to balance sheet.

It is, therefore, necessary to realize the importance of distinction between capital and revenue items in as much as any error on this account will falsify the final accounts. Though it is extremely difficult to lay down a rule for distinguishing the revenue item from capital item, an attempt has been made to explain the procedure by giving general norms with examples.

5.2 Capital Expenditure

A capital expenditure is one which increases the value at which a fixed or capital asset may properly be carried on in the books. All expenditure which results in the acquisition of permanent assets which are intended to be continually used in the business for the purpose of earning revenue is capital expenditure. The term capital expenditure is generally used to signify that expenditure which:

1. Increases quantity of fixed assets
2. Increases quality of fixed assets
3. Results in the replacement of fixed assets.

Quantity Aspect: An addition increases the quantity of fixed asset. Hence amount spent on the purchase of fixed asset is treated as capital expenditure.

Quality Aspect: The quality of a fixed asset is said to have increased when expenditure results in any or some of the following events:

1. When probable useful life of the fixed asset increases.
2. When capacity of the fixed asset increases.
3. When efficiency of the fixed asset increases.
4. When operating economy is achieved.
5. When quantity of its output increases beyond that originally anticipated.

Replacement Aspect: This involves a substitution of a new asset or asset component for part or all of an existing asset.

5.2.1 Principle of Materiality in Capital Expenditure

This principle has also important bearing on the capital revenue classification. For practical purposes, most companies establish minimum cost below which expenditure items are charged to current expense regardless of the length of their expected useful lives.

Following are the examples of capital expenditure:

1. Expenditure resulting in the acquisition of long lived assets; *e.g.*, land, building, machinery, furniture, motor car, trade marks.
2. Expenditure resulting in extension or improvement of fixed assets, *e.g.*, amount spent on increasing the seating accommodation in the picture hall.
3. Expenditure in connection with the purchase, receipt or erection of a fixed asset, *e.g.*, wages paid or expenses on the erection of plant and machinery, expenses on cartage, insurance of a fixed asset.
4. Major repairs and replacement of parts resulting in increased efficiency of a fixed asset.
5. Expenditure incurred for acquiring the right to carry on a business e.g., patent rights, copy right, good will.
6. "Used" property that is acquired usually requires expenditure for rehabilitating or reconditioning to restore its efficient operating state.

7. Legal charges and stamp duty paid for conveyancing on acquisition of a property.
8. Architect's fees paid for supervising construction of a property.
9. Cost of stand by equipment and servicing equipment.
10. Cost of experimenting when the same results ultimately in acquisition of a patent.

An expenditure cannot be said to be a capital expenditure only because:

1. The amount is large.
2. The amount is paid in lump-sum. A capital expenditure can be paid either in lump sum or instalment.
3. The amount is paid out of that fund which has been received out of the sale of fixed asset.
4. The receiver of the amount is going to treat it for the purchase of fixed asset.