# 3.2. CAPITAL AND REVENUE ITEMS

## 3.2.1. Introduction

At the end of every accounting year, financial statements are organized summaries of detailed information about the financial position and performance of a business. Traditionally the term 'financial statements' includes only two basic statements which are as under:

1) Balance sheet which shows the financial position of a business on a particular date.
2) Trading and profit and loss account which shows net profit earned and net loss incurred during the year.

These accounts are referred to as final accounts. Balance sheet is not an account but when one talks of final accounts, one may be referring to balance sheet also.

Before discussing the preparation of final accounts, it is essential to understand clearly the distinction between the capital and revenue items because while preparing the final accounts, all revenue items would have to be shown in manufacturing, trading, profit and loss account whereas capital items will form part of balance sheet.

Some other examples of revenue expenditures are as follows:

1) Interest on loan borrowed for business.
2) Taxes and legal expenses.
3) Loss from sale of fixed asset.
4) Discounts and allowances.
5) Bad debts.
6) Loss of goods in transit or at godown.
7) Fire insurance premium.
8) Loss of goods by fire.
9) Distribution expenses.
10) All office and administration expenses.

### 3.2.2.3. Deferred Revenue Expenditure

Deferred revenue expenditure is the expenditure which yields benefits extendi beyond the current accounting period but for relatively a shorter period than t period for which a capital expenditure is expected to yield benefits. Su expenditures are normally for a period of 3 to 5 years.

When a large sum of revenue expenditure is incurred in any particular year, th benefit of such expenditures may extend to several years, such expenditure i called 'Deferred Revenue' expenditure. The utilized (used) portion of expenditur is charged to profit and loss account and unutilized part taken to assets side of th Balance Sheet. Following are the **main characteristics of deferred revenu expenditure:**

1) Such expenses are of revenue nature.
2) The benefits of such expenses are extended beyond the accounting year or several accounting years.
3) These expenses are relatively of every large amount.

The following types of expenditure are usually treated deferred revenue expenditure:

1) **Expenditure Wholly Paid in Advance:** These are the expenses which are usually paid in advance in full during the accounting year such as telephone rental is payable entirely for the future period and no benefit accrues during the current year and hence full amount is carried forward and shown to the asset side of balance sheet. The other examples may be the office or shop rent paid in advance for the whole accounting year will be given the same treatment.

2) **Expenditure Partly Paid in Advance:** Such expenses include insurance premium which is payable partly for current year and partly for the next year. This is allocated between expired period and unexpired period. Former is charged to profit and loss account and later is taken to balance sheet as prepaid item. It may include heavy advertisement expenditures incurred in launching a new product.

3) **Abnormal Losses:** Any loss of exceptional nature arising on account of uninsured risky – say, loss by fire, loss in transit due to accident or confiscation of property in a foreign country. Such losses are spread over two to three years. The amount to be written off is charged to profit and loss account and balance is shown to assets side under miscellaneous expenditure.

4) **Development Expenditure:** When certain sum of money is spent on the development of train asset, such sums are usually attributable over several accounting years during which the asset to be used, e.g., cost of developing mines and plantations is be allocated over its useful period. The period or utilized cost is charged to profit and loss account and unexhausted amount is taken to the sets side of balance sheet.

**Examples of Deferred Revenue Expenditure**

Some examples of deferred revenue expenditures are as follows:

1) Preliminary expenses.
2) Brokerage or commission on underwriting of shares or debentures.
3) Cost of issue of shares and debentures.
4) Exceptional repairs.
5) Heavy cost of advertisement.
6) Cost of change in location of business.
7) Research and development costs, etc.

### 3.2.2.4. Revenue Expenditure Becoming Capital Expenditure

Following are some of the circumstances under which an expenditure which is usually of revenue nature may be taken as an expenditure of a capital nature:

1) **Wages and Salaries:** The amount spent as wages and salaries generally taken as a revenue expenses. However, amount of wages and salaries paid for the erection of a new plant or machinery or wages paid to workman engaged in construction of a fixed asset are taken as expenditure of a capital nature.

2) **Carriage in:** Carriage charges are usually of a revenue nature but carriage charges incurred for a new plant and machinery are taken as expenditure of a capital nature and are added to the cost of asset.

3) **Repairs:** The amount spent on repairs of plant, furniture, building, etc., is taken as revenue expenditure. However, when some second hand plant, motorcar, etc., is purchased, the expenditure incurred for immediate repairs of such plant, motorcar, etc., to make it fit for use will be taken as a capital expenditure.

4) **Legal Expenses:** These expenses are usually taken as expenditure of a revenue nature but legal expenses incurred in connection with purchase of fixed assets should be taken as a part of the cost of fixed asset.

5) **Raw Materials and Stores:** They are usually taken as of a revenue nature, but raw materials and stores consumed in construction is the fixed assets

should be treated as capital expenditure and be taken as a part of the cost of such fixed asset.

6) **Interest:** Interest paid during the construction of factory or building or plant may be capitalized and thus added to the cost of the asset concerned.

7) **Brokerage and Stamp Duty:** Paid on purchase of asset are taken as capital expenditure.

8) **Advertising:** Cost of advertising undertaken for the purpose of introducing a new product should be treated as capital expenditure, since the benefit of such expenditure will be available in future years.

9) **Preliminary Expenses:** Expenses incurred in formation of a new company are termed as preliminary expenses and should be treated as capital expenditure.

10) **Development Expenditure:** In case of some business such as tea, rubber, mines, plantations, horticulture, etc., a long period is required for development. They start earning only after expiry of a long period which can be termed as development period. The expenditure incurred during such periods is termed as development expenditure and may be treated as a capital expenditure. However, once they begin to earn, the expenditure incurred to maintain them will be revenue expenditure.

### 3.2.2.5. Differences between Capital Expenditure and Revenue Expenditure

| Basis of Difference | Capital Expenditure | Revenue Expenditure |
|---|---|---|
| 1) Nature | It is the expenditure which is incurred for acquiring a fixed asset or making additions to existing fixed asset. | It is an expenditure which is incurred to maintain the day-to-day working of the business. |
| 2) Life of Assets | Capital expenditure increases the life of the fixed assets. | It does not increase the life of a fixed asset. |
| 3) Cost | It helps in reducing the cost of production. | It does not reduce the cost of production. |
| 4) Type | It is a non-recurring expense. | It is a recurring expense. |
| 5) Benefit Period | Generally the benefit of this expenditure is not exhausted in one year and is available for a longer period. | The benefit of this expenditure is usually exhausted in one year. |
| 6) Amount | Normally the amount spent is large. | The amount spent is relatively low. |
| 7) Examples | Land, building, plant and machinery, furniture, etc. | Salary, wages, electricity, telephone charges, rent, etc. |

### 3.2.2.6. Differences between Capital Expenditure, Revenue Expenditure and Deferred Revenue Expenditure

| Basis of Difference | Capital Expenditure | Revenue Expenditure | Deferred Revenue Expenditure |
|---|---|---|---|
| 1) Duration of Benefit | Capital expenditure is incurred to benefit the organization for a long period. | It is incurred to benefit the organization for current year only. | Its benefits last partly for current year and partly for next year. |
| 2) Nature of Cost | It represents wholly unexpired cost meant for future use. | It represents wholly expired cost. | It represents both partly expired and partly unexpired. |
| 3) Relations with Assets | It relates of acquisition addition, extension or improvement of fixed assets only, | It relates to purchase of current assets and maintenance of fixed assets. | It related to heavy revenue expenditure. |
| 4) Nature of Expenditure | It is treated as non-recurring expenditure. | It is treated as recurring expenditure. | It is also a non-recurring expenditure. |
| 5) Relation with Earning | It helps to enhance capacity and reduce cost of operation. | It helps to maintain existing earning capacity. | It endured both. |
| 6) Property Right | It entails property rights which are transferable for a consideration. | It does not enjoy property rights and not transferable. | There is no such property right as such. |
| 7) Accounting Treatment | It is shown on the assets side of balance sheet. | It is charged to profit and loss account. | It is partly charged to profit and loss account and partly shown in the balance sheet. |