

Answer on Question #41857, Management, Other

Distinguish between Revenue Expenditure and capital expenditure. How are they treated while preparing the final accounts? If by mistake the accountant of a firm treats a capital expenditure as revenue expenditure, how will it affect the final accounts of the firm? Give an example.

Explanation:

To begin for comprehensive analysis of this issue is necessary to understand the definition of each type of expenditure.

Expenditure on fixed assets may be classified into Capital Expenditure and Revenue Expenditure. The distinction between the nature of capital and revenue expenditure is important as only capital expenditure is included in the cost of fixed asset.

A capital expenditure is an amount spent to acquire or improve a long-term asset such as equipment or buildings. Usually the cost is recorded in an account classified as Property, Plant and Equipment. The cost (except for the cost of land) will then be charged to depreciation expense over the useful life of the asset.

Capital expenditure, as opposed to revenue expenditure, is generally of a one-off kind and its benefit is derived over several accounting periods. Capital Expenditure may include the following:

- Cost of goodwill.
- Cost of freehold land and building and the legal charges incurred in this connection.
- Cost of lease.
- Cost of machinery, plants, tools, fixtures, etc.
- Cost of trademarks, patents, copy rights, designs, etc.
- Cost of car, lorry etc.
- Cost of installation of lights and fans.
- Cost of any other assets acquired by way of equipment.
- Erection cost of plant and machinery.
- Cost of addition to existing assets.
- Structural improvements and alteration in the existing assets.
- Expenses for developments in case of mines and plantations.
- Expenses for administration incurred during construction and equipment of any industrial enterprise.
- Expenses incurred in experimenting which finally result in the acquisition of patent or other rights.

So we can refer them to the following categories:

- Purchase costs (less any discount received).
- Delivery costs.

- Legal charges.
- Installation costs.
- Up gradation costs.
- Replacement costs.

As capital expenditure results in increase in the fixed asset of the entity, the accounting entry is as follows:

Debit	Fixed Assets
Credit	Cash/Payable

Capital expenditure is a pure movement in the balance sheet that does not touch the profit and loss account therefore capital expenditure will not make a business look more or less profitable. It should be noted that any depreciation or amortization in respect of the asset will be transferred to the profit and loss account, although not all assets are subject to depreciation.

The double entry when dealing with capital expenditure is to debit the fixed assets in the balance sheet and credit the bank account in the balance sheet, providing the asset was bought out of existing funds that is. If the asset was bought using credit the double entry is to debit the fixed assets in the balance sheet and credit the creditors in the balance sheet.

Now we consider the Revenue expenditures.

Revenue expenditure incurred on fixed assets includes costs that are aimed at 'maintaining' rather than enhancing the earning capacity of the assets. These are costs that are incurred on a regular basis and the benefit from these costs is obtained over a relatively short period of time. Even significant repairs that do not extend the life of the asset or do not improve the asset (the repairs merely return the asset back to its previous condition) are revenue expenditures.

Revenue costs therefore comprise of the following:

- Wages or salaries paid to factory workers.
- Machine Oil to lubricate.
- Electricity or Power required to run machinery or motor.
- Expenditure incurred in the ordinary conduct and administration of business, i.e. rent, , carriage on saleable goods, salaries, wages manufacturing expenses, commission, legal expenses, insurance, advertisement, free samples, postage, printing charges etc.
- Repair and maintenance expenses incurred on fixed assets.
- Cost of saleable goods.
- Depreciation of fixed assets used in the business.
- Interest on borrowed money.
- Freight, cartage, transportation, insurance paid on saleable goods.
- Petrol or diesel consumed in motor vehicles.

- Service charges to motor vehicles.
- Bad debts.

So we can refer them to the following categories:

- Repair costs.
- Maintenance charges.
- Repainting costs.
- Renewal expenses.

As revenue costs do not form part of the fixed asset cost, they are expensed in the income statement in the period in which they are incurred. The accounting entry to record revenue expenditure is therefore as follows:

Debit	Revenue Expense (Income Statement)
Credit	Cash/Payable

Revenue expenditure is posted to the profit and loss account therefore it can make a business look more or less profitable, which will have an effect on the tax liability. Revenue expenditure includes purchases of stock, payment of rent and rates, payment of utilities, payment of wages and salaries and any other expense that is in the profit and loss account.

The double entry to record revenue expenses is to debit the relevant expense code in the profit and loss account, and credit the purchase ledger control account, the bank account, the credit card control or the petty cash account, obviously depending on how the expense was settled.

Based on the above we can note the major differences of the expenses.

In category purpose the Capital expenditure incurred for the acquisition or erection of fixed assets to use in the business. On the other hand, revenue expenditure is incurred for the day-to conduct of business.

In category earning Capacity the Capital expenditure increases the ability to work in business while spending does not increase the income earning capacity as they are incurred to maintain the existing earning capacity.

In category Period the benefit capital expenditures applies to more than one year, the benefit applies only to revenue expenditure for the current year.

In category accounting the Capital expenditure is shown in the balance sheet as an asset, on the other hand, revenue expenditure is shown as an expense in the trading account or Pro statement.

In category Nature the Capital expenditure is fickle nature, because such costs incurred minutes every day. In contrast, the cost income recurring in nature, as incurred in daily operations.

In category impact on assets the Capital expenditure increases the value of fixed assets. But spending income does not increase the value of these assets.

We can also reduce costs comparative table below lists.

Table

Capital Expenditure	Revenue Expenditure
Its effect is long term i.e., it is not exhausted within the current account year. Its benefit is enjoyed in future year or years also. In a word, its effect is reduces gradually.	Its effect is temporary, i.e., it is exhausted within the current accounting year.
An asset is acquired or the value of an asset is increased as a result of this expenditure.	Neither an asset is acquired nor is the value of an asset increased.
It does not occur again and again – it is non-recurring and irregular.	It occurs repeatedly – It is recurring and regular.
Generally, it has physical existence i.e., it can be seen with eyes.	It has no physical existence, i.e., it cannot be seen with eyes.
This expenditure improves the position of the concern	This expenditure helps to maintain the concern
A portion of this expenditure is shown in the trading and profit and loss account or income and expenditure account as depreciation.	The whole amount of this expenditure is shown in trading and profit and loss account or income and expense account. But deferred revenue expenditures and prepaid expenses are not shown.
It appears in balance sheet until its benefit is fully exhausted.	It does not appear in balance sheet. Deferred revenue expenditure, outstanding expenditure, outstanding expenses and prepaid expenses, however, temporarily shown in the balance sheet.
It does not reduce the revenue of the concern. Purchase of fixed assets does not affect revenue.	It reduces revenue. Payment of salaries to employees decreases revenue.

It should also be noted the Revenue expenditure treated as Capital Expenditure in the following circumstances:

1. Raw Materials and Stores: When these are used for manufacturing a fixed asset, these expenses are treated as capital expenditure.
2. Carriage and Freight: If these expenses are paid on the transportation of newly acquired fixed asset, these are treated as capital expenditure.
3. Wages: Wages paid for the construction of a building or for the installation of a machine are related as capital expenditure and are added to the cost of the asset.
4. Repairs: Expenses incurred to repair a second hand machine, purchase by the firm, to make it usable are treated as capital expenditure.
5. Preliminary Expenses: Expenses incurred on the formation of a company are treated as capital expenses because their benefit will be available over a long period.
6. Brokerage: Brokerage paid on the purchase of a fixed asset is treated as capital expenditure.
7. Legal Expenses: Stamp duty and other legal expenses incurred in connection with the acquisition of fixed assets are treated as capital expenditure.
8. Advertising: Advertising expenses incurred for introducing a new product in the market are related as capital expenditure.
9. Interest: Interest paid on loan and capital when paid during the construction of fixed assets is treated as capital expenditure.

If by mistake the accountant of a firm treats a capital expenditure as revenue expenditure?

Earlier we defined the capital expenditure and revenue expenditure, also considered their relationship when reporting accounting, conducted a comparative description. Appealing to the above mentioned we can analyze how treats a capital expenditure as revenue expenditure in the financial statements.

To account a capital expenditure, the bookkeeper debits the corresponding asset account and credits the cash account. This entry increases corporate long-term assets. To record an operating expenditure, the junior accountant debits the corresponding expense account and credits the cash account. This entry increases corporate expenses and reduces net income. Now that entries for both scenarios are clear, it's easier to see what would happen in the event of a mismatch or inaccurate recording. If a bookkeeper inaccurately records a capital expenditure as revenue expenditure, the junior accountant essentially would overestimate corporate expenses and underestimate long-term assets.

Thus we can say the following in case when a capital expenditure is treated as revenue expenditure, then expenses are overstated and owners' equity is understated.

As an example we can consider the following. Acquisition turbo generator for turbine should significantly increase the useful life of the appliance, and such as, its value must be

capitalized. Nevertheless, the carrying amount of the replaced generator should be recognized in the same manner as any fixed asset disposal. As noted earlier accountant mistakenly refers data acquisition costs turbo generator on revenue expenditure as a result we obtain further underutilized amount equal to the cost of the equipment purchased, and in this case the discrepancy are inflated they are given the current period and do not increase the equity.

Summarizing the reasoning and comparative characteristics of costs, we can note the following for each of the types of expenses.

Capital expenditure is on an item that will help generate profits over the longer term (12 months or more) so a purchase of a machine or van etc. The item is depreciated over the items useful life and each depreciable amount is charged to the Income statement in the year the item has help generate profit.

1. Capital expenditure is that expenditure the benefits of which are not fully consumed in a year but spread over several years.
2. It is the expenditure which results in the purchase or acquisition of asset or property.
3. It is the expenditure incurred in connection with the purchase of asset.
4. It is the expenditure incurred to bring an old asset into working condition.
5. It is the expenditure incurred for extending or improving an existing asset to increase its productivity or to increase the earning capacity of business or to decrease working expenditure.

It can be said that the capital expenditure benefits not only in the current accounting year but also many years in the future. The expenditure is generally non-recurring and the amount spent is normally large. However, it should be noted that not every big expenditure is capital expenditure. Capital expenditure is capitalized. This means that it does not appear in the profit and loss account as an expense but goes straight on to the balance sheet. However, the cost of a fixed asset will appear in the profit and loss account as an expense, but this will be on the form of 'depreciation' which we will cover in this module.

Now we note the characteristics of operating Revenue expenditures.

1. Revenue expenditure is the expenditure which benefits in the current accounting year. It is not carried forward to the next year or years.
2. It is the expenditure which is incurred in the normal course of business to run the business and to maintain the fixed assets of business.
3. It is the expenditure which is incurred on purchase of goods meant for resale or to purchase materials which will be used to convert them into final product.

Therefore, revenue expenditure is a recurring expenditure made to maintain the business. The amount spent is generally small and the benefit is for a short period which is not more than a year. All revenue expenditures are charged to trading and profit and loss account.

Revenue expenditure will appear in the profit and loss account in the period in which it is incurred: