Capital and Revenue

What Are Capital Expenditures (CapEx)?

Capital expenditures (CapEx) are funds used by a company to acquire, upgrade, and maintain physical assets such as property, plants, buildings, technology, or equipment. CapEx is often used to undertake new projects or investments by a company.

Making capital expenditures on fixed assets can include repairing a roof, purchasing a piece of equipment, or building a new factory. This type of financial outlay is made by companies to increase the scope of their operations or add some economic benefit to the operation.

Important Points:

- Capital expenditure (CapEx) is a payment for goods or services recorded—or capitalized—on the balance sheet instead of expensed on the income statement.
- CapEx spending is important for companies to maintain existing property and equipment, and invest in new technology and other assets for growth.
- If an item has a useful life of less than one year, it must be expensed on the income statement rather than capitalized (i.e., cannot be considered CapEx).

Capital expenditures can include the purchase of the following:

- A facility or factory, including an upgrade or expansion
- Vehicles, such as trucks used for the delivery of products
- Manufacturing equipment
- Computers
- Furniture

Revenue Expenditures

Revenue expenditures are short-term expenses used in the current period or typically within one year. Revenue expenditures include the expenses required to meet the ongoing operational costs of running a business, and thus are essentially the same as operating expenses (OPEX).

Revenue expenditures also include the ordinary repair and maintenance costs that are necessary to keep an asset in working order without substantially improving or extending the useful life of the asset. Revenue expenses related to existing assets include repairs and regular maintenance as well as repainting and renewal expenses. Revenue expenditures can be considered to be recurring expenses in contrast to the one-off nature of most capital expenditures.

Other examples of revenue expenditures include the following:

- Salaries and employee wages
- Any overhead expense, such as salaries for the corporate office, which typically fall under selling, general, and administrative expenses (SG&A)
- Research and development (R&D)
- Utilities and Rent
- Business travel

- Property taxes

Revenue Expenditures Accounting Treatment

Revenue expenditures or operating expenses are recorded on the income statement. These expenses are subtracted from the revenue that a company generates from sales to eventually arrive at the net income or profit for the period.

Revenue expenses can be fully tax-deducted in the same year the expenses occur. In other words, the expenses reduce profit from a tax standpoint, and thus, reduce the taxable income for the tax period.

Differences between capital expenditure and revenue expenditure:

Capital Expenditure	**Revenue Expenditure**
Definition	
Expenditure incurred for acquiring assets, to enhance the capacity of an existing asset that results in increasing its lifespan	Expense incurred for maintaining the day to day activities of a business
Tenure	
Long Term	Short term
Value Addition	
Enhances the value of an existing asset	Does not enhance the value of an existing asset
Physical Presence	
Has a physical presence except for intangible assets	Does not have a physical presence
Occurrence	
Non-recurring in nature	Recurring in nature
Availability of Capitalisation	
Yes	No
Impact on Revenue	
Do not reduce business revenue	Reduce business revenue

Potential Benefits	
Long-term benefits for business	Short-term benefits for business
Appearance	
Appears as assets in the balance sheet and some portion in the income statement	Always appears in the income statement

Rules for Determining Capital Expenditure:

1. Expenditure incurred for acquiring Land, Building, Machinery, Investments, Patents or Furniture etc. are permanent or fixed assets. The fixed asset is used in the business for earning profit and not for resale, is called a Capital Expenditure. For instance, when we purchase furniture it is a capital expenditure and at the same time to the Furniture Shop, who is engaged in buying and selling of furniture, it is not capital expenditure.

2. Expenditure incurred for putting an old asset in working condition or for putting a new asset to use, is capital expenditure. For instance, an old machine is purchased for Rs. 10,000 and Rs 2,000 is spent for its repairs and installation and the total expenditures are capita, expenditure.

3. Expenditure incurred on an existing asset which results in the improvement or extension of the business by increasing the earning capacity of the asset or by reducing the cost of production is also called capital expenditure. For instance, installations of machine or additions to buildings or plant etc. are capital expenditure.

4. When benefit of expenditure is not fully consumed in one period but spread over several periods, is called capita, expenditure. For instance, expenditure met for massive advertisements.

5. Expenditure which increases the earning capacity in any way of a fixed asset can be called capital expenditure. For instance, amount spent on cinema theatre for air conditioning.

6. Expenditure spent on raising the capital required for earning profit is called capital expenditure. For instance, underwriting commission, brokerage etc.

Items of Capital Expenditure:

1. Cost of Land, Building, Plant and Machinery.

2. Cost of lease hold Land and Building.

3. Cost of manufacture or purchase of furniture and fixtures.

4. Cost of office Cars, Vans, Lorries or Vehicles.

5. Cost of installation of lights, fans etc.

6. Cost of erection of Plant and Machinery.

7. Cost of Trade Mark, Patents, Copy rights, Patterns and Designs.

8. Preliminary Expenses.

9. Cost of Goodwill.

10. Cost of addition to and extension of existing fixed assets.

11. Cost of development in case of Mines and Plantations.

12. Cost of invention.

13. Cost of increasing capacity of fixed asset.

14. Cost of administration in industrial enterprises incurred during the period of construction.

Features of Revenue Expenditures

Revenue expenditures have the following features:

1. Recurring nature

2. Arise from trading activities
3. The amount spent on revenue expenditures is relatively small
4. The period of benefit from revenue expenditure is limited to an accounting period

Rules for Determining Revenue Expenditures

Any expenditure can be referred to as an item of revenue expenditure if it is incurred for one of the following purposes:

1. Routine Expenses

Routine expenditures incurred during the daily conduct of business with a benefit of less than one year.

Examples

Salaries paid to employees, office rent, **interest** on **capital**, and sales and marketing expenses.

2. Maintenance of Fixed Assets

Expenditures incurred to maintain fixed **assets**.

Examples

Repairs, renewals, and **depreciation**.

3. Consumable Items

Expenditures incurred on consumable items or goods and services for resale in their original or improved shape.

Examples

Purchase of raw materials, office stationery, etc.

More Examples

To clarify **revenue expenditures** further, a list is given below that includes more examples:

1. Salaries and wages paid to employees
2. Rent and rates for the factory or office premises
3. Depreciation on plant and machinery
4. Consumable stores
5. Inventory of raw materials, work-in-progress, and finished goods
6. Insurance premium
7. Taxes and legal expenses

8. Repairs, renewals, and replacements for the purpose of maintaining the existing fixed assets of the business
9. Interest on loans borrowed for business
10. **Cost** of oil to lubricate machines
11. Cost of merchandise bought for resale

What Is a Capital Gain?

The term capital gain refers to the increase in the value of a capital asset when it is sold Put simply, a capital gain occurs when you sell an asset for more than what you originally paid for it. Almost any type of asset you own is a capital asset whether that's a type of investment (like a stock, bond, or real estate) or something purchased for personal use (like furniture or a boat). Capital gains are realized when you sell an asset by taking the subtracting the original purchase price from the sale price. The Internal Revenue Service (IRS) taxes individuals on capital gains in certain circumstances.

Important Points:

- A capital gain is the increase in a capital asset's value and is realized when the asset is sold.
- Capital gains apply to any type of asset, including investments and those purchased for personal use.
- The gain may be short-term (one year or less) or long-term (more than one year) and must be claimed on income taxes.
- Unrealized gains and losses reflect an increase or decrease in an investment's value but are not considered a taxable capital gain.
- A capital loss is incurred when there is a decrease in the capital asset value compared to an asset's purchase price.

Understanding Capital Gains

As noted above, capital gains represent the increase in the value of an asset. These gains are typically realized at the time that the asset is sold. Capital gains are generally associated with investments, such as stocks and funds, due to their inherent price volatility. But they can also be realized on any security or possession that is sold for a price higher than the original purchase price, such as a home, furniture, or a vehicle.

Capital gains fall into two categories:

- Short-term capital gains are those realized on assets that you've sold after holding them for one year or less
- Long-term capital gains are realized on assets that you've sold after holding them for more than one year

Both short- and long-term gains must be claimed on your annual tax return. Understanding this distinction and factoring it into investment strategy is particularly important for day traders and others who take advantage of the greater ease of trading in the market online.

Realized capital gains occur when an asset is sold, which triggers a taxable event. Unrealized gains, sometimes referred to as paper gains and losses, reflect an increase or decrease in an investment's value but are not considered a capital gain that should be treated as a taxable event. The tax rates for capital gains are listed below.

A capital loss is the opposite of a capital gain. It is incurred when there is a decrease in the capital asset value compared to an asset's purchase price.

What Is Revenue?

Revenue is the money generated from normal business operations, calculated as the average sales price times the number of units sold. It is the top line (or gross income) figure from which costs are subtracted to determine net income. Revenue is also known as sales on the income statement.

Important Points:

- Revenue, often referred to as sales or the top line, is the money received from normal business operations.
- Operating income is revenue (from the sale of goods or services) less operating expenses.
- Non-operating income is infrequent or nonrecurring income derived from secondary sources (e.g., lawsuit proceeds).

Understanding Revenue

Revenue is money brought into a company by its business activities. There are different ways to calculate revenue, depending on the accounting method employed. Accrual accounting will include sales made on credit as revenue for goods or services delivered to the customer.

It is necessary to check the cash flow statement to assess how efficiently a company collects money owed. Cash accounting, on the other hand, will only count sales as revenue when payment is received. Cash paid to a company is known as a "receipt." It is possible to have receipts without revenue. For example, if the customer paid in advance for a service not yet rendered or undelivered goods, this activity leads to a receipt but not revenue.

Revenue is known as the top line because it appears first on a company's income statement. Net income, also known as the bottom line, is revenues minus expenses. There is a profit when revenues exceed expenses.

To increase profit, and hence earnings per share (EPS) for its shareholders, a company increases revenues and/or reduces expenses. Investors often consider a company's revenue and net income separately to determine the health of a business. Net income can grow while revenues remain stagnant because of cost-cutting.

Such a situation does not bode well for a company's long-term growth. When public companies report their quarterly earnings, two figures that receive a lot of attention are revenues and EPS. A company beating or missing analysts' revenue and earnings per share expectations can often move a stock's price.

Revenue is also known as sales, as in the price-to-sales (P/S) ratio—an alternative to the price-to-earnings (P/E) ratio that uses revenue in the denominator.

Types of Revenue

A company's revenue may be subdivided according to the divisions that generate it. For example, a recreational vehicles department might have a financing division, which could be a separate source of revenue.

Revenue can also be divided into operating revenue—sales from a company's core business—and non-operating revenue which is derived from secondary sources. As these non-operating revenue sources are often unpredictable or nonrecurring, they can be referred to as one-time events or gains. For example, proceeds from the sale of an asset, a windfall from investments, or money awarded through litigation are non-operating revenue.

Examples of Revenue

In the case of government, revenue is the money received from taxation, fees, fines, inter-governmental grants or transfers, securities sales, mineral or resource rights, as well as any sales made.

For non-profits, revenues are its gross receipts. Its components include donations from individuals, foundations, and companies; grants from government entities; investments; fundraising activities; and membership fees.

In terms of real estate investments, revenue refers to the income generated by a property, such as rent or parking fees. When the operating expenses incurred in running the property are subtracted from property income, the resulting value is net operating income (NOI).

Distinguish between Capital Receipts and Revenue Receipts:

BASIS FOR COMPARISON	CAPITAL RECEIPT	REVENUE RECEIPT
Meaning	Capital Receipts are the income generated from investment and financing activities of the business.	Revenue Receipts are the income generated from the operating activities of the business.
Nature	Non-Recurring	Recurring
Term	Long Term	Short Term
Shown in	Balance Sheet	Income Statement

BASIS FOR COMPARISON	CAPITAL RECEIPT	REVENUE RECEIPT
Received in exchange of	Source of income	Income
Value of asset or liability	Decreases the value of asset or increases the value of liability.	Increases or decreases the value of asset or liability.

Practical Problems:

Illustration 1

State whether the following are capital, revenue or deferred revenue expenditure.

(i) Carriage of ₹ 7,500 spent on machinery purchased and installed.

(ii) Heavy advertising costs of ₹ 20,000 spent on the launching of a company's new product.

(iii) ₹ 200 paid for servicing the company vehicle, including ₹ 50 paid for changing the oil.

(iv) Construction of basement costing ₹ 1,95,000 at the factory premises.

Solution

(i) Carriage of ₹ 7,500 paid for machinery purchased and installed should be treated as a ***Capital Expenditure.***

(ii) Advertising expenses for launching a new product of the company should be treated as a ***Deferred Revenue Expenditure.***

(iii) ₹ 250 paid for servicing and oil change should be treated as a ***Revenue Expenditure.***

(iv) Construction cost of basement should be treated as a ***Capital Expenditure.***

Illustration 2

State with reasons whether the following are capital expenditure or revenue expenditure :

(i) ₹ 50,000 spent towards addition to the machinery;

(ii) Second-hand motor car purchased for ₹ 2,00,000 and spent ₹ 20,000 for repairs immediately;

(iii) ₹ 10,000 spent for whitewashing the factory building;

(iv) Carriage of ₹ 15,000 spent on machinery purchased and installed. ***[C.U.B.Com. (General) — 2012]***

Solution

(i) ₹ 50,000 spent towards machinery addition will be treated as Capital Expenditure. The machine will help to generate revenue for several years.

(ii) ₹ 20,000 spent on repairing of a second-hand motor car will be treated as Capital Expenditure. This repairing is necessary to make the old car usable.

(iii) ₹ 10,000 spent for whitewashing the factory building will be treated as Revenue Expenditure.

(iv) Carriage of ₹ 15,000 spent on machinery purchased and installed will be treated as Capital Expenditure. It is necessary to make the machinery useful.

Illustration 3

State whether the following are capital or revenue expenditure.

(i) Paid a bill of ₹ 10,000 of Mr. Kumar, who was engaged as the erection engineer to set up a new automatic machine costing ₹ 20,000 at the new factory site.

(ii) Incurred ₹ 26,000 expenditure on varied advertisement campaigns undertaken yearly, on a regular basis, during the peak festival season.

(iii) In accordance with the long-term plan of providing a well- equipped Labour Welfare Centre, spent ₹ 90,000 being the budgeted allocation for the year 2010.

Solution

(i) Expenses incurred for erecting a new machine should be treated as a ***Capital Expenditure***.
(ii) Advertisement expenses during peak festival season should be treated as a ***Revenue Expenditure***.
(iii) Expenses incurred for Labour Welfare Centre should be treated as a ***Capital Expenditure***.

Illustration 4

Classify the following items as capital or revenue expenditure : (i) An extension of railway tracks in the factory area; (ii) Wages paid to machine operators; (iii) Installation costs of new production machine; (iv) Materials for extensions to foremen's offices in the factory; (v) Rent paid for the factory; (vi) Payment for computer time to operate a new stores control system; (vii) Wages paid to own employees for building the foremen's offices. Give reasons for your classification.

Solution

(i) Expenses incurred for extension of railway tracks in the factory area should be treated as a ***Capital Expenditure*** because it will benefit the business for more than one accounting period.
(ii) Wages paid to machine operators should be treated as a ***Revenue Expenditure*** because it will benefit only the current period.
(iii) Installation costs of new production machine should be treated as a ***Capital Expenditure*** because it will benefit the business for more than one accounting period.
(iv) Materials for extensions to foremen's offices in the factory should be treated as a ***Capital Expenditure*** because it will benefit the business for more than one accounting period.
(v) Rent paid for the factory should be treated as a ***Revenue Expenditure*** because it will benefit only the current period.
(vi) Payment for computer time to operate a new stores control system should be treated as ***Revenue Expenditure*** because it has been incurred to carry on the normal business.
(vii) Wages paid for building foremen's offices should be treated as a ***Capital Expenditure*** because it will benefit the business for more than one accounting period.

Illustration 5

For each of the cases numbered (i) to (iv) below, indicate whether the income/expenditure is ***capital*** or ***revenue***.

(i) Payment of wages to one's own employees for building a new office extension.
(ii) Regular hiring of computer time for the preparation of the firm's accounts.
(iii) The purchase of a new computer for use in the business.
(iv) The use of motor vehicle, hired for five years, but paid at every six months.

Solution

(i) Payment of wages for building a new office extension should be treated as a ***Capital Expenditure***.
(ii) Computer hire charges should be treated as a ***Revenue Expenditure***.
(iii) Purchase of computer for use in the business should be treated as a ***Capital Expenditure***.
(iv) Hire charges of motor vehicle should be treated as a ***Revenue Expenditure***.

Illustration 6

State with reasons whether the following are capital or revenue expenditure:

(1) Freight and cartage on the new machine ₹ 150, and erection charges ₹ 500.
(2) Fixtures of the book value of ₹ 2,500 sold off at ₹ 1,600 and new fixtures of the value of ₹ 4,000 were acquired, cartage on purchase ₹ 5.
(3) A sum of ₹ 400 was spent on painting the factory.
(4) ₹ 8,200 spent on repairs before using a second hand car purchased recently, to put it in usable condition.

Solution

(1) Freight and cartage totalling ₹ 650 should be treated as a ***Capital Expenditure*** because it will benefit the business for more than one accounting year.
(2) Loss on sale of fixtures ₹ (2,500 – 1,600) = ₹ 900 should be treated as a ***Capital Loss***. The cost of new fixtures and carriage thereon should be treated as a ***Capital Expenditure*** because the fixture will be used for a long period.
(3) Painting of the factory should be treated as a Revenue Expenditure because it has been incurred to maintain the factory building.
(4) Repairing cost of second hand car should be treated as a ***Capital Expenditure*** because it will benefit the business for more than one accounting year.

Illustration 7

State the nature (capital or revenue) of the following expenditure which were incurred by Harikishore & Co. during the year ending 30th June, 2010:

(i) ₹ 350 was spent on repairing a second hand machine which was purchased on 8th July, 2009 and ₹ 200 was paid on carriage and freight in connection with its acquisition.
(ii) A sum of ₹ 500 was paid as compensation to two employees who were retrenched.
(iii) ₹ 150 was paid in connection with carriage on goods purchased.

(iv) ₹ 20,000 customs duty is paid on import of a machinery for modernisation of the factory production during the current year and ₹ 6,000 is paid on import duty for purchase of raw materials.

(v) ₹ 18,000 interest had accrued during the year on term loan obtained and utilised for the construction of factory building and purchase of machineries; however, the production has not commenced till the last date of the accounting year.

Solution

(i) Repairing and carriage totalling ₹ 550 for second hand machine should be treated as a ***Capital Expenditure***.

(ii) Compensation paid to employees shall be treated as a ***Revenue Expenditure***.

(iii) Carriage paid for goods purchased should be treated as a ***Revenue Expenditure***.

(iv) Customs duty paid on import of a machinery should be treated as a ***Capital Expenditure***. However, import duty paid for raw materials should be treated as a ***Revenue Expenditure***.

(v) Interest paid during pre-construction period should be treated as a ***Capital Expenditure***.

Illustration 8

State with reasons whether the following items relating to Sitalpur Sugar Mill Ltd. are capital or revenue:

1. A truck costing ₹ 1,00,000 and standing in the books at ₹ 60,000 was sold for ₹ 70,000.
2. ₹ 50,000 received from issue of shares including ₹ 10,000 by way of premium.
3. Purchased agricultural land for the mill for ₹ 60,000. ₹ 500 also paid for land revenue.
4. ₹ 5,000 paid as contribution to PWD for improving roads of sugar producing area.
5. ₹ 40,000 paid for exise duty on sugar manufactured.
6. ₹ 70,000 spent for constructing railway siding.

Solution

(i) Profit on sale of truck ₹ 10,000 should be treated as a ***Capital Profit***.

(ii) ₹ 40,000 (₹ 50,000 – ₹ 10,000) received from issue of shares will be treated as a ***Capital Receipt***. The premium of ₹ 10,000 should be treated as a ***Capital Profit***.

(iii) Cost of land ₹ 60,000 will be treated as a ***Capital Expenditure*** and land revenue of ₹ 500 will be treated as a ***Revenue Expenditure***.

(iv) Contribution paid to PWD should be treated as a ***Revenue Expenditure***.

(v) Excise duty of ₹ 40,000 should be treated as a ***Revenue Expenditure***.

(vi) ₹ 70,000 spent for constructing railway siding should be treated as a ***Capital Expenditure***.

Illustration 9

State with reasons whether the following are Capital Expenditure or Revenue Expenditure :

(i) Expenses incurred in connection with obtaining a licence for starting the factory were ₹ 10,000.

(ii) ₹ 1,000 paid for removal of stock to a new site.

(iii) Rings and Pistons of an engine were changed at a cost of ₹ 5,000 to get full efficiency.

(iv) ₹ 2,000 spent as lawyer's fee to defend a suit claiming that the firm's factory site belonged to the Plaintiff. The suit was not successful.

(v) ₹ 10,000 were spent on advertising the introduction of a new product in the market, the benefit of which will be effective during four years.

(vi) A factory shed was constructed at a cost of ₹ 1,00,000. A sum of ₹ 5,000 had been incurred for the construction of the temporary huts for storing building materials.

Solution

(i) ₹ 10,000 incurred in connection with obtaining a licence for starting the factory is a ***Capital Expenditure***. It is incurred for acquiring a right to carry on business for a long period.

(ii) ₹ 1,000 incurred for removal of stock to a new site is treated as a ***Revenue Expenditure*** because it is not enhancing the value of the asset and it is also required for starting the business on the new site.

(iii) ₹ 5,000 incurred for changing Rings and Pistons of an engine is a ***Revenue Expenditure*** because, the change of rings and piston will restore the efficiency of the engine only and it will not add anything to the capacity of the engine.

(iv) ₹ 2,000 incurred for defending the title to the firm's assets is a ***Revenue Expenditure***.

(v) ₹ 10,000 incurred on advertising is to be treated as a ***Deferred Revenue Expenditure*** because the benefit of advertisement is available for 4 years, ₹ 2,500 is to be written off every year.

(vi) Cost of construction of Factory shed of ₹ 1,00,000 is a ***Capital Expenditure***, similarly cost of construction of small huts for storing building materials is also a ***Capital Expenditure***.