

WEEK 5 notes & Activity

Sub-strands 12.1.1.6: Revenue and Capital Expenditure

The distinction between revenue and capital expenditure is based on:

- Time (in which the expenditure is being consumed by the business)
- Size or materiality of the expenditure

About the time:

Expenditure which will be consumed during the current accounting period are referred to as Revenue expenditure.

- *These are the expenses that appear in the Statement of Financial Performance to be matched with the revenues in order to determine the profit or loss for the period such as wages, fuel and oil, electricity etc.*

Expenditures resulting in the acquisition of an asset whose life will extend over more than one accounting period is referred to as Capital expenditure. These expenditures are capitalized (treat as an asset) and appears in the Balance Sheet (Statement of Financial Position).

About the size:

Only the material expenditures are capitalized and treat as an asset. Expenditures which are not material such as maintenance are treated as revenue expenditures.

Expenditure on fixed assets;

The following are regarded as **capital expenditure**:

- **Expenditure made to bring an asset into a location and condition ready for use by the business** – such as the cost price of the fixed asset, freight if the asset is brought from another place, installation cost and any legal fees if a land is purchased. These costs are capitalized as the total cost for the fixed asset.
- **Improvement or addition to existing asset** – such as new body for a delivery van, extension to an existing building, storage facility etc. these expenditures are capitalized and add to the existing value of that particular fixed asset.
- **Major expenditure to extend the life of the asset** – such as the cost of fitting a new or reconditioned motor to a vehicle to extend its useful life to the business. This expenditure is also capitalized.

EXAMPLE A: Capital Expenditure

OE	=	A	-	L
Capital	=	Cash + Vehicle	-	Account Payable
16,200	=	11,000 6,200		1,000

A new tractor costing \$ 400 cash is bought for the business and the accounting equation becomes:

OE	=	A	-	L
<i>Capital</i>	=	<i>Cash + Vehicle</i>	-	<i>Account Payable</i>
16,200	=	7,000 6,200		1,000

In this equation, the cash of the business is reduced by \$4,000 and the value of vehicles is increased by this amount. If the business has to spend money fitting a safety frame to the tractor, to make it comply with safety requirements, the cost of the frame is added to the purchase price. Suppose a frame costing \$ 350 was added to the tractor in Example A. this would be regarded as a capital expenditure, because it is upgrading the asset.

OE	=	A	-	L
<i>Capital</i>	=	<i>Cash + Vehicle</i>	-	<i>Account Payable</i>
16,200	=	7,000 + 6,200		1,000
		-350 + +350		
16,200	=	6,650 + 10,550	-	1,000

The tractor would be shown in the business books at \$4,350 (\$4,000 + \$350 for the frame).

The following are regarded as **revenue expenditure**:

- ***Expenditure to maintain an asset in an efficient condition*** – such as repairing damages (maintenance), repainting a building, replacing tyres on a motor vehicle etc.
- ***Expenditure associated with assets but which will be consumed during the accounting period*** – such as motor vehicle registration, insurance, fuels and oils.

EXAMPLE B: Revenue Expenditure

OE	=	A	-	L
<i>Capital</i>	=	<i>Cash + Vehicle</i>	-	<i>Account Payable</i>
16,200	=	6,650 + 10,550		1,000

The owner has to spend \$ 250 on diesel and oil to keep the tractor operating and in good order. The accounting equation becomes:

OE	=	A	-	L
<i>Capital</i>	=	<i>Cash + Vehicle</i>	-	<i>Account Payable</i>
15, 950	=	6,400 + 10,550		1,000

In this equation, the cash of the business and the capital are decreased by \$250.

EXAMPLE C: Profit in the Accounting Equation

The accounting equation for Leila Day's business at the beginning of the accounting period was:

OE	=	A	-	L
Capital	=	Bank + Debtors + Furniture	-	Account Payable
20,800	=	10,000 + 4,600 + 16,000		9,800

During the accounting period, Leila:

- Banks revenue of \$1,200, and
- Pays electricity of \$200.

Therefore, she makes a profit of \$1,000, which is \$1,200 of revenue with \$200 subtracted for expenses. The profit is shown on the right-hand side of the equation.

OE	+	(R - E)	=	A	-	L
Capital			=	Bank + Debtors + Furniture	-	Account Payable
20,800			=	10,000 + 4,600 + 16,000		9,800
	+	(1,200 - 200)	=	+ 1,200		
				- 1,200		
20,800	+	1,000	=	11,000 + 4,600 + 16,000	-	9,800

Because **Profit = Revenue - Expenses** the accounting equation can be rearranged as follows:

OE	=	A	-	L
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EXAMPLE C: The rearranged Accounting Equation

OE	+	(R - E)	=	A	-	L
20,800	+	(1,200 - 200)	=	11,000 + 4,600 + 16,000	-	9,800

Note:

What happen if the expenditures are incorrectly recorded?

- If **revenue expenditure** is incorrectly recorded as *capital expenditure* – the period's **profit is overstated** (because the expenses decrease) and the **assets is also overstated**.
- If the **capital expenditure** is incorrectly recorded as **revenue expenditure** – the period's **profit is understated** (because the expenses are overstated) and the **asset is understated**.

Activity 1: Capital Expenditure & Revenue Expenditure

1. Classify the following transaction into a capital transactions and revenue transactions.

- a. Paid wages.
- b. Bought new office cabinets.
- c. Paid rent.
- d. Paid for petrol/oil for a van.
- e. Paid postage.
- f. Bought a cash register.
- g. Paid the power bill.
- h. Paid fire insurance.
- i. Installed a sprinkler system.

CAPITAL TRANSACTIONS	REVENUE TRANSACTION

2. Calculate the amount of asset in this rearranged accounting equation.

$$\text{OE} + (\text{R} - \text{E}) = \text{A} - \text{L}$$

$$12,000 + (6,000 - 1,200) = \underline{\hspace{2cm}} - 300$$

Must show your working:

3. Janes Evans cleans works of art for private owners as well as for galleries and she employs young girl whom she is training. Janes has the following assets, liabilities and owner's equity at the end of April:

- Bank \$ 2,200

- Car \$ 15,000

- Owner's Equity \$ 17,200

During the month