TESTS FOR DIFFERENTIATING CAPITAL AND REVENUE EXPENDITURES

(1) Type of Asset:

Any amount paid for the purchase of fixed asset is "Capital Expenditure" and any amount paid for the purchase of floating or circulating asset is "Revenue Expenditure".

Explanation:

"Fixed Asset" means an asset purchased for the purpose of use in business (not for sale) whereas circulating or floating asset is purchased for the purpose of sale on profit.

Examples:

(i) Purchase of machinery for flour mill is a "Capital Expenditure".

(ii) Purchase of wheat for flour mill or raw material for manufacturing goods is a "Revenue Expenditure".

(2) Duration of Benefit:

If an expense provides long term benefit to the business then it is considered "Capital Expenditure" and if an expense provides short term benefit to the business then it is a "Revenue Expenditure".

Examples:

(i) Purchase of building for office, to be used for business activities, is "Capital Expenditure".

(ii) Rent paid for office building, is "Revenue Expenditure".

(3) Earning Capacity:

If the earning capacity of business increases due to an expense then the expense is treated as "Capital Expenditure" and if the earning capacity of business remains same due to an expense then it is a "Revenue Expenditure".

Examples:

i) Purchase of additional plant for the factory is a "Capital Expenditure".

i) Annual overhauling charges of the plant is a "Revenue Expenditure".

(4) Initial / Preliminary Expenses:

Expenses incurred for establishing a business or before the start of commercial production are "Capital Expenditures" and expenses incurred as a routine or during the course of business, are called "Revenue Expenditure".

Examples:

(i) Fee paid to legal expert for the preparation of Memorandum or Articles of a Company is a "Capital Expenditures".

(ii) Fee paid to legal expert by a company for an income tax appeal is a "Revenue Expenditure".

(5) Volume of Business:

If an expense results in expanding the volume of business then it is "Capital Expenditure" and if an expense does not expand the volume of business then it is "Revenue Expenditure".

Examples:

(i) Cost of issuing debentures is a "Capital Expenditure" of a company.

(ii) Interest paid on debentures is a "Revenue Expenditure" of a company.

MORE EXAMPLES OF CAPITAL EXPENDITURES

(i) Legal charges and stamp duty paid on the purchase of land for factory.

(ii) Cost of new spindle and installed in a textile mill.

(iii) Amount spent on signboard for the advertisement of shop.

(iv) Interest on loan and capital during the construction period of factory.

(v) Money spent to bring a second hand asset into working condition.

MORE EXAMPLES OF REVENUE EXPENDITURES

(i) Expenses on repair and maintenance of the old machinery.

(ii) Rent paid for machinery hired for business.

(iii) Wages of paid to workers for manufacturing goods.

(iv) Advertisement expenses of a product.

(v) Royalty paid for the use of copyright or patent.