Learning Objective

4. Distinguish between revenue and capital expenditures, and account for them.

1. ADDITIONAL EXPENDITURES

After a company acquires a plant asset and puts it into service, it often makes additional expenditures for that asset’s operation, maintenance, repair, and improvement. In recording these expenditures, it must decide whether to capitalize or expense them (to capitalize an expenditure is to debit the asset account). The issue is whether these expenditures are reported as current period expenses or added to the plant asset’s cost and depreciated over its remaining useful life.

Revenue expenditures, also called income statement expenditures, are additional costs of plant assets that do not materially increase the asset’s life or productive capabilities. They are recorded as expenses and deducted from revenues in the current period’s income statement. Examples of revenue expenditures are cleaning, repainting, adjustments, and lubricants. Capital expenditures, also called balance sheet expenditures, are additional costs of plant assets that provide benefits extending beyond the current period. They are debited to asset accounts and reported on the balance sheet. Capital expenditures increase or improve the type or amount of service an asset provides. Examples are roofing replacement, plant expansion, and major overhauls of machinery and equipment.

Financial statements are affected for several years by the accounting choice of recording costs as either revenue expenditures or capital expenditures. This decision is based on whether the expenditures are identified as ordinary repairs or as betterments and extraordinary repairs.

Ordinary Repairs

Ordinary repairs are expenditures to keep an asset in normal, good operating condition. They are necessary if an asset is to perform to expectations over its useful life. Ordinary repairs do not extend an asset’s useful life beyond its original estimate or increase its productivity beyond original expectations. Examples are normal costs of cleaning, lubricating, adjusting, and replacing small parts of a machine. Ordinary repairs are treated as revenue expenditures. This means their costs are reported as expenses on the current period income statement. Following this rule, Brunswick reports that “maintenance and repair costs are expensed as incurred.” If Brunswick’s current year repair costs are $9,500, it makes the following entry.

<table>
<thead>
<tr>
<th>Date</th>
<th>Description</th>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Dec. 31</td>
<td>Repairs Expense</td>
<td>9,500</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Cash</td>
<td></td>
<td>9,500</td>
</tr>
<tr>
<td></td>
<td>To record ordinary repairs of equipment.</td>
<td></td>
<td>9,500</td>
</tr>
</tbody>
</table>

Financial Statement Effect

<table>
<thead>
<tr>
<th>Accounting</th>
<th>Expense</th>
<th>Timing</th>
</tr>
</thead>
<tbody>
<tr>
<td>Revenue expenditure</td>
<td>Income stmt. account debited</td>
<td>Expensed currently</td>
</tr>
<tr>
<td>Capital expenditure</td>
<td>Balance sheet account debited</td>
<td>Expensed in future</td>
</tr>
</tbody>
</table>

Point: Many companies apply the materiality constraint to treat low-cost plant assets (say, less than $500) as revenue expenditures. This practice is referred to as a “capitalization policy.”

Assets = Liabilities + Equity

$9,500 = $9,500
Learning Objective 4

Betterments and Extraordinary Repairs

Accounting for betterments and extraordinary repairs is similar—both are treated as capital expenditures.

Betterments (Improvements) Betterments, also called improvements, are expenditures that make a plant asset more efficient or productive. A betterment often involves adding a component to an asset or replacing one of its old components with a better one, and does not always increase an asset’s useful life. An example is replacing manual controls on a machine with automatic controls. One special type of betterment is an addition, such as adding a new wing or dock to a warehouse. Since a betterment benefits future periods, it is debited to the asset account as a capital expenditure. The new book value (less salvage value) is then depreciated over the asset’s remaining useful life. To illustrate, suppose a company pays $8,000 for a machine with an eight-year useful life and no salvage value. After three years and $3,000 of depreciation, it adds an automated control system to the machine at a cost of $1,800. This results in reduced labor costs in future periods. The cost of the betterment is added to the Machinery account with this entry.

<table>
<thead>
<tr>
<th>Date</th>
<th>Machinery (Additions)</th>
<th>Cash</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Jan. 2</td>
<td>1,800</td>
<td>1,800</td>
<td></td>
</tr>
</tbody>
</table>

To record installation of automated system.

After the betterment is recorded, the remaining cost to be depreciated is $6,800, computed as $8,000 − $3,000 + $1,800. Depreciation expense for the remaining five years is $1,360 per year, computed as $6,800/5 years.

Extraordinary Repairs (Replacements) Extraordinary repairs are expenditures extending the asset’s useful life beyond its original estimate. Extraordinary repairs are capital expenditures because they benefit future periods. Their costs are debited to the asset account (or to accumulated depreciation). For example, Delta Air Lines reports, “modifications that ... extend the useful lives of airframes or engines are capitalized and amortized [depreciated] over the remaining estimated useful life of the asset.”

1. Subsequent expenditure on property, plant, and equipment—fixed assets

Introduction

Subsequent expenditures on fixed assets may be either on maintaining the capacity and productive efficiency of these assets or might be incurred to enhance the capacity or efficiency of these assets. Depending upon the impact of the expenses on capacity and efficiency of the fixed asset, the accounting effect is provided.

Improvements vs Repairs and Maintenance

Improvement costs are such subsequent costs that result into any or all of the following:

- Productive capacity of the fixed asset is enhanced.
- Economic life of the fixed asset is improved.
- Scope of functional uses/performance is widened.
- Quality of output from fixed asset is enhanced.
- Speed of the fixed asset in discharging intended functions improves.

As per the provisions of IAS-16 and AS-10, if a subsequent expenditure in connection with a particular fixed asset is likely to augment the previously estimated performance or capacity of the fixed asset it is to be capitalized and added to the carrying cost – gross book value of the concerned fixed asset.

All such subsequent costs are called improvement costs and these should be capitalized, i.e. to be added to the existing carrying cost of the asset.
Repairs and Maintenance expenses are expenditures that are incurred in routine to maintain the performance or capacity of the fixed asset. These expenses are part of the routine servicing or maintenance of the asset so that the capacity or performance of the concerned asset can be maintained. Therefore, these expenses/costs should be considered as normal repairs and maintenance cost to be charged to the revenue of the current period by debiting to the profit and loss account. These costs should not be capitalized as these do not result into augmenting the capacity/performance of the fixed asset; rather, maintain the capacity/performance of the asset.

Renewal Costs vs Relocation Costs

Renewal costs are costs that help in making a modification in the existing project/fixed asset—property, plant, and equipment. These costs not only help in maintaining the existing performance of the asset but also augment the performance of the fixed asset concerned. The practical impact of these costs might be in the form of replacement of some component of the asset or help in expanding the scope or life of the asset. Therefore, these are also called replacement and extension/expansion costs. All these costs should be capitalized and depreciated as the main asset is depreciated.

Illustration Cost incurred on replacing the diesel engine of a four-wheeler with a petrol engine. Such replacement is likely to enhance the performance of the asset as well as likely to result into additional economic benefits for business enterprises. Similarly, replacing a petrol engine with a CNG (compressed natural gas) engine to bring improvement in the existing car is to be capitalized.

Sometimes, such renewal leads to the expansion of the existing asset, such as building or plant and economic life of such extension is longer as compared to the economic life of the main asset. In this situation, both the main asset and the extension should be depreciated separately, as if these were independent assets, but generating synergy benefits.

Relocation costs are such costs that are incurred in shifting a particular fixed asset to a new location from its existing location. If such relocation is likely to enhance the capacity/performance of the existing asset then it is to be capitalized and added to the existing carrying cost of the asset. On the contrary, if relocation costs do not result in the enhancement of the capacity/performance then it is to be considered as revenue expense and debited to the profit and loss account.

Example 1 The following facts have been extracted from the books of accounts of Reliable Enterprises Ltd. (REL):

The company acquired a new plant and machinery costing ₹12,00,000 and spent ₹30,000 as carriage and ₹20,000 as installation charges to install it. To finance it, the company raised a loan of ₹7,00,000 on July 1, 2010 bearing a rate of interest 12% p.a. The plant and machinery was ready for commercial production on December 31, 2010. The loan was repaid on March 31, 2011 along with interest thereon. In the month of February 2011, ₹5,000 were spent for the routine inspection and ₹15,000 for annual maintenance contract (AMC) for 12 months.

Show how these costs are to be recognized for the year ending March 31, 2011.

Solution As per the provisions of AS-10, cost of fixed assets should comprise only purchase price, purchase expenses, installation charges, and borrowing cost till the date of commissioning of asset. In this case, the cost of plant and machinery ₹12,00,000, carriage ₹30,000 is considered as purchase expense and ₹20,000 installation charges and interest ₹42,000 (7,00,000 × 12/100 × 6/12) on loan up to December 31, 2010 are to be considered as initial cost of plant and machinery. Therefore, plant and machinery should be recognized initially at ₹12,92,000 (12,00,000 + 30,000 + 20,000 + 42,000) the initial cost of plant and machinery.

The interest ₹21,000 from January 1, 2011 till March 31, 2011, ₹5,000 on routine inspection and ₹15,000 of AMC are to be considered as routine expenses and to be expensed to the profit and loss account for the year ending March 31, 2011.
Glossary

- **Capital expenditures**: These are also called *balance sheet expenditures*. These expenditures are incurred to improve the efficiency or productive capacity of the asset. These are capitalized and put to depreciation as the initial cost is put to depreciation.

- **Renewal costs**: These are costs that help in making modification in the existing project/fixed asset – property, plant, and equipment. These costs not only help in maintaining the existing performance of the asset but also augment the performance of the fixed asset concerned.

- **Replacement costs**: Replacement costs are costs that are incurred in shifting a particular asset to a new location from its existing location. If such relocation is likely to enhance the capacity/performance of the existing asset, it is to be *capitalized* and added to the existing carrying cost of the asset. On the contrary, if relocation costs do not result in the enhancement of the capacity/performance, these are to be considered as *revenue expense*.

- **Revenue expenditures**: These are also called *income statement expenditures*. These are incurred to maintain the productive capacity and efficiency of the assets and do not result in the improvement in the productive capacity of the assets concerned. These are expensed to the profit and loss account like other revenue expenses.

Summary

Revenue expenditures expire in the current period and are debited to the profit and loss account (income statement) so as to match the expenses with the revenue for a period. These expenses generate utility only for the current financial year. Capital expenditures generate utility over a longer time period, even beyond the current financial year. Hence, these are not expenses to profit and loss account and are instead capitalized. These are amortized over the useful life of the asset. Amortization is the process to show the capitalized cost of an asset as an expense.

Useful Formulae

Carrying cost of an asset

\[= \text{Present net block} + \text{Additional cost capitalized}\]

Useful Tips

- Renewal expenses resulting into enhancement in the performance of the asset are to be capitalized.

- Relocation expenses, if they augment the capacity of the asset, should be capitalized; otherwise, they are expenses like other revenue expenses.