

32.2 An exercise on the distinction between capital expenditure and revenue expenditure

REQUIRED

State whether the following should be treated as capital expenditure or revenue expenditure. Give reasons for your decision and/or state any further information you may need in order to make a decision.

In the case of capital expenditure, also outline the depreciation policy you would propose for the relevant fixed asset.

1. legal fees in connection with the purchase of land for construction of a new factory

This should be treated as capital expenditure – part of the cost of building the new factory. It should be depreciated on the same basis as the factory itself.

2. major repairs to the roof of a building

If this involves mere repairs, it should be treated as revenue expenditure – an expense in the current P&L Account. If it involves any element of improvement to the roof (for example improved insulation, better lighting, etc.), then the proportion of the cost that relates to improvements may be treated as capital expenditure, with depreciation accounted for on the same basis as the building itself.

3. purchase of a pencil sharpener and stapler for use in an office

Technically these are fixed assets – acquired for long-term use in the business. However, in view of the very small value involved, the expenditure would in most firms be treated as revenue expenditure and shown as an expense in the current P&L Account.

(Notice that most firms have a financial limit below which expenditure on a single item will not be treated as capital expenditure. Can you think of any possible perverse consequences of such a policy?)

4. purchase of hand-tools by a self-employed craftsman

In a large firm the purchase of hand tools may well be regarded as revenue expenditure, because the value involved is small relative to the investment in the business as a whole. A self-employed craftsman however (operating on a much smaller financial scale) might decide to capitalize the expenditure on certain hand tools, depending on their cost, and on their expected useful life.

5. purchase of hand-tools by an engineering factory

This would probably be treated as revenue expenditure. Alternatively, the tools held in the business at each year-end could be treated as a form of stock.

6. purchase of overalls for factory workers

This would probably be treated as revenue expenditure.

7. purchase of costumes by a nightclub artiste

Depending on the cost involved (which may be very high) and the expected useful life of the costumes, this may well be treated as capital expenditure, with the costumes shown as fixed assets in the artiste's balance sheet.

8. staff training costs

Although staff training may provide future benefits for the firm, prudence dictates that the expenditure should be treated as an expense (revenue expenditure) because the benefit is hard to estimate, and the trained staff may leave the firm before the benefit is realized.

9. patent registration fees

If the patent is granted, and likely to prove profitable, the registration fees may be treated as capital expenditure, and included in the cost of the invention as a fixed asset in the balance sheet. If/when the patent is not likely to prove profitable, the costs associated with it should be treated as expenses (revenue expenditure).

10. advertising to promote a special offer

This should be treated as revenue expenditure – an expense in the current P&L Account.

11. advertising to promote ‘name awareness’

‘Name awareness’ is in practice a valuable asset, and can boost sales for many years to come. On these grounds, expenditure to create name awareness could arguably be treated as capital expenditure, with depreciation accounted for in future P&L Accounts as an expense against the sales to which it may give rise. However, on grounds of prudence (because the extent of the future benefit cannot be reasonably known in advance), most accountants would argue that like any other advertising it should be treated as revenue expenditure.

12. legal fees in connection with defence of patent rights

If the court action is to defend against minor infringements, the expenditure should be treated as revenue expenditure. However, if the action successfully establishes a point of law that was previously in doubt, and therefore increases the value of the patent, then the expenditure could be treated as capital expenditure, and depreciated over the remaining useful life of the patent.

13. costs of setting up a new accounting system

Although a successful new accounting system should bring future benefits to the firm, on the grounds of prudence, this expenditure would in most circumstances be treated as revenue expenditure – an expense in the current P&L Account.

14. costs of recruiting skilled staff

Despite their probable future value to the firm, to the extent that skilled staff are not tied to the firm and may leave at any moment, the expenditure involved in their recruitment should be treated as revenue expenditure.

15. major costs associated with arranging a very large long-term loan

The costs of arranging a large loan in connection with the purchase or construction of a fixed asset may be treated as capital expenditure and included in the cost of the fixed asset.

16. cost of farm-workers' labour in digging drainage ditches

Ditches are fixed assets which provide future economic benefits, and therefore the costs of digging new ditches could be treated as capital expenditure. (The cost of merely digging out old ditches would be revenue expenditure.)

17. a football transfer fee of £8 million

Transfer fees are usually treated as capital expenditure, and depreciation is charged over the life of the contract. (Compare the answer to Q14 – why are these treated differently?)

18. market research prior to the launch of a new product

Effective market research may make for more profitable sales in the future, and to that extent, in theory, its cost may be capitalized or treated as a fixed asset. However, prudence is again invoked to require that most such costs are treated as revenue expenditure and expensed in the P&L Account.