REVALUATION OF FIXED ASSETS

Fixed assets are purchased to be used for longer period. In the subsequent years, the value of asset could be higher or lower than its present book value due to inflationary condition of the economy. Assets are valued at Historical Cost in the books of accounts.

Historical Cost

Historical cost is the original cost of the asset at which it was purchased plus additional costs incurred on the asset to bring it in working condition. Sometimes, the management of the business, if it thinks fit, revalues the asset to present it at current market value. Once the asset is revalued to its market value, then its value has to be constantly monitored to reflect the changes in the market value.

Recording the effects of Revaluation of an Assets

If an asset is revalued at higher cost than its original cost, the excess amount will be treated as profit on revaluation of fixed assets and it is credited to Revaluation Reserve Account. On the other hand, if an asset is revalued at lower cost than its original value, the balance amount will be treated as loss on revaluation of fixed assets and it is shown in the profit & loss account of that year in which asset was revalued.

Fair Value

It is the value, at which an asset would bring to the management, when sold to a knowledgeable party in a fair deal.

Rules for Revaluation

- Revaluation has to be carried out at regular intervals
- The change in the value should be permanent
- Whole class of asset has to be revalued

Illustration:

An asset is purchased at the cost of Rs. 300,000. It was decided by the management that depreciation would be charged @ 20% on the basis of straight line method. At the end of third year, following information is given:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Accumulated Depreciation</td>
<td>Rs. 180,000</td>
</tr>
<tr>
<td>Written Down Value</td>
<td>Rs. 120,000</td>
</tr>
</tbody>
</table>

The management has decided to revalue it to the current market value. The current market value of the asset is 180,000. You are required to make the necessary adjustments.
Solution:

There are two options for making adjustments for the above mentioned changes:

1. Charge the accumulated depreciation to the cost of asset and increase the value of asset with the difference of current market value and WDV.
2. Calculate the proportion of increase and increase the cost of asset and accumulated depreciation with that proportion.

Option # 1:

The accumulated depreciation is charged off against the cost of asset with the help of following entry:

<table>
<thead>
<tr>
<th>Debit:</th>
<th>Accumulated Depreciation 180,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Credit:</td>
<td>Cost of asset A/c 180,000</td>
</tr>
</tbody>
</table>

Cost of asset is increased to current market value, i-e., Rs.180,000. The difference between current market value and WDV is Rs. 60,000 (180,000 – 120,000). The credit is given to Revaluation Reserve Account.

<table>
<thead>
<tr>
<th>Debit:</th>
<th>Cost of asset A/c 60,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Credit:</td>
<td>Revaluation Reserve A/c 60,000</td>
</tr>
</tbody>
</table>

Option # 2:

Both Cost and Accumulated Depreciation are increased in a proportionate manner so that the resulting Book Value is equal to the revalued amount.

Desired increase in WDV:
180,000 – 120,000 = 60,000

Rs.60,000 is 50% of 120,000. Therefore desired increase in Cost and Accumulated Depreciation is 50%.

Cost is increased by 50% by following entry:

<table>
<thead>
<tr>
<th>Debit:</th>
<th>Cost of asset A/c 150,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Credit:</td>
<td>Revaluation Reserve A/c 150,000</td>
</tr>
</tbody>
</table>

Accumulated depreciation is increased by 50% with the help of the following entry:

<table>
<thead>
<tr>
<th>Debit:</th>
<th>Revaluation Reserve A/c 90,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Credit:</td>
<td>Accumulated Depreciation A/c 90,000</td>
</tr>
</tbody>
</table>
Capital and Revenue Expenses

Capital Expenses are those expenses for which benefit is enjoyed for more than one accounting period. For example, the business has bought a car. Now, car will be used for many years. So, it is a capital expense. Capital Expenditure generally adds Fixed Asset Units or increases economic life, capacity or efficiency of existing fixed assets. The term used for Capital expenditures is ‘Capitalized’.

Capital Expenditures are incurred in two ways:
- When an asset is acquired, and
- When an improvement is made in an existing asset.

All the expenditure incurred up to the point of bringing the asset to its intended use is capitalized as the initial cost of asset.

An expenditure that improves the performance of an asset from its originally assessed performance is termed as capital expenditure. However, the expenditure incurred on the maintenance of an asset is treated as Revenue Expense.

Revenue Expenses are those expenses for which, the benefit is enjoyed within one accounting period. For example, the business has purchased stationery for office use. Now, the stationery is used within one year in the office. So, this will be a revenue expense. The term used for Revenue Expenditures is ‘Charged Off’.

Revenue Expenses are those expenses that are:
- Incurred in day to day running of the business.
- Incurred to maintain fixed assets in their original / useable condition.

All Capital Expenses are grouped in balance sheet & all Revenue expenses are grouped in Profit & Loss account.

**Distinction between Capital Expenditure & Revenue Expenditure**

<table>
<thead>
<tr>
<th>Capital Expenditure</th>
<th>Revenue Expenditure</th>
</tr>
</thead>
<tbody>
<tr>
<td>Its effect is long term, i-e. It is not exhausted within the current accounting period. Its benefit is received for a number of years in future.</td>
<td>Its effect is short term, i-e. The benefit is received within one accounting period.</td>
</tr>
<tr>
<td>Expenditure is said to be capital expenditure when an asset is acquired or performance of an existing asset is increased.</td>
<td>Neither an asset is acquired nor is the performance of any asset increased.</td>
</tr>
<tr>
<td>It does not occur again and again. It is non-recurring and irregular.</td>
<td>It is recurring and regular and it occurs repeatedly.</td>
</tr>
<tr>
<td>This expenditure improves the financial position of the business.</td>
<td>This expenditure helps to maintain the business.</td>
</tr>
<tr>
<td>A portion of this expenditure (Depreciation on asset) is shown in the profit &amp; loss account and the balance is shown in the balance sheet on asset side.</td>
<td>The whole amount of this expenditure is shown in the profit &amp; loss account or income statement.</td>
</tr>
<tr>
<td>It appears in the balance sheet until its benefit is fully exhausted.</td>
<td>It does not appear in the balance sheet.</td>
</tr>
<tr>
<td>It does not reduce the profit of the concern.</td>
<td>It reduces the profit of the concern.</td>
</tr>
</tbody>
</table>
Deferred Expenditure

The revenue expenditure that provides benefit for more than one year is called deferred expenditure. It is initially shown in balance sheet. Subsequently, it is charged to profit and loss account over the period in which benefit is derived from it.

Prepaid Expenses are amounts that are paid in advance to a vender or creditor for goods and services. Typically, insurance premiums are paid in advance of the coverage contained in the policy. Prepaid Expenses is a Current Asset for our business. This is because we have paid for something and someone owes us the service or the goods for which we prepaid.

The General Rule

The general rule for distinguishing between capital and revenue expenditure is as follows:
- The expense whose benefit lasts for a period longer than an accounting period is called capital expenditure, and
- The expense whose benefit is obtained within an accounting period is termed as a revenue expense.

Exceptions

Depending upon the size of expenditure and policy of the organization, following expenditures can be “Charged to Profit and Loss” instead of “Capitalizing”.
- **Legal Charges** – are as per rule charged to P & L but when these are incurred to acquire an asset these should be capitalized with the asset.
- **Repairs** – are also charged to P&L but when it is of such nature that it enhances the performance of an asset from its original performance than it should be capitalized.
- **Wages** – are normally revenue expense but when these are paid to men employed to create an asset these should be capitalized as the cost of asset.
- **Freight and Carriage** – normally a revenue expense, but when paid to bring an asset to its intended use then it is treated as capital.
- **Interest on Loan** – is normally revenue expenditure but when the loan is taken to purchase an asset its interest is treated as Capital and is added to cost of the asset.

Capital and Revenue Receipts

Capital Receipts

Receipts which are non-recurring and whose benefits are enjoyed over a long period are called ‘Capital Receipts’. For instance, Capital invested, Loan from bank, Sale proceed of fixed assets etc. Capital receipts are shown on the liability side of the balance sheet.

Revenue Receipts

Receipts which are recurring by nature and which are available for meeting all day to day expenses of a business concern are known as ‘Revenue Receipts’. For example, sale proceeds of goods, interest received, rent received etc.