

Financial Accounting
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Lecture – 65
5.14 Tutorial Outstanding Expenses

In this tutorial I am going to talk about Outstanding Expenses in a little more detail.

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What amount should be shown in final accounts?

- You are running a furniture trading company and have hired a local premises to be used as store. The owner of store charges Rs 10,000 per month as rent. You are also to bear the electricity expenses attributable to the premises which are Rs 1000 per month. ✓ Rent
✓ Electricity
- Every year, you pay rent in the month of April 1 and Oct 1 for next six months. However, during FY2015-16, you could not pay the second installment of rent in Oct. However, you convinced store owner to collect the same on April 1 along with rent for first six months of FY2016-17.
- How should the above be accounted for in final accounts?



On the screen you see some statements: I will walk you through this and then we will talk about how to think about the items relating to outstanding expenses. So, the statement says you are running a furniture trading company and you have hired a local premises, meaning a building, or a store, to be used as a store actually: so, it is a store. The owner of the store charges you 10,000 per month as the rent. You are also to bear the electricity expenses attributable to the premise, which are fixed at 1000 per month. So, the two types of expenses are rent and electricity bill. Every year you pay rent in the months of April and October on the 1st days of these months and you pay for the next six months.

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What amount should be shown in final accounts?

FY 2015-16
 2015 April Oct. 2016 Mar 31 April 1

① Rent
 ② Electricity

Paid $10000 \times 6 = 60000$ Unpaid $10000 \times 6 = 60000$
 Electricity $1000 \times 12 = 12000$

Pay 60000
 + 60000
 120000

X	Cash Basis	Rent	60,000
		Elect	12,000
✓	Accrual Basis	Rent	120,000
		Elect	12,000

Let me first draw this in order to illustrate it better. Which financial year are we talking about? We are talking about 15 and 16. This is going to start on 2015, April 1 and it is going to end on 2016, March 31st. You have 12 months in between. So, 1, 2, 3, 4, 5, 6, 7, 8, 9, 10, 11 and 12, alright. You pay on April 1st and October 1st. So, April 1st you are going to pay something and then after May, June, July, August, September, in October, so let me write October 1st: you are going to pay something here. When you pay here you pay for the next 6 months and then you pay for the next 6 months. In effect you are paying in advance you pay for the next 6 months and that is how the rent market functions. People do not let you pay after you have used the building, you have to pay in advance for the use in the next period and in case of commercial establishments the rent is typically collected for 6 months or for 12 months or sometimes even more than you know 12 months as well. Let us now look at the arrangement that they have which is first of these two months they have to pay and then during this year you could not pay the second installment. So, in this year how much did you pay? You paid 10,000 a month, so you paid Rs. $10,000 \times 6$ months = Rs. 60,000 was paid on April 1st. On April 1st one instalment was paid and then on October 1st you could not pay it. So, this is unpaid, the unpaid amount is also $10,000 \times 6$ as well. So, 60,000 has not been paid. However, you convince the store owner to collect the same on April 1st along with the rent for the first 6 months of the next financial year. So, when you begin April 1st next year, you are telling your landlord and this is in the future. You are saying you will pay this rent 60,000 for the previous 6 months plus you will pay rent for next 6 months.

Thus, in the next year you will pay Rs. 1,20,000 which will take care of half of this year and half of the upcoming year. So, this is the arrangement you have arrived at. How should the above be accounted for in the final accounts? The other expense we have missed is electricity expenses which are 1000 per month and you pay this every month. Let me write rent here and the other one is electricity which is 1000 per month and you do not pay it 6 monthly, but you pay every month. So, in total you are paying 12000. So, Rs. 1000 *12months= Rs.12000. So, there are two expenses; rent and electricity. Electricity is being paid every month 12,000 for the year and rent is paid 6 monthly and now you have not paid it.

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What amount should be shown in final accounts?

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	Rent 60000	
	+ Outstanding 60000	
	120000	
	Electricity expense 12000	
		Balance sheet
		Current liabilities
		Outstanding Rent 60000

The question is: when we are preparing the final accounts, profit and loss account and balance sheet, in these statements what amount do we write? We clearly know that rent and electricity both are going to be considered as an indirect expense. Of course, you can again debate that this storage is for a factory outlet. In that case you can write it in the first half. But I am going to assume the second half: this is a store of finished goods, a sales store. So, here we are going to show rent and we are going to show electricity expenses. What amount is to be shown in this year is the question. If you go cash basis then you would say rent that has been paid is 60,000 and electricity expenses have been paid 12000, so show this. However, we know that accounting is done on accrual basis, it does not matter whether you have paid or not: you have used the store, the expenses have become due in this year, the benefit from the store has been derived in this year, and due to that benefit, you have been able to generate sales. You have to match the revenue, the sale of this year, to the expenses of this year. Whether you have paid

for it or not, it does not matter. On an accrual basis, the rent for the year is 1,20,000 and electricity expenses have been paid. Actually, there is no accrual of electricity; 12,000 is the actual expense that you should show. Therefore, the amount to be shown is going to be on accrual basis and not cash basis. This leads us to say that the rent to be shown is going to be 60,000 plus, you are going to say an outstanding rent, outstanding rent of 60,000. So, the expense of the current year should be counted as 120,000. Now, the common perception of expenses is that we pay for it and then we count it as an expense. However, in accounting language, the expense means, whatever you have taken the benefit in the given year, you call it an expense. If you have not paid, it does not matter. So, accounting is done on an accrual basis. This 60,000 which is outstanding will go to current liabilities. We will say outstanding rent 60,000 is going to be shown here. See the double entry system: there are two effects happening- the rent which has been paid is shown here and whatever has been paid will be taken out will be deducted from the cash account, which will be on the debit side and all of that is taken care of. The outstanding expense of 60,000, is shown in the income statement as an expense and also as a liability because you will have to pay for it. Electricity expenses, on the other hand, are 12,000, they will be shown as expenses paid for electricity bill. Nothing goes to the balance sheet. This is how you are going to treat the outstanding expenses. Any outstanding expenses will have to be first of all recognized as an expense and shown in the income statement. Second, the amount of outstanding expenses has to be shown in the liability side under the current liabilities, because you will have to pay for it in the next one year. Alright, I will see you in another tutorial.