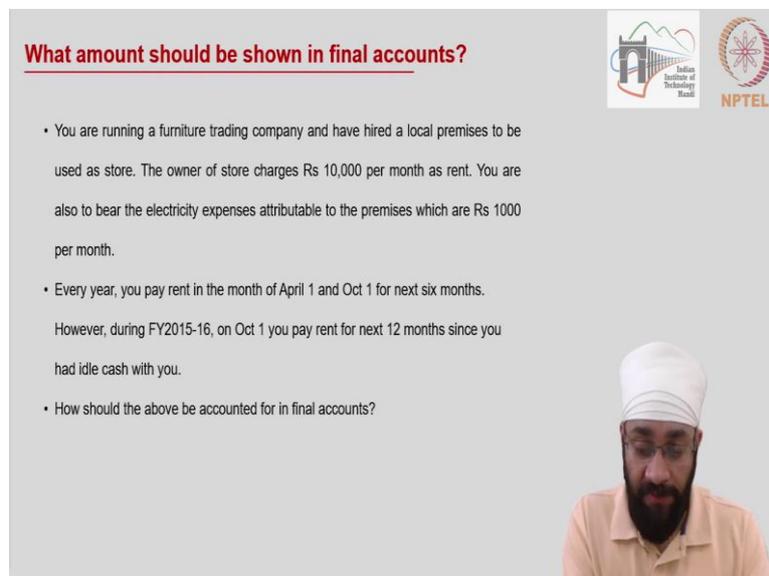


Financial Accounting
Dr. Puran Singh
School of Humanities and Social Sciences
Indian Institute of Technology, Mandi

Lecture – 66
5.15 Tutorial - Prepaid Expenses

This is a tutorial on Prepaid Expenses. In the previous tutorial, we discussed the outstanding expenses. Prepaid expenses are just the reverse of that. We are going to discuss how prepaid expenses are treated and some other dynamics relating to it.

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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.
- Every year, you pay rent in the month of April 1 and Oct 1 for next six months. However, during FY2015-16, on Oct 1 you pay rent for next 12 months since you had idle cash with you.
- How should the above be accounted for in final accounts?

The slide includes logos for Indian Institute of Technology Mandi and NPTEL in the top right corner. A video overlay of a man with a beard and glasses is visible in the bottom right corner of the slide area.

Same setup: we have the store and you pay 10,000 a month for that financial year. Again, payment terms are the same: you pay on April 1st and October 1st for the next six months. The only thing which is different is that you pay additional rent. Again, let me draw the timeline to help you think through this better.

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What amount should be shown in final accounts?

The slide contains handwritten notes and T-accounts. At the top, it asks 'What amount should be shown in final accounts?'. Below this, there are calculations for rent expense. For FY 2015-16, starting April 1, 2015, 10,000 is multiplied by 6 to get 60,000. For FY 2015-16, starting Oct 1, 2015, 10,000 is multiplied by 6 to get 60,000. For FY 2016, starting Mar 21, 2016, 10,000 is multiplied by 6 to get 60,000. A total of 120,000 is shown. Below these calculations, a 'Cash basis' entry shows 'Rent paid → 180,000'. To the right, a T-account for 'P&L A/C' shows 'Rent' 180,000 on the debit side and 'Less: (Prepaid Rent)' 60,000 on the credit side, resulting in a balance of 120,000. Below this, a T-account for 'Balance Sheet' shows 'Current Asset' with 'Prepaid Rent' 60,000 on the debit side and a total of 120,000 on the credit side.

Financial year 2015 and 16 is going on and in 2015 you are on April 1st and then there is October 1st in the same year and in 2016, March 31st - the financial year comes to an end. Then you have April 1st of the same year, but that is the next financial year. So, what you do is you pay rent here and here for the next six months. In this question during 15-16, on October 1st you pay rent for 12 months. So, on October 1st you had to pay rent for six months which was equal to 10000×6 , for this financial year. However, you had idle cash, extra cash, and you paid for the next six months as well. That is what is different in this question. You, of course, paid here 10000×6 months; so that is also done. So, you have already paid 60,000 here and here you paid 60,000 for this year plus you paid 60,000 for the next year. So, total 120,000. Thus, in this financial year, you have actually paid 180,000. Now the question is: when you are preparing the profit and loss account and the balance sheet, how much should be shown as an expense? And what happens to this extra money that you have paid. That is what we are going to discuss. Again, if you go on a cash basis, you will say well rent paid is equal to 180,000, you show it like this. However, we do accounting on an accrual basis which means whatever is due in that financial year. In the previous tutorial where we were discussing outstanding expenses, the case was that you have not paid the expense for the financial year but the accrual basis says it does not matter whether you have paid for it or not: if you have taken the benefit of the expense, show it as an expense. Now in this case you have paid for the next year also and not only for this year. The accrual basis still says please do not consider next year's expense as this year's expense because the next year's expense has not become due on the accrual basis. Only show the amount which has become due in this year. So, following the accrual basis, the amount to

be shown is going to be 120,000 only. Let me prepare it here. When you prepare the profit and loss account, you are going to show rent paid as 180,000 and then you are going to deduct from it the 60,000 which is for the next year. Actually, you can only show 120,000 as the expense in the current year. Again, I am invoking the matching principle, the accrual principle, that you cannot show the expense of the next year in this year. So, this is prepaid rent that you are deducting. This is the actual expense that you show. On the other side, the balance sheet will show you the impact of the 60,000 that has been paid. You have paid for it; the cash has gone out. You have to do something about it. So, if you have paid in advance, it is shown as the current asset. So, in the balance sheet under the current assets you show an item called prepaid rent and the amount is going to be 60,000. That is the effect on the balance sheet. Any prepaid expenses for that matter are going to be treated like this. You have paid in advance, you can't show it as an expense for this year, because the benefit of this expense will be realized in the next year and that is when it should be shown as an expense.

So, this was a discussion on prepaid expenses. We learnt that prepaid expenses are shown as current assets in the balance sheet and any prepaid expenses cannot be shown as an expense in the current financial year.