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Year – II
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Paper - II

Advanced Accountancy - I



Centre for Distance and Online Education

श्रीचन्द्रशेखरेन्द्रसरस्वतीविश्वमहाविद्यालयः

Sri Chandrasekharendra Saraswathi Viswa Mahavidyalaya

Deemed to be University u/s 3 of UGC Act 1956 - Accredited with 'A' grade by NAAC

Enathur, Kanchipuram 631561.

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Course Writers

Dr. P. Balaji
Assistant Professor
Department of Commerce
SCSVMV

Dr. C. Kathirvel Babu
CDOE
Department of Commerce
SCSVMV

Programme Coordinator

Mr. S. Swaraj
Assistant Professor,
CDOE
SCSVMV

Chief Editors

Dr. B. Balaji Srinivasan
Director, CDOE
SCSVMV

Dr. Hema Narayanan
Head of the Department,
Department of Commerce,
SCSVMV

BC312 Advanced Accountancy – I

Course Objective

- To understand accounting as an information system and the role of accounting standards in providing reliable financial information.
- To learn the accounting treatment of royalty transactions, including minimum rent, short workings, and sub-leases.
- To understand the accounting procedures under hire purchase and instalment systems, including interest calculation and repossession.
- To develop skills in maintaining accounts for branches and departments, including allocation of expenses and inter-department transfers.
- To understand the accounting for insurance claims on stock and loss of profits and for investment transactions.

Unit – I

Accounting as an information system-Concept– users of accounting information – Accounting Standards-concept-types – benefits– difficulties in standard setting– standard setting in India (Theory only)

Unit – II

Royalty Accounts: Meaning – Minimum rent – Short workings – Recoupment of short workings – Accounting records in the books of the lessor and lessee – Sub lease.

Unit – III

Hire Purchase and Instalment Systems: Hire purchase system – Features – Calculation of interest – Accounting treatment in the books of buyer and seller (excluding hire purchase trading accounts and stock and debtors' system) – Default and repossession – Complete repossession - Partial repossession– Instalment system – Difference between hire purchase system and instalment system

Unit – IV

Branch Accounts: Branch accounting – types of branches – independent branch – debtors' system (excluding stock and debtors' system, foreign branches) Departmental Accounts–

allocation of expenses – inter-department transfers (Excluding unrealized profit on closing stock)

Unit – V

Insurance Claims: Claims for loss of stock – Calculation of normal and abnormal items – Application of average clause – Loss of profits – Steps in the preparation of claim under loss of profits policy. Investment Accounts– Meaning – Cum-dividend/Cum- interest – Ex-dividend/Ex- interest - Investment accounts in columnar form.

Course Outcomes:

- Students will be able to explain the concept of accounting, identify its users, and describe the types and benefits of accounting standards, including their formulation in India.
- Students will be able to record royalty transactions in the books of lessor and lessee and calculate recoupment of short workings.
- Students will be able to prepare accounts for buyers and sellers under hire purchase and instalment systems and handle default and repossession scenarios.
- Students will be able to prepare branch and departmental accounts and record inter-department transactions accurately.
- Students will be able to compute insurance claims, apply average clause, and record investment transactions in columnar form.

Text Book

1. Advanced Accounting – R.L. Gupta & M. Radhaswamy
2. Advanced Accountancy – S.N. Maheshwari & S.K. Maheshwari
3. Advanced Accountancy – M.C. Shukla & T.S. Grewal
4. Modern Accountancy – Mukherjee & Hanif
5. Advanced Accounting – Ashok Sehgal & Deepak Sehgal

Reference Books

1. Advanced Accountancy - Vol-I - R. L. Gupta & M. Radaswamy, Revised edition – 2016
S. Chand & Company Ltd, Ram Nagar, New Delhi-110 055

2. Financial Accounting - S. P. Jain & J.L. Narang, Revised Edition 2007, Kalyani Publishers, B-I/1292, Rajinder Nagar, Ludhiana
3. Shukla Grewal and Gupta, "Advanced Accounts", volume 1, S.Chand and Sons, New Delhi.
4. Advanced Accounting – J.R. Batliboi
5. Advanced Accountancy – R.L. Gupta

Web Resources

1. ICAI – Accounting Standards and Guidance Notes
2. AccountingTools.com – Advanced Accounting Topics
3. Investopedia – Accounting Principles
4. Corporate Finance Institute – Accounting Resources
5. Swayam – Online Accounting Courses

ACCOUNTING STANDARDS

Structure

- Overview
- Learning Objectives
- 1.1 Introduction to Accounting as an Information System
- 1.2 Meaning of Accounting Standards:
- 1.3 Need for Accounting Standards:
- 1.4 Objectives of Accounting Standards:
- 1.5. Significance or advantages of Accounting Standards:
- 1.6. Limitations of Accounting Standards:
- 1.7. Accounting standards in Indian context:
- 1.8. The scope and functions of Accounting Standards Board are:
- 1.9. Conclusion
- Check Your Progress
- Let Us Sum Up
- Glossary of Terms
- Answers to Check Your Progress
- Suggested Reading

Overview

Accounting is not just a process of recording transactions but serves as a crucial information system for decision-making. This unit explores the conceptual foundations of accounting as an information system, identifies key users and their needs, and delves into the structure and significance of accounting standards, their types, benefits, and challenges in setting them—particularly in the Indian context.

Learning Objectives

By the end of this unit, students will be able to:

- Understand accounting as an information system
- Identify various users of accounting information

- Explain the concept and types of accounting standards
- Analyze the benefits and limitations of standard setting

Discuss the process and bodies involved in accounting standard setting in India

1.1 Introduction to Accounting as an Information System

Accounting standards are formal written guidelines issued by a professional accounting authority, the government, or another regulatory institution. They address various aspects of identifying, measuring, presenting, and disclosing financial transactions in financial reports. These standards act as a foundational structure that allows for the preparation of reliable and consistent financial statements. They are developed to bring uniformity to diverse accounting methods and policies. The main purpose of these standards is to limit the variety of accounting choices available when preparing financial statements, while still maintaining logical and reasonable options. This ensures that the financial reports of different organizations can be compared effectively, offering valuable insights to a wide range of users. Accounting standards outline the fundamental accounting concepts and how to apply them during the preparation and presentation of financial data, ensuring that the statements reflect a true and fair representation. This in turn promotes transparency and strengthens financial discipline in the market. Furthermore, they assist regulatory bodies in assessing the accuracy and reliability of financial reporting.

1.2 Meaning of Accounting Standards:

As defined by the Institute of Chartered Accountants of India (ICAI), Accounting Standards are formal documents that include rules, methods, and procedures issued by a recognized accounting authority, government body, or regulatory institution. These standards cover aspects such as the identification, valuation, processing, presentation, and disclosure of accounting transactions in financial reports.

In essence, an accounting standard can be viewed as a form of regulatory guideline—a framework for action, a settled foundation for accounting practices and behavior.

Accounting Standards primarily address the following areas:

- a. The recognition of financial events and transactions in the accounts;

- b. The valuation or quantification of these transactions and events;
- c. The format and clarity with which these transactions are reported in the financial statements so that users can understand them easily; and
- d. The necessary disclosures that should be included, allowing the general public, stakeholders, and especially potential investors to gain clarity on what the financial statements are conveying. This helps them to make well-informed and sound business decisions.

1.3. Need for Accounting Standards:

- a) To eliminate discrepancies that may arise between accounting theories and actual practices, and to establish uniformity across diverse accounting principles used by different entities.
- b) A meaningful comparison between two companies is only possible when they follow consistent accounting policies. For instance, if Company A applies the FIFO method for inventory valuation and Company B uses the LIFO method, comparing their financial outcomes would be inaccurate. Such a comparison becomes valid only when both companies use the same method for valuing inventory.
- c) The objective is to create standardized accounting practices when preparing financial statements, ensuring consistency and accurate comparison of the financial data provided to users of accounting information.
- d) To uphold fairness, consistency, and transparency in accounting methods, which enhances trust and satisfies the expectations of various users of financial reports.
- e) To address and resolve potential conflicts of interest among the various external parties—such as investors, creditors, and analysts—who depend on the financial statements for decision-making.
- f) Accounting standards help limit the range of accounting choices available during the preparation of financial statements, within reasonable boundaries. This enhances the comparability of financial reports across different organizations. Therefore, accounting standards serve as an essential tool to minimize financial disputes among key stakeholders in the economy.

g) To bring about alignment in accounting policies and procedures used by various businesses, enabling the standardization of diverse accounting treatments applied to different elements of financial reporting.

1.4. Objectives of Accounting Standards:

To bring uniformity to varied accounting methods and procedures

To minimize, as far as possible, the lack of comparability in financial reports

To enhance the trustworthiness and dependability of financial statements

To improve the mathematical precision and correctness in financial reporting

To help users interpret the accounting treatments applied in financial statements

To offer a consistent set of accounting practices, valuation guidelines, and requirements for disclosure

1.5. Significance or advantages of Accounting Standards:

1. Investors can benefit from accounting standards as they assist in evaluating the returns and risks associated with various investment options across different companies and countries.
2. These standards offer authoritative guidelines for public accountants (such as Chartered Accountants in India) when preparing financial statements. This ensures that the reports are created in a truthful and fair manner, promoting professional commitment and ethical integrity in the accounting field.
3. Accounting standards also contribute to enhancing the quality of auditing, aiding auditors in their role of providing accurate reports on financial statements.
4. Government bodies, tax departments, and other regulatory agencies view financial reports prepared under recognized standards as credible and trustworthy.
5. Such standardized financial statements serve as dependable resources for analysts, researchers, and consultants, facilitating economic analysis, forecasting, and strategic planning.

1.6. Limitations of Accounting Standards:

1. For some accounting issues, multiple valid approaches may exist, each supported by logical reasoning. As a result, selecting the most appropriate method among these alternatives can be challenging.
2. The implementation of accounting standards might lead to inflexibility, reducing the ability to adapt to unique situations, as they may encourage a more rigid approach to financial reporting.
3. Accounting standards do not have the authority to override legal provisions. They must be designed within the framework of existing laws and regulations.

1.7. Accounting standards in Indian context:

In India, the Accounting Standards are formulated and issued by the Accounting Standards Board (ASB), which functions under the Institute of Chartered Accountants of India (ICAI), in collaboration with the National Advisory Committee on Accounting Standards (NACAS). Recognizing the importance of bringing uniformity to the varied accounting methods and policies being followed across the country, the ICAI established the Accounting Standards Board on April 21, 1977.

1.8. The scope and functions of Accounting Standards Board are:

- a. To develop Accounting Standards that can be officially issued by the Council of the Institute in India. While drafting these standards, the Accounting Standards Board (ASB) considers relevant laws, customs, business practices, and the economic environment of the country.
- b. To align with the goals of the International Accounting Standards Committee (IASC), as the Institute is a member of this international body. The ASB takes into account the International Accounting Standards, adapting them where appropriate to suit Indian conditions and practices.
- c. To promote awareness and encourage the adoption of these standards by stakeholders involved in the preparation and presentation of financial statements.

- d. To release guidance notes and offer clarifications regarding issues related to the Accounting Standards.
- e. To periodically review and update the Accounting Standards as necessary.

1.9. Conclusion

Accounting as an information system is the foundation for financial communication. Its role becomes effective when governed by robust standards that promote clarity and comparability. Despite challenges, India's move toward global convergence through Ind AS has enhanced its credibility in global markets.

Check Your Progress

1. What is meant by accounting as an information system?
2. Who are the primary users of accounting information?
3. Explain the concept and types of accounting standards.
4. List any three benefits of accounting standards.
5. What are the major challenges in setting accounting standards?
6. What are the scope and functions of Accounting Standards Board?

Let Us Sum Up

This unit explained how accounting functions as an information system, identified the users of such information, and detailed accounting standards' purpose and implementation. We explored the benefits and challenges of standardization and outlined the standard-setting mechanisms in India.

Glossary of Terms

- Accounting Standards: Rules for preparing financial statements
- GAAP: Generally Accepted Accounting Principles
- IFRS: International Financial Reporting Standards
- Ind AS: Indian Accounting Standards aligned with IFRS
- ICAI: Institute of Chartered Accountants of India
- NFRA: National Financial Reporting Authority

Answers to Check Your Progress

1. A structured process that collects, processes, and communicates financial information.
2. Management, investors, creditors, regulators, tax authorities, etc.
3. Standards that guide financial reporting; types include GAAP, IFRS, Ind AS.
4. Uniformity, comparability, transparency.
5. Diverse practices, political pressures, rapid economic changes.
6. ICAI, NFRA, and MCA.

Suggested Reading

1. T.S. Grewal, “Double Entry Book Keeping”
2. ICAI publications on Accounting Standards
3. Narayanaswamy, R. – Financial Accounting
4. ACCA and IFRS Foundation Learning Materials
5. Ministry of Corporate Affairs website – www.mca.gov.in

ROYALTY ACCOUNTS

Structure

- Overview
- Learning Objectives
- 2.1 Meaning of Royalty
- 2.2 Difference Between Rent And Royalty
- 2.3 Important Terms In Connection With Royalty
- 2.4 Accounting Procedure
- 2.5 Accounting Records in the Books of the Lessor and Lessee
- 2.6 Conclusion
- Check Your Progress
- Let Us Sum Up
- Glossary of Terms
- Answers to Check Your Progress
- Suggested Reading

Overview

Royalty accounting deals with agreements where one party (lessee) pays another (lessor) for the right to use assets like patents, copyrights, trademarks, or mineral rights. These payments are governed by specific contractual terms, including minimum rent, short workings, and recoupment rights. This unit aims to provide a comprehensive understanding of royalty accounting from both the lessor's and lessee's perspectives, including treatment of subleases.

Learning Objectives

After studying this unit, learners will be able to:

- Define royalty and related terms such as minimum rent and short workings
- Explain the concept and process of recoupment of short workings
- Record royalty transactions in the books of both the lessor and lessee
- Understand the accounting treatment in case of a sublease agreement

2.1 Meaning of Royalty

Royalty refers to a recurring payment made periodically based on the production output or sales volume, in exchange for the right to use a specific asset or privilege. This payment is made by one party to another for the use of an asset. The individual who pays the royalty is known as the *lessee*, while the individual receiving the payment—typically the asset owner—is called the lessor or landlord. Examples include royalties paid by publishers to authors, by manufacturers to patent holders, or by companies extracting resources from oil wells to the property owners. The Royalty Account is treated as a nominal account and is similar in nature to a rent account. Being a nominal account, it is debited in the books of the lessee as an operational expense and credited in the books of the lessor as income. At the close of each financial year, the royalty account is transferred to the Profit and Loss Account to finalize the books.

2.2. Difference between Rent and Royalty

The key distinctions between **rent** and **royalty** are outlined below:

1. Rent is a payment made for the use of physical or tangible assets such as buildings, land, or equipment. In contrast, royalty is compensation paid for utilizing intangible assets or special rights, like mineral resources, patents, or copyrights.
2. The amount of rent remains constant and is usually predetermined, whereas royalty payments fluctuate based on the quantity of goods produced or sold, making them variable in nature.

2.3. Important Terms In Connection With Royalty

1. Lessor or Landlord:

This refers to the individual who owns a particular asset and grants another party the right to use it in exchange for a payment called *royalty*. The owner who provides this usage right is known as the *lessor*.

2. Lessee:

The party who pays the royalty in return for the right to use the asset is termed as the *lessee*.

3. Minimum Rent / Dead Rent / Fixed Rent:

This is the least amount that the lessee must pay the lessor, regardless of whether any benefit has been derived from the use of the asset or right. This predetermined minimum amount is agreed upon at the start of the contract and ensures that the lessor receives a guaranteed income, even when production or sales are low. The lessee is liable to pay the higher of either the actual royalty or the minimum rent. This fixed payment is also known by terms like *dead rent*, *flat rent*, or *fixed rent*. However, under certain conditions outlined in the agreement, it may also be variable.

4. Shortworking:

When the royalty amount based on actual production or sales falls below the agreed minimum rent, the difference is termed as *shortworking*.

Formula:

Shortworking = Minimum Rent – Actual Royalty

Example:

If the minimum rent is ₹10,000 and the actual royalty is Rs.4,000 in the first year and Rs.9,500 in the second year, the shortworking will be Rs.6,000 and Rs.500 for the respective years.

5. Recoupment of Shortworking:

During the initial years of a lease, operations might not be fully active due to setup time, leading to shortworkings. To address this, lease agreements may include provisions for recouping such shortfalls. The various methods are:

(i) Without a Specified Time Limit:

In this case, the agreement allows the lessee to recover shortworkings at any time during the lease period. Unrecouped balances are transferred to the Profit and Loss Account only in the final year of the lease term.

(ii) Within a Fixed Time Period:

Some contracts specify a fixed period—such as the first 3, 4, or 5 years—within which the lessee must recover shortworkings. *Example:* If a coal mine is leased from 1st January 2000 for 10 years, and the agreement permits recoupment only within the first 4 years, then shortworkings can be recovered only up to 2003. Any remaining shortworking after this period is charged to the Profit and Loss Account.

(ii) Over a Specific Number of Subsequent Year

Under this clause, each year's shortworking can be recovered within a defined number of years following the year it occurred. *Example:* If a mine lease starts on 1st January 1990 for 20 years and the agreement allows for a 3-year recoupment window for each year's shortworking, then shortworking from 1990 can be recouped till 1993, from 1991 till 1994, and so on. Any amount not recouped within this allowed timeframe is transferred to the Profit and Loss Account in the year that recoupment right expires.

2.4 Accounting Procedure

The following points need to be noted down before preparing the Royalty Accounts:-

1. Name of Landlord and Lessee.
2. Period of Lease.
3. Commencement of agreement.
4. Royalty Rates.
5. Minimum Rent.
6. Right of recoupment of shortworkings.
7. Mode of payment to Landlord.

A calculation table may be prepared before making the Journal entries which makes easy solution, The format of table is as follows:-

Year	Output	Royalty	Short working	Shortworking recouped	Unrecouped shortworkings transferred to P&L Account	Amount paid to Landlord
		Rs.	Rs.	Rs.	Rs.	Rs.

2.5 Journal entries in the books of lessee

There may be three types of situations in order to pass Journal entries in the books of lessee:-

1. When minimum Rent is more than Royalty.
2. When minimum Rent is equal to Royalty.
3. When minimum Rent is less than Royalty.

Ist Case

When Minimum Rent is more than Royalty :-

- (i) When Royalty is due :-

Royalty A/c	Dr.
Shortworkings A/c	Dr.

To Landlord A/c

(Being Royalty and Shortworkings due to Landlord)

- (ii) When payment is made :-

Landlord A/c	Dr.
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To Cash/Bank

(Being Cash paid to Landlord)

- (iii) Closing entry at the end of the year :-

Profit & Loss A/c	Dr.
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To Royalty A/c

(Being Royalty Account transferred to Profit & Loss A/c.)

IInd Case

When Minimum Rent and Royalty are equal

(i) When Royalty is due :-

Royalty A/c Dr.

To Landlord A/c

(Being Royalty due)

(ii) When payment is made:-

Landlord A/c Dr.

To Cash/Bank

(Being Payment made to Landlord)

(iii) For closing Royalty A/c at the end of the year

Profit & Loss A/c Dr.

To Royalty A/c

(Being Royalty Account transferred to Profit & Loss a/c.)

IIIrd Case

When Minimum Rent is less than Royalty and Shortworking recouped.

(i) For Royalty due

Royalty A/c Dr.

To Landlord A/c

(Being Royalty due to Landlord)

(ii) For payment & recouped of shortworking

Landlord A/c Dr.

To Cash/Bank

To Shortworking (Recouped)

(Being payment made to landlord and shortworking recouped)

(iii) For closing Royalty a/c and unrecouped shortworking :-

Profit & Loss A/c Dr.

To Royalty A/c

To Shortworking (Unrecouped)

(Being Royalty & Unrecouped shortworking transferred to Profit& Loss A/c.)

Kinds of Royalties

1. Royalties in Connection with mines
2. Royalties regarding oil –wells
3. Royalties regarding Brick Making
4. Royalties regarding patents
5. Royalties regarding copyright

Illustration 1:

Ram Goal Ltd., leased in a colliery on 1st Jan 2001 at a minimum rent of Rs.15000 merging into a royalty of Re.1 per ton with a right to recoup shortworking over the first three years of the lease. The output for the first four years of the lease was 8000,13000, 21000 and 18000 tones respectively. Show the necessary ledger accounts

Solution

Calculation Table

Year	Output	Royalty	Minimum Rent	Short Workings	Short Workings Recouped	Unrecouped S.W transfer to P & L A/C.	Paid to Landlord
2001	8,000	8,000	15,000	7,000	-	-	15,000
2002	13,000	13,000	15,000	2,000	-	-	15,000
2003	21,000	21,000	15,000	-	6,000	3,000	15,000
2004	18,000	18,000	15,000	-	-	-	18,000

Problem: 1

The Bengal Mines Co. Ltd. From Mr.Dass, a lease of a mine for a period of 25 years from 01.01.1986, on a royalty of Rs.5 per tonne of mineral raised with a dead rent of Rs.20000 and power to recoup shortworkings during the first years of the lease.

Year	1986	1987	1988	1989	1990
Tonnes	2000	3000	4000	4500	5000

Calculate royalty.

Problem: 2

Ramu took a lease of mine for a period of 20years. Royalty payable is Rs.1 per tonne subject to a minimum rent of Rs.12000 per annum. The shortworkings are recoupable during the first three years of the lease. The output was:

Year	1990	1991	1992	1993
Output in tonnes	Nil	4000	20000	40000

Give journal entries, shortworking account and landlord's account in the books of ramu.

Problem: 3

A acquired the right to manufacture and sell locks from B on 01.01.1995. A has to pay a royalty of Rs.5 for each lock with a minimum annual payment of Rs.50000 amount are to be settled on 31st December

Year	1995	1996	1997	1998
Number of Locks	8000	9000	11000	18000

Calculate royalty.

Problem: 4

Assam Coal Company has taken a mine on lease for 30 years on 01.01.2002 on the following conditions. Royalty is to be paid at Re.0.75 per tonne of coal production. Minimum rent for the first year would be Rs.10500. It will increase every year by Rs.500 and will go up to Rs.12000. Thereafter it will be Rs.12000 for all the years. Shortworking made in a year is to be recouped within the next two years.

The quantity produced for the first 6 years were as follows:

Year	2002	2003	2004	2005	2006	2007
Quantity produced	4000	8000	14000	22000	28000	35000

Calculate royalty.

Problem: 5

X Ltd. has given its coal mine to Z Ltd. It was decided that royalty of Rs.10 per tonne of coal extracted is to be paid by Z Ltd. Minimum rent per year would be Rs.80000 and if there is any short working it should be recouped within the first 2 years of lease. The production for the first three years is as follows

Year	2006	2007	2008
Quantity produced	5000	9000	8000

Calculate royalty.

2.6 Conclusion

Royalty accounting involves unique concepts such as minimum rent, short workings, and recoupment, all of which are governed by specific contractual clauses. Both lessor and lessee must maintain accurate records. Subleases add another layer of complexity but follow similar principles of accrual and payment tracking.

Check Your Progress

1. Define royalty and give two examples.
2. What is minimum rent? How does it differ from royalty?
3. Explain the meaning of short workings with an example.
4. How is recoupment of short workings accounted for?
5. Mention the accounting entries in the books of a lessor.
6. What is a sublease in royalty accounting?

Let Us Sum Up

In this unit, we learned about the accounting treatment of royalty transactions involving lessors and lessees. We covered key terms like **minimum rent**, **short workings**, and **recoupment**, and studied how subleases are handled. The understanding of these concepts ensures proper financial reporting in contracts involving intellectual property or natural resources.

Glossary of Terms

- **Royalty:** Payment for the use of rights or assets
- **Minimum Rent:** Guaranteed minimum payment to lessor
- **Short Workings:** Difference between minimum rent and actual royalty
- **Recoupment:** Adjustment of short workings against future surplus royalties
- **Sublease:** Secondary lease arrangement by lessee to another party

Answers to Check Your Progress

1. Royalty is a payment for use of resources; examples: book publishing, mining.
2. Minimum rent is a fixed guaranteed payment; royalty may vary with usage/output.
3. If royalty = 8,000 and minimum rent = 10,000 → short working = 2,000
4. Recoupment is adjusting previous short workings against future excess royalty.
5. Lessee A/c Dr To Royalty A/c (when earned); Bank A/c Dr To Lessee A/c (when received)
6. A sublease is when the lessee grants rights to a third party under a new contract.

Suggested Reading

1. R.L. Gupta & Radhaswamy – *Advanced Accountancy*
2. T.S. Grewal – *Double Entry Bookkeeping – Volume 2*
3. Jain & Narang – *Advanced Accounting*
4. ICAI Study Materials on Royalty Accounting
5. M.C. Shukla – *Advanced Accounts*

HIRE PURCHASE AND INSTALMENT SYSTEMS

Structure

- Overview
- Learning Objectives
- 3.1 Hire Purchase System – Meaning
- 3.2. Nature of Hire Purchase Agreement
- 3.3. Features of Hire Purchase Agreement
- 3.4. Hire Purchase transactions are characterized by the following features
- 3.5. Distinction between hire-purchase and instalment system
- 3.6. Various Types of Calculation of interest:
- 3.7. Conclusion
- Check Your Progress
- Let Us Sum Up
- Glossary of Terms
- Answers to Check Your Progress
- Suggested Reading

Overview

The Hire Purchase and Instalment Systems are two popular credit purchase mechanisms. This unit explores how assets are bought and paid for in instalments, focusing on accounting entries, interest calculations, and treatment of defaults and repossession under the hire purchase method. It also introduces the instalment system and highlights the differences between the two

Learning Objectives

After completing this unit, learners will be able to:

- Understand the concept and features of the hire purchase system
- Calculate interest in hire purchase agreements
- Pass relevant journal entries in the books of both buyer and seller
- Account for complete and partial repossession
- Explain the instalment purchase system
- Distinguish between hire purchase and instalment systems

3.1 Meaning

Hire Purchase System allows a buyer to take possession of goods by paying an initial amount (down payment) and the remaining in periodic instalments. Ownership is transferred only after the final instalment is paid. Instalment Payment System is similar but ownership transfers immediately on signing the agreement.

3.2. Nature of Hire Purchase Agreement

In a hire purchase arrangement, the buyer (known as the hire purchaser) is allowed to take possession and use the goods right from the beginning. The payment for these goods is made in agreed-upon instalments over a fixed period. However, legal ownership of the goods stays with the seller (hire vendor) and is transferred to the purchaser only after all instalments have been fully paid. Every instalments paid by the hire purchaser is considered as a charge for using the asset. If the purchaser fails to pay any instalments—even the final one—the seller (hire vendor) has the right to repossess the goods. In such a case, the vendor is not obligated to refund any portion of the amount already received from the purchaser up to the date of default.

3.3. Features of Hire Purchase Agreement

1. Possession: Under a hire purchase agreement, the seller (hire vendor) hands over possession of the goods to the buyer (hire purchaser) immediately after the agreement is signed, while ownership remains with the vendor.
2. Down Payment: It is common for the purchaser to make an initial payment—known as the down payment—at the time of entering into the agreement.
3. Repossession: If the purchaser defaults on any instalments, including the final one, the vendor has the legal right to reclaim the goods without offering any refund for the payments already made.

3.4. Hire Purchase transactions are characterized by the following features:

- (a) The buyer pays for the goods in periodic instalments.
- (b) Each instalment is considered a hire charge. If there is a default at any stage, even in the final payment, the seller can repossess the goods without compensating the buyer.
- (c) Ownership of the goods is transferred to the buyer only after all instalments have been successfully paid.

3.5. Distinction between hire-purchase and instalment system

S.No	Basis	Hire Purchase System	Instalment System
1	Nature of Agreement	It is essentially a lease agreement with an option to purchase the asset	It is a direct sale agreement involving deferred payment
2	Ownership Transfer	Ownership shifts to the hirer only after the final instalment is cleared	Ownership is passed to the buyer at the time the contract is signed
3	Terminology for Parties	The purchaser is referred to as the hirer, and the seller is the hire vendor or owner	The individuals involved are known as the buyer and seller
4	Legal Relationship	The hirer and the hire vendor have a bailor-bailee relationship	The buyer and seller have a debtor-creditor relationship until full payment is made
5	Risk of Damage or Loss	The hirer is not liable for damage or loss if due care has been taken	The buyer bears the risk of loss since ownership lies with them
6	Right to Sell	The hirer cannot transfer ownership until the final payment is made	The buyer has the freedom to resell the asset, even if instalments are pending
7	Recovery of Goods	If payments are not made, the owner has the right to reclaim the asset	The seller cannot reclaim the goods but may initiate legal action for recovery
8	Cancellation of Contract	The hirer can opt out of the agreement by returning the item	The agreement is binding and cannot be cancelled unilaterally
9	Instalment Composition	Each payment includes both a rental charge and a portion of the principal price	Each payment consists of interest along with part of the principal amount
10	Governing Law	Regulated by the Hire Purchase Act of 1972	Governed under the Sale of Goods Act

3.6. Various Types of Calculation of interest:

The hire purchase price is typically higher than the cash price of the goods. This is because it includes an additional charge, often referred to as interest, which compensates the seller for two main factors:

1. The delay in receiving full payment, and
2. The potential risk that the buyer might default on future payments.

Interest in a hire purchase arrangement represents the cost of allowing the buyer to pay in parts after the goods have already been handed over. Generally, the interest rate applied in such transactions is higher than what would be charged on a standard loan or advance. This is because it incorporates not only the time value of money but also a risk premium — an extra amount added to account for the possibility that the buyer may miss payments, leading the seller to recover the goods in potentially used or damaged condition.

In hire purchase agreements, this risk charge is built into the interest component and not shown separately, as doing so would conflict with the basic nature of a hire purchase transaction.

From an accounting perspective, the difference between the hire purchase price and the cash price is considered the interest or finance charge. Since every instalment includes this interest element, which affects financial income or expense, it becomes important to accurately determine the interest involved.

Interest included in each instalment can be calculated under the following situations:

1. When the interest rate, cash price, and instalment amounts are known.
2. When the interest rate is not provided.
3. When the total cash price is unknown.
4. When the instalment amount or total instalment price is not specified.
5. When the cash price is determined using the annuity method.

Illustration: 1 (Model when rate of interest, total cash price and instalments are given)

On 01.01.2013 Raman purchased an Air conditioner from TVS Ltd. Chennai. Under Hire purchase system. Its cash price was Rs.62700. its other things are as follows:

1. Rs.18000 is to be given at the time of signing the agreement.
2. The balance amount is to paid in 3 equal annual instalments of Rs.18000
3. The rate of interest charged by the seller is 10%

Calculate the interest to be paid by the buyer to the seller.

Solution

Date of payment	Instalment	Actual Cash price	Interest@10%	Actual instalment amount paid
01.01.2013	18000	62700	-	18000
31.12.2014	18000	$62700-18000=44700$	$44700*10/100=4470$	13530
31.12.2015	18000	$44700-13530=31170$	$31170*10/100=3117$	14883
31.12.2016	18000	Last instalment payable 18000 but cash price due $(31170-14483)=$ difference is interest that is $18000-16287$	$18000-16287=1713$	16287
Total	72000		9000	62700

Illustration: 2 (Rate of interest is Not given)

Mr. Karthik of Balaji Purchased a LED TV from a TV Merchant under Hire Purchase Agreement, its cash price was Rs.162000 on 01.01.2015 and is payable in 12 Monthly instalments of Rs.20000 Starting from 31.01.2016. You are required to calculate the amount of interest and cash price included in each instalment.

Solution:

Working Note: Calculation of total interest payable under HP agreement.

Particulars	Working	Rs.
HPP	20000×12	240000
CP	As given	162000
Total interest	HPP- CP	78000

Statement of Apportionment of Total Interest of Rs.78000 & Cash Price of Rs.162000

Month	No of Month from inception	HPP outstanding	HPP outstanding Ratio	Amount Payable Per instalment	Working	Interest	Cash Price
JANUARY	12	240000	12	20000	$78000 \times 12/78$	12000	8000
FEBRUARY	11	220000	11	20000	$78000 \times 11/78$	11000	9000
MARCH	10	200000	10	20000	$78000 \times 10/78$	10000	10000
APRIL	9	180000	9	20000	$78000 \times 9/78$	9000	11000
MAY	8	160000	8	20000	$78000 \times 8/78$	8000	12000
JUNE	7	140000	7	20000	$78000 \times 7/78$	7000	13000
JULY	6	120000	6	20000	$78000 \times 6/78$	6000	14000
AUGUST	5	100000	5	20000	$78000 \times 5/78$	5000	15000

SEPTEMBER	4	80000	4	20000	$78000 \times 4/78$	4000	16000
OCTOBER	3	60000	3	20000	$78000 \times 3/78$	3000	17000
NOVEMBER	2	40000	2	20000	$78000 \times 2/78$	2000	18000
DECEMBER	1	20000	1	20000	$78000 \times 1/78$	1000	19000
		1560000	78	240000		78000	162000

Illustration: 3 (Cash price is Not given)

Mr.Madhavan enter into an Hire Purchase agreement to buy a car with the car dealer by paying a down payment of Rs.100000 on January 1. 2014 and agreed to pay the balance of Rs.510000 in three equal annual instalment with 5% interest per annum. You are required to calculate the amount of interest included in each instalment and cash price of the car

Solution

Note 1 Give hire purchase price is Rs.610000 (Down payment +Balance payable). As per the agreement balance of Rs.510000 is payable in three equal annual instalment of Rs.170000 each (510000×3) combining payment for cash price and interest?

Note 2 the hire purchase instalment always includes amount payable an account of interest and cash price, here the rate of interest is 5% on cash price of 100% and therefore the HIP =105% so interest = $HPI/105 \times 5$

Table showing calculation of interest and Cash price

Year	Due date	Instalment	Calculation inverse method (starting from last instalment)	Interest	Cash Price
	1	2	3	4	$5=2-4$
III	31.12.2016	170000	$170000 \times 5/105$	8095	161905
II	31.12.2015	170000	$161905 + 170000 \times 5/105$	15805	154195
I	31.12.2014	170000	$161905 + 154195 + 170000 \times 5/105$	23148	146852

0	31.12.2014	100000	No part of interest on the down payment	-	100000
		610000		47048	562952

Illustration: 4 (When Hire purchase instalment Not given)

Ragu transport Ltd., purchased from TATA motors 3 vans costing Rs.1500000 each on hire purchase system. Payment was to be made Rs.300000 down and the remainder in three equal annual instalments together with interest at 12% p.a. Calculate interest for each year

Solution:

Statement of interest and HPI Calculation

Particulars	Cash Price	Interest	HPI
Cash price	1500000		
Less: down payment	300000	-	300000
Outstanding cash price at the end of the first year	1200000		
1 st instalment	400000	144000	544000
Outstanding cash price at the end of the second year	800000		
2 nd instalment	400000	96000	496000
Outstanding cash price at the end of the third year	400000		
3 rd instalment	400000	48000	448000
Total		288000	1708000

Note: Cash price-down payment = amount of outstanding Cash price which is paid in three equal annual instalment that is $12000000/3= 400000$

Illustration: 5 (Annuity method)

Mr.Sakthi a sole trader purchased a motor van for his business under hire purchase system payable Rs.30000 annually, for 10 years. The rate of interest is 5%. Gives the present value of annuity of Rs.1 for 10 years at 5% is Rs.7.7217. Calculate cash price.

Solution:

Note: Cash Price = instalment * Annuity factor given

- Since on Rs.1 annuity (instalment) for 10 year at 5% present worth that is . cash price is Rs.7.7217
- Hence on Rs.300000 annuity that is, instalment for 10 years at 5 % intrest. Present worth = Rs. 7.7217 * Rs.30000= Rs. 231651

Illustration: 6

Malan purchased a machinery on hire purchase system on 1st January 2013. The terms of payments are four annual instalments of Rs.12690 at the end of each year. Interest is charged @5% and is included in the annual payments of Rs.12690.

Show machinery account and Hire vendor account in the books of Malan who defaulted in the payment of the third yearly payment whereupon the vendor repossessed the machinery. Malan provides depreciation on the machinery @10% p.a. on reducing balance.

Calculation of cash price and interest

No of instalment	Amount of instalment (Rs.)	Interest	Net cash price(Rs.)
4 th	12690	$12690 \times 5/105 = 604$	12086
3 rd	12690	$(12690+12086) \times 5/105 = 1180$	11510

2 nd	12690	$(12690+12860+11510) \times \frac{5}{105}=1728$	10962
1 st	12690	$(12690+12860+11510+10962) \times \frac{5}{105} = 2250$	10440
	50760	5762	44998

In the books of Malan (Buyer)

Machinery A/C

1-1-13	To Hire vendor A/c	Rs. 44998	31-12-13	By Depreciation	Rs. 4500
				By balance C/D	40498
		44998			44998
1-1-14	To Balance B/D	40498	31-12-14	By Depreciation	4050
				By Balance C/D	36448
		40498			40498
1-1-15	To Balance B/D	36448	31-12-15	By Depreciation	3645
				By Hire vendor	24776
				By profit & loss- loss	8027
		36448			36448

Hire vendor A/c

		Rs.			Rs.
31-12-13	To Bank (1 st)	12690	1-1-13	By machinery	44998
	To Balance C/D	34558	31-12-13	By interest	2250
		47248			47248
31-12-14	To Bank (2 nd)	12690	1-1-14	By balance B/d	34558
	To Balance C/D	23596	31-12-14	By interest	1728
		36286			36286
31-12-15	To Machinery A/c	24776	1-1-15	By balance C/d	23596
			31-12-15	By interest	1180
		24776			24776

Problem 1

Raman purchases a motor car from Bharathan whose cash price is Rs.56,000 on 1.1.03 Rs.15,000 is paid on signing the contract and the balance is to paid in three equal

annual instalment of Rs.15,000 Each. The rate of interest is 5% p.a. Calculate the amount of interest included in each instalment.

Problem 2

The Madras Trading company purchased a motor car from Bombay motor company on hire purchase agreement on 1.1.90. Paying cash Rs. 10,000 and agreeing to pay further three instalments of Rs. 10,000 each on 31st December each year. The cash price of the car is Rs. 37,250 and the Bombay motor company charges interest at 5% p.a.

Problem 3

On 1-1-86, X purchased machinery on hire purchase system. The payment is to be made. 4,000 down (on signing of the contract) and. 4,000 annually for three years. The cash price of the machinery is. 14,900 and the rate of interest is 5% p.a. Calculate the interest in each year's instalment.

3.7. Conclusion

Hire purchase and instalment systems provide alternatives for credit purchases. While hire purchase involves conditional transfer of ownership, the instalment system offers ownership upfront. Proper understanding of accounting treatments helps in accurate recording and reporting of such transactions.

Check Your Progress

1. What is meant by hire purchase?
2. How is interest calculated under the hire purchase system?
3. What journal entry is passed in the books of the buyer for down payment?
4. What is complete repossession?
5. List two key differences between hire purchase and instalment systems.
6. What happens in partial repossession?

Let Us Sum Up

This unit covered the fundamentals of hire purchase and instalment purchase systems, including their accounting treatment, interest calculation, and handling of defaults. Special emphasis was laid on repossession and the legal/accounting distinctions between the two systems.

Glossary of Terms

- **Hire Purchase:** A system of credit sale where ownership passes after all payments
- **Instalment System:** A sale where ownership transfers immediately
- **Repossession:** Seller taking back goods due to default
- **Interest:** Additional payment for credit use
- **Depreciation:** Reduction in asset value over time

Answers to Check Your Progress

1. It is a credit purchase system where goods are hired, and ownership is transferred after final instalment.
2. On outstanding balance of cash price \times rate \times time
3. Hire Vendor A/c Dr To Bank A/c
4. Seller takes back the entire asset due to default
5. Ownership transfer timing, right to repossess
6. Seller takes back only part of the asset

Suggested Reading

1. R.L. Gupta & Radhaswamy – *Advanced Accountancy*
2. Jain & Narang – *Advanced Accounting*
3. T.S. Grewal – *Double Entry Bookkeeping*
4. ICAI Study Materials
5. M.C. Shukla – *Advanced Accounts*

BRANCH ACCOUNTING

Structure

- Overview
- Learning Objectives
- 4.1 Introduction
- 4.2 Departments vs. Branches
- 4.3 Objectives of Branch Accounts
- 4.4 Features of Branches
- 4.5 Types of Branches
- Let Us Sum Up
- Check Your Progress
- Glossary

Overview

In modern business, organizations often expand by opening branches in various locations. Proper accounting of each branch's transactions helps in monitoring performance and ensuring control. This unit lays the groundwork for understanding the core principles of branch accounting.

Learning Objectives

By the end of this unit, learners will be able to:

- Understand the definition and need for branch accounts
- Distinguish between types of branches
- Recognize the special features of dependent branches

- Comprehend the objectives of maintaining branch accounts

4.1 Introduction

A branch is an extension of the head office operating in a different location but engaging in similar business activities. According to Section 29 of the Companies Act, 1956, a branch refers to any location where the company conducts operations similar to the head office.

When a business operates within a small local area, it can easily serve its customers from a single office. However, as the business expands to different regions, it becomes difficult and expensive to manage all operations from one central office. To solve this, a part of the business is separated from the main office and set up in another location. This separated unit is known as a branch, while the main office is referred to as the head office.

According to Section 2(9) of the Companies Act, 1956, a branch office is any establishment that carries out activities similar to those of the head office or is engaged in any form of production, processing, or manufacturing. Large organizations, such as those involved in banking, insurance, manufacturing, and trade, often have multiple branches located both within and outside the country.

This lesson explains the basic accounting procedures used to record and control the financial activities of such branches.

4.2. Departments vs. Branches

Although both departments and branches are divisions of the same organization, they differ significantly in the following ways:

1. Location

Departments usually function within the same building or premises as the head office, whereas branches are located in different places, often at considerable distances. Due to this geographical separation, branches are sometimes referred to as departments conducted at a distance.

2. Control and Supervision

Since departments are located near the head office, their activities can be constantly supervised and effectively controlled. However, it is difficult for the head office to maintain close supervision over distant or overseas branches. Control may be strong for nearby branches but weak for far-off ones.

3. Nature of Activities

Departments generally perform different functions or specialize in distinct lines of work (for example, production, marketing, and finance). In contrast, branches may perform similar functions as the head office, such as selling or manufacturing. For instance, companies like Bata Shoe Company operate many retail branches that all perform similar activities. On the other hand, a company such as the Delhi Cloth and General Mills Ltd. has branches that engage in diverse operations such as textiles, sugar, chemicals, and machinery.

4.3 Objectives of Branch Accounts

- To ascertain individual branch profit or loss
- To monitor branch-wise financial status
- To evaluate and compare performance across branches
- To regulate branch activities
- To assess inventory and fund needs
- To aid in legal compliance and internal control

4.4. Features of Branches

- Physically separate from the head office
- May operate under direct control or with independence
- Revenue and expenses are usually handled centrally
- Profits are remitted to the head office

4.5 Types of Branches

Branches can differ in nature, size, and the amount of independence they enjoy. Therefore, different accounting systems are used depending on the type of branch. Generally, branches are classified according to two main factors:

1. Based on Location

- ✓ **Home Branches** – Branches located within the same country as the head office.
- ✓ **Foreign Branches** – Branches established outside the home country.

2. Based on the Level of Autonomy

- ✓ **Dependent Branches** – These branches do not maintain their own books of accounts. The head office handles all major accounting records.
- ✓ **Independent Branches** – These branches maintain their own books of accounts, make local purchases, and manage daily transactions autonomously.
- ✓ **Foreign Branches** – Though situated abroad, they are usually treated as independent branches and maintain full accounting records.

Branches can also be classified based on the nature of work they perform:

- Some branches only sell goods (like retail shops).
- Others deal in wholesale trade.
- Certain large branches may even be engaged in manufacturing. For example, the Delhi Cloth and General Mills Ltd. operates several branches that manufacture textiles, sugar, oils, fertilizers, and other products. Such large units are often called *divisions* due to their high level of independence.

The extent of accounting work done by a branch depends on how much responsibility the head office gives it. Generally, the more autonomy a branch has, the more accounting records it maintains.

Major Classes of Branches

Branches are commonly divided into the following five categories:

1. Branches Selling Only for Cash

These branches receive goods solely from the head office and sell them for cash. All cash collections are remitted back to the head office, and the head office provides funds to meet branch expenses.

2. Branches Selling for Cash and Credit

These branches receive goods only from the head office, sell them both for cash and on credit, and remit the cash received to the head office. Their expenses are met through remittances from the head office.

3. Branches Invoiced at Selling Price

In this type, goods are sent from the head office to the branch at selling price (not cost price). The accounting treatment differs slightly, as adjustments for the profit element (called loading) are made later.

4. Independent Branches

These branches handle purchases, sales (both cash and credit), and other operations independently. They maintain their own complete set of books and periodically send statements of accounts to the head office for consolidation.

5. Foreign Branches

These are independent branches located in other countries. They maintain their own records in the local currency and prepare separate financial statements, which are later converted and incorporated into the head office books.

Let Us Sum Up

This unit covered the definition, objectives, and classification of branches and their relevance in financial reporting.

Check Your Progress

1. What is the meaning of a branch as per the Companies Act?
2. Mention any three objectives of maintaining branch accounts.
3. What are the key features of a dependent branch?
4. Differentiate between dependent and independent branches.

Glossary

- **Branch:** A physically separate business unit functioning under the main office
- **Head Office:** Central administrative unit of an organization
- **Dependent Branch:** Branch whose records are fully maintained by the H.O.
- **Independent Branch:** Branch that maintains its own books of accounts

Illustration 1:

Chennai Ltd. invoices goods to its Maduri Branch at cost. All the expenses are paid direct from the head office, except petty cash expenses which are paid by branch manager.

	Rs.		Rs.
Stock (Jan. 1)	2,100	Salaries and Wages	1,860
Petty Cash (Jan. 1)	50	Advertisement	240
Furniture (Jan. 1)	250	Rent and Rates	360
Goods supplied from H.O.	7,800	Stock (Dec. 31)	1,950

Goods returned back to H.O	300	Petty Cash (Dec. 31)	30
Cash Sales	15,250	Furniture (Dec. 31)	230

Solution

Books of Chennai Papers Ltd. (H.O.) Maduri Branch Account

	Rs.	Rs.		Rs.	Rs.
To balance b/d			By Return of Goods to H.O.		300
Stock	2,100		Bank (Sale proceeds)		15,250
Petty Cash	50		By balance c/d		
Furniture	250	2,400	Stock	1,950	
Goods supplied to Branch		7,800	Furniture	230	
Cash:			Petty Cash	30	2,210
Salaries & Wages	1,860				
Rent and Rates	360				
Advertisement	240	2,460			
Profit transferred to Profit & Loss A/c		5,100			
		17,760			17,760

Illustration 2:

Ram Co of Kanchipuram has a branch at Chennai. 'Goods are sent by the Head Office at invoice price which is at the profit of 25% on cost price. All expenses of the branch are paid by the Head Office. From the following particulars, prepare branch account in the Head Office books:

	Rs.
Opening Balance:	
Stock at invoice price	11, 000
Debtors	1,7 00
Petty Cash	100
Goods sent to branch at invoice price	20, 000
Expenses made by head office:	
Rent	600
Wages	200
Salary, etc.	900
Remittances made to Head Office:	
Cash sales	2,6 50
Cash collected from Debtors	21, 000
Goods Returned by Branch at invoice price	400
Balance at the end:	
Stock at invoice price	13, 000
Debtors at the end	2,0 00
Petty Cash	25

Solution

Books of Ram Ltd. (H.O.) Chennai Branch Account

When goods are shown at cost price

To Opening Balance		By Cash:	
Stock		Cash Sales	2,650
(Rs. 11,000-2.200)	8,800	Cash collected from	
Debtors	1,700	Debtors	21,000
Petty Cash	100	By Goods sent to Branch A/c (at cost)	320
To Goods sent to Branch A/c (at cost)	16,000		
To Bank Expenses		By Closing Balances:	
Rent	600	Stock (at cost)	10,400
Wages	200	Debtors	2,000
Salaries	900	Petty Cash	25
To Net Profit transferred to General Profit & Loss A/c	8,905		
	36,395		36,395

Problem 1:

Loyal Shoe Company opened a branch at Madras on 1-1-2006. Prepare the Madras Branch Account for the years 2006 and 2007.

Particulars	2006	2007
Goods sent to branch	15,000	45,000
Rent	1,800	1,800
Salaries	3,000	5,000
Other expenses	1,200	1,600
Cash received from branch	24,000	60,000
Stock (31st Dec)	2,300	5,800
Petty Cash (31st Dec)	40	30

Problem 2: From the following particulars prepare Branch Accounts

Item	Value
Opening stock	41,000
Opening debtors	12,500
Opening petty cash	1,000
Opening creditors	10,000
Cash purchase (branch)	12,500
Payment to creditors	45,000
Goods sent to branch	75,000
Credit sales	40,000
Cash sales	75,000
Cash received from debtors	45,000
Allowances	50
Discount	100
Bad debts	150
Salaries (by H.O.)	6,000
Rent for year (paid by H.O.)	1,200
Insurance (upto 31.3.2004)	750
Furniture (purchased by branch)	2,000
Petty expenses (by branch)	250
Closing stock	1,00,000
Closing creditors	27,500

Problem 3

Kanpur Shoe Company opened a branch at Delhi in 1998. Prepare Delhi Branch Account for the year.

Item	Amount
Goods sent to branch	15,000
Cash sent for expenses	6,000
Cash received from branch	24,000
Stock (31-12-1998)	2,300
Petty cash in hand	40

Problem 4:

From the following particulars prepare the Branch Accounts for Salem Branch
Goods invoiced at cost + 20%

Particulars	Amount
Goods sent to branch	2,11,872
Total sales	2,06,400
Cash sales	1,10,400
Cash from branch debtors	88,000
Opening stock (invoice price)	7,680
Closing stock (invoice price)	13,440
Opening debtors	24,000

Problem 5:

Subramani & Co. of Chennai sends goods to branch at Karaikudi at cost plus 25%. All cash received by the branch is remitted to the Head Office. All expenses are paid from Chennai. From the following particulars, show how the branch account will appear in the books of H.O.

	Rs.
Stock on 1.1.199 (invoice price)	12,500
Stock on 31.12.1999 (invoice price)	15,000
Debtors on 1.1.1999	12,000
Debtors on 31.12.1999	32,500
Goods invoiced from Chennai	60,900
Remittance to Chennai :	
Cash sales	16,000
Cash received from debtors	29,500
Goods returned to H.O.	2,400
Cheque received from Chennai :	
Wages and salaries	11,000
Rent	3,000
Sundry expenses	510

Problem 6:

Stock and Debtors System – Invoice Price P.O. Ltd. Calcutta – Bombay Branch
(Goods at cost + 20%)

Item	Amount
Cost of goods sent	50,000
Goods received by branch (invoice price)	54,000
Credit sales	58,000
Debtors (closing)	20,800
Bad debts & discount	200
Cash remitted to H.O.	43,000
Cash in hand (closing)	2,000
Cash sent by H.O.	3,000
Closing stock (invoice price)	6,000
Branch expenses	12,000

DEPARTMENTAL ACCOUNTING

Structure

- Overview
- Learning Objectives
- 4.5 Meaning and Concept
- 4.6 Objectives of Departmental Accounting
- 4.7 Difference Between Department and Branch
- 4.8 Basis of Departmental Accounting
- 4.9 Expense Allocation Methods
- 4.10 Types of Departments
- 4.11 Interdepartmental Transfers
- 4.12 Departmental Accounting Illustration Summary
- Let Us Sum Up
- Check Your Progress
- Glossary

Overview

Departmental Accounting is a method of tracking financial performance by different functional areas within a business. Each department's profitability is assessed independently to aid managerial decision-making, performance comparisons, and strategic planning.

Learning Objectives

By the end of this unit, learners will be able to:

- Define departmental accounting and its significance
- Understand the key objectives and benefits of maintaining department-wise records
- Distinguish between branch and departmental accounting
- Apply expense allocation techniques for different departments
- Prepare departmental trading and profit & loss accounts
- Make adjustments for interdepartmental transfers

4.5 Meaning and Concept

A **department** is a specialized section within an organization, often structured based on the nature of activities (e.g., sales, manufacturing, and clothing). Departmental Accounting refers to the process of maintaining separate financial records for each department, helping in analyzing their performance individually.

4.6 Objectives of Departmental Accounting

- Evaluate the performance of each department
- Identify profitable and non-performing departments
- Aid in resource allocation and managerial decisions
- Assist in planning for expansion or closure of departments
- Ensure transparency for internal and external stakeholders

4.7 Difference between Department and Branch

Basis	Departmental Accounting	Branch Accounting
Location	Same premises	Different geographical locations
Accounts	Centrally maintained	Maintained at H.O.; sometimes partial at branch
Allocation	Common expenses allocated	Less need for allocation
Currency	No currency conversion	Foreign branches may require conversion
Reconciliation	Not needed	Reconciliation may be necessary

4.8 Basis of Departmental Accounting

Two primary approaches:

1. **Columnar Books:** Separate columns for each department in main books
2. **Separate Books:** Full accounts maintained per department

4.9 Expense Allocation Methods

Expense Type	Allocation Basis
Rent, Insurance	Floor area
Lighting, Heating	Number of light points
Selling Commission, Discounts	Sales ratio
Depreciation	Value of fixed assets
Labour-related costs	Number of employees

4.10 Types of Departments

- **Dependent Departments:** Outputs of one department serve as inputs for another.
Example: Fabric to Garment department.
- **Independent Departments:** Operate independently without major interdependence.

4.11 Interdepartmental Transfers

- **At Cost:** No adjustment required
- **At Invoice/Selling Price:** Adjustment made for unrealised profit using Stock Reserve

4.12 Departmental Accounting Illustration Summary

- Allocate common expenses using logical basis
- Adjust for internal transfers and depreciation
- Prepare separate Trading and Profit & Loss Accounts
- Use stock reserve to eliminate unrealised profits in closing stock

- Consolidate departmental results if needed

Let Us Sum Up

This unit explained the concept, objectives, and structure of departmental accounting. Emphasis was placed on the differences from branch accounting, proper allocation of expenses, and the importance of adjusting for interdepartmental transfers.

Check Your Progress

1. What is departmental accounting and why is it important?
2. Mention two bases for allocating shared expenses between departments.
3. How are interdepartmental transfers treated in departmental accounts?
4. List three differences between branch and departmental accounting.

Glossary

- **Department:** A division of a business handling a specific task or product
- **Expense Allocation:** Dividing common expenses logically among departments
- **Stock Reserve:** Adjustment account for unrealised profit in interdepartmental stock
- **Interdepartmental Transfers:** Movement of goods/services between departments
- **Columnar Book:** Book with separate columns for department-wise recording

Illustration 1:

A firm has two departments, cloth and ready-made garments. The garments were made by the firm itself out of cloth supplied by the cloth department at its selling price. From the following figures prepare Departmental Trading and Profit & Loss Account for the year 1997.

Particulars	Cloth Department	Ready-made Garments
Opening Stock on 1.1.1997	6,00,000	1,00,000
Purchases	40,00,000	30,000
Sales	44,00,000	9,00,000
Transfer to Ready-made Garments Department	6,00,000	-
Expenses - Manufacturing	-	1,20,000
Selling -Expenses	40,000	12,000
Stock on 31.12.1997	4,00,000	1,20,000

The stock in the ready-made garments department may be considered as consisting of 75% cloth and 25% other expenses. The cloth department earns profit at the rate of 15% in 1996. General expenses of business as a whole came to ₹ 2, 20,000.

Solution

Departmental Trading and Profit and Loss A/c for the year ending Dec 31, 1997

Particulars	Cloth (Rs)	Readymade Garments (Rs)	Total	Particulars	Cloth (Rs)	Readymade Garments (Rs)	Total
To Opening Stock	6,00,000	1,00,000	7,00,000	By Sales	44,00,000	9,00,000	53,00,000
To Purchases	40,00,000	30,000	40,30,000	By Transfer to Ready-made Garments Dept.	6,00,000		6,00,000
To Transfer from Cloth Dept.		6,00,000	6,00,000	By Closing Stock	4,00,000	1,20,000	5,20,000
To Mfg. Exp.		1,20,000	1,20,000				
To Gross Profit c/d	8,00,000	1,70,000	9,70,000				
	54,00,000	10,20,000	64,20,000		54,00,000	10,20,000	64,20,000
To Selling Exp.	40,000	12,000	52,000	By Gross Profit b/d	8,00,000	1,70,000	9,70,000
To Net Profit c/d	7,60,000	1,58,000	9,18,000				
	8,00,000	1,70,000	9,70,000		8,00,000	1,70,000	9,70,000
To Gen. Exp.			2,20,000	By Net Profit b/d			9,18,000
To Stock Reserve (cl.			14,400	By Stock Reserve (op.			11,250

stock)				stock)			
To Net Profit			6,94,850				
			9,29,250				9,29,250

Illustration 2:

A firm has two departments, cloth and ready-made garments. The garments were made by the firm itself out of cloth supplied by the cloth department at its selling price. From the following figures prepare Departmental Trading and Profit & Loss Account for the year 1997.

The following figures relate to the business of Mr. Siva Rama Associates for the year ended 31st December, 2007:

Particulars	Department	
	X	Y
Stock (1st Jan, 2007)	8 0,000	--
Purchases from outside	4,0 0,000	40,000
Wages	20,000	2,000
Transfer of Goods from Dept. X	--	1,00,000
Stock at Cost (31 st December, 2007)	60,000	20,000
Sales	4,0 0,000	1 42,000

The stock in the ready-made garments department may be considered as consisting of 75% cloth and 25% other expenses. The cloth department earns profit at the rate of 15% in 1996. General expenses of business as a whole came to ₹ 2, 20,000.

Solution

Departmental Trading and Profit and Loss A/c for the year ending Dec 31st 2007

Particulars	X (Rs)	Y (Rs)	Particulars	X (Rs)	Y (Rs)
To Opening Stock	80,000	--	By Transfer of Goods to Y	1,00,000	---
To Purchases	4,00,000	40,000	By Sales	4,00,000	1,42,000
To Wages	20,000	2,000	By Closing Stock	60,000	20,000
TO Goods from X	--	1,00,000			
To Gross Profit c/d	60,000	20,000			
	5,60,000	1,62,000		5,60,000	1,62,000
To Adm. & Selling Expenses	24,000	6,000	By Gross profit b/d	60,000	20,000
To Net Profit	36,000	14,000			
	60,000	20,000		60,000	20,000

Illustration 3:

A firm had two department, Cloth and readymade garments. The garments were made by the firm itself out of cloth supplied by the cloth department at its usual selling price. From the following figures, prepare departmental trading and profit and loss account for the year ended 31.03.2014

`Particulars	Cloth	Readymade
Opening sock	300000	50000
Purchases	2000000	15000
Sales	2200000	450000
Transfer to readymade	300000	-
Manufacturing expenses	-	60000
Selling expenses	20000	6000
Closing stock	200000	60000

The stock in the readymade garments departments may be considered as consisting of 75% cloth and 25% other expenses. The cloth department earned gross profit @15% in 2013-13. General expenses of the business as a whole came to Rs.110000

Solution

Departmental Trading and profit & loss A/C for the year ending 31.3.2014

	Cloth Rs.	Readymade Rs.		Cloth Rs.	Readymade Rs.
To Opening stock	3,00,000	50,000	By sales	22,00,000	4,50,000
To purchases	20,00,000	15,000	By transfer to		
To Transfer from			Readymade	3,00,000	-
Cloth department	-	3,00,000	department	2,00,000	60,000
To manufacturing			By closing		
expenses	-	60,000	stock		
To gross profit c/d					
(departmental)	4,00,000	85,000			
	2700000	510000		2700000	510000
				4,0,000	85,000
To selling			By gross profit		
expenses	20,000	6,000	b/d		
To net profit c/d					
(departmental)	3,80,000	79,000			
	400000	85000		400000	85000

General P & L A/c for the year ending 31.3.2014

	Rs.		Rs.
To general expenses	1,10,000	By net profit b/d (3,80,000 + 79,000)	4,59,000
To stock reserve (closing) (60,000x75% x 16%)	7,200	By stock reserve (opening) (50,000x75% x15%)	5,625
To net profit (bal figure)	3,47,425		
	465625		664625

Working Note

Stock reserve has been calculated as follows:

Rate of Gross profit on sales of cloth department = $4,00,000/2500000 \times 100 = 16\%$

Element of cloth in closing stock of readymade garments = $60000 \times 75\% = 45000$

Reserve required for unrealized profit in closing stock = $45000 \times 16\% = \text{Rs.}7200$

Reserve already existing in opening stock = $50000 \times 75\% \times 15\% = 5625$

Illustration 4:

Mehta Ram of Ram Nagar purchased goods for his three departments as following.

Dept. A – 200 units

Dept. B – 1400 units Total cost of Rs.5100

Dept. C – 400 units

Sales of the three department were as follows.

Dept. A – 180 units at Rs. 15 each

Dept. B – 1,500 units at Rs.18 each

Dept. C – 450 units at Rs. 6 each

Other information about stock in the beginning was as follows:

Dept. A –100 units

Dept. B – 400 units

Dept. C –60 units

Mehta Ram informs you that the rate of gross profit is the same in all departments.

You are required to prepare Departmental Trading A/C

Solution

1. Calculation of closing stock

Opening stock + Purchases – Sales

Department	Opening stock	Purchases	Sales	Closing stock
X	100	200	180	120
Y	400	1400	1500	300
Z	60	400	450	10

2. Calculation of Gross Profit Ratio

Department X $200 \times 15 = 3000$

Department Y $1400 \times 18 = 25200$

Department Z $400 \times 6 = 2400$

30600

Less: Total Cost 5100

Gross Profit 25500

Gross Profit ratio = $\text{gross profit} / \text{sales} \times 100$

$25500 / 30600 \times 100 = 83.33\%$

3. Calculation of Cost per units

Department X $15 - 15 \times 83.33 / 100 = 12.50 = 2.50$

Department Y $18 - 18 \times 83.33 / 100 = 15 = 3$

Department Z $6 - 6 \times 83.33 / 100 = 5 = 1$

4. Calculation of amount of opening stock (Cost Price)

Department	Opening stock	Cost Price	Amount
X	100	2.50	250
Y	400	3	1200
Z	60	1	60

5. Calculation of amount of Purchases (Cost Price)

Department	Purchases	Cost Price	Amount
X	200	2.50	500
Y	1400	3	4200
Z	400	1	400

6. Calculation of amount of closing stock (Cost Price)

Department	closing stock	Cost Price	Amount
X	120	2.50	300
Y	300	3	900
Z	10	1	10

7. Calculation of amount of Sales (Selling Price)

Department	Sales	Selling Price	Amount
X	180	15	2700
Y	1500	18	27000
Z	450	6	2700

Departmental Trading Account

Particulars	X	Y	Z	Particulars	X	Y	Z
To Opening Stock	250	1200	60	By Sales	2700	27000	2700
To Purchases	500	4200	400	By Closing Stock	300	900	10
To Gross Profit B/F	2250	22500	2250				
	3000	27900	2710		3000	27900	2710

Problem: 1

The following purchases were made by a business house having three departments.

Dept. A – 1,000 units

Dept. B – 2,000 units {at a total cost c of Rs.1, 00,000)

Dept. C – 2,400 units

Stocks on 1st January Were:

Dept. A –120 units

Dept. B – 80 units

Dept. C –152 units

Sales Were:

Dept. A – 1,020 units at Rs. 20 each

Dept. B – 1,920 units at Rs.22.50 each

Dept. C – 2,496 units at Rs. 25 each

The rate of gross profit is same in each case. Prepare Departmental Trading Account

Problem: 2

The following purchases were made by a business house having three departments.

Dept. A – 1,500 units

Dept. B – 1,000 units {at a total cost of Rs. 92 000)

Dept. C – 2000 Units

Stocks on 1st January Were:

Dept. A –200 units

Dept. B – 300 units

Dept C - 150

Selling price

Dep A Rs.200

Dep B Rs. 25

Dep C Rs. 30

The rate of gross profit is same in each case. Prepare Departmental Trading Account

Problem: 3**Prepare:**

- Departmental Trading and Profit & Loss A/c
- Combined Income Statement

Particulars	Dept. X	Dept. Y
Opening Stock	92,000	–
Purchases	4,60,000	46,000
Wages	23,000	2,300
Goods Transfer (X to Y)	–	1,15,000
Sales	4,60,000	1,63,300
Closing Stock	69,000	23,000
Admin & Selling Exp.	34,500 total (shared in 4:1 ratio)	

FIRE INSURANCE CLAIMS IN ACCOUNTING

Structure

- Overview
- Learning Objectives
- 5.1 Introduction to Fire Insurance Claims
- 5.2 Principles of Indemnity and Stock Valuation
- 5.3 Computation Procedures
- 5.4 The Average Clause and Its Application
- 5.5 Illustrative Problems
- 5.6 Conclusion
- Check Your Understanding
- Let Us Sum Up
- Glossary of Key Terms
- Suggested Readings

Overview

This unit introduces learners to the concept of fire insurance accounting, focusing on how businesses recover stock and profit losses due to fire-related incidents. The content explores the calculation of claim amounts, use of trading accounts, and the significance of policy clauses like the average clause.

Learning Objectives

By the end of this unit, learners will be able to:

- Understand how fire insurance policies compensate for stock and profit loss.
- Apply the average clause in calculating admissible claims.
- Prepare memorandum trading accounts for estimating stock loss.
- Analyze scenarios involving salvaged stock, underinsurance, and damaged goods.
- Compute insurance claims using real-life accounting problems.

5.1 Introduction to Fire Insurance Claims

Fire incidents can result in major financial disruptions for businesses. To mitigate these losses, businesses often take fire insurance policies. These policies offer financial recovery for damaged or destroyed stock, provided the policyholder adheres to the terms and maintains adequate coverage.

5.2 Principles of Indemnity and Stock Valuation

Insurance contracts operate on the principle of indemnity, which ensures that the insured is reimbursed only for the actual amount **of loss** incurred. The value of stock lost due to fire is usually computed using a Memorandum Trading Account that estimates the stock as on the date of fire.

5.3 Computation Procedures

Two types of losses can occur:

- Total Stock Loss: When all stock is destroyed.
- Partial Stock Loss: When only part of the stock is damaged or salvaged.

5.4 The Average Clause and Its Application

The average clause prevents overcompensation when the stock is underinsured. If the sum insured is less than the actual stock value at the time of fire, the insurer will pay a proportionate amount based on the insured value.

Illustration 1:

On 17th June 2013 , a fire occurred in the premises of Mr. Bookworm , a bookseller. Most of the stock was destroyed , the cost of the salvaged stock being Rs.11,200/-. In addition , some stock was salvaged in damaged condition and its value was estimated at Rs.10,400/- . The following particulars were available from the books of accounts:

- Stock at the close of accounts on 31st December 2012 was Rs.83,500/-
- Purchases from 01-01-2013 to 17-06-2013 amounted to Rs.1,12,000/- and sales during that period amounted to Rs.1,54,000/-
- On the basis of the past three years it appears that on average the gross profit of 25% is earned on sales.

Solution:

Memorandum Trading A/c (From 01-01-2013 to 17-06-2013)

Particulars	Amount	Particulars	Amount
To Opening Stock	83,500.00	By Sales	154,000.00
To Purchases	112,000.00		
To Gross Profit (1,54,000 x 25/100)	38,500.00		80,000.00
	234,000.00	By Closing Stock (Bal Fig)	234,000.00

Computation of loss	
Stock on date of fire	80000
Less: Saved value	21600

Loss	58400

1.5 Problem 1

How will you arrive at the amount of claim under loss of profit insurance?

A fire occurred on 01.09.1993 in the godown of Mr. Ganesan. From the following particulars find out the claim to be lodged;

Stock on 01.01.1993	25300
Purchases from 1.1.93 to date of fire	50400
Sales from 1.1.93 to date of fire	156000
Manufacturing expenses and wages	60000
Goods taken by Ganesan at cost	2500
The rate of gross profit on cost is	30%
Value of salvaged stock	3600

Problem 2

The premises of merchant caught fire on 1.10.92 and his stock was damaged. The stock was fully insured. The merchant had made up his accounts to 31st December each year. The following information was available.

Stock on 31.12.91	26544
Stock on 31.12.90	19228
Purchases from 1.1.92 to the date of fire	70000
Purchases up to 31.12.91	90516
Sales up to 31.12.91	104000
Sales from 1.1.92 to the date of fire	100000

Additional information

- ✓ In May 1992 goods costing Rs.5000 were given as free samples for advertising purpose. No entry was made in the books.
- ✓ During 1992, a Clerk had misappropriated unrecorded cash sales Rs.2000
- ✓ The rate of gross profit is constant.
- ✓ The stock salvaged was Rs.1500

Problem 3

A fire broke out in the godown of Mr. Agni on 15-07-2012 and entire stock of goods was destroyed. Mr. Agni had insured the stock fully. From the following particulars, calculate the amount of claim.

Stock on 01-04-2012- Rs.88,000.

Purchases from 01-04-2012 to 15-07-2012- Rs.2,00,000.

Sales from 01-04-2012 to 15-07-2012- Rs.1,92,000.

Mr. Agni earns a gross profit of 20% on sales normally.

Problem 4

A fire occurred in the business of Mr. Indra on 10-10-2011 and Rs.21,500 worth of stock was saved from fire. Stock as per Trading A/c as on 31-03-2011 was Rs.1,80,000.

Purchases from 1-4-2011 to 10-10-2011 amounted to Rs.2,23,000. Sales from 1-4-2011 to 10-10-2011 amounted to Rs.2,60,000.

On the basis of the past 3 years the average gross profit is 25%. Calculate the amount of claim.

Problem 5

Mr. Chandra had insured his goods fully. A fire broke out in his godown resulting in a heavy loss of goods on 21-09-2012. Goods of the value of Rs.10,000 were saved. From the following information, calculate the amount of claim.

Stock on 1-4-2012 Rs.46,000, Purchases from 1-4-2012 to 21-09-2012 Rs.4,00,000, Sales from 1-4-2012 to 21-09-2012 Rs.3,60,000, Returns during the year– Sales- Rs.8,000, Purchases- Rs.6,000.

On the observation of past records the gross profit for the preceding 3 years were 15%, 20% and 25%. The expenses incurred to extinguish fire amounted to Rs.2,000.

Problem 6

Mr. Surya had insured his stock-in-trade with United Insurance Co. A fire broke out on 12-12-12 destroying most part of his godown and stock salvaged was worth Rs.4,000. Stock on 1-4-12 was Rs.1,90,000, Purchases from 1-4-12 to 12-12-12 was Rs.2,80,000, Sales from 1-4-12 to 12-12-12 was Rs.4,60,000.

The opening stock was overvalued by Rs.10,000 and sales includes Rs.16,000 being sale of furniture. Mr. Surya normally enjoyed a gross profit of 25% on his sales. Find out the amount of claim.

Problem 7

A fire broke out in the godown of Mr. Rahu on 24-08-2009 and goods worth Rs.16,000 was saved. From the following information, calculate the amount of claim.

Purchases during 2008-09 Rs.1,80,000, Sales during 2008-09 Rs.2,55,000, Purchases from 1-4-2009 to 24-08-2009 Rs.60,000, Sales from 1-4-2009 to 24-08-2009 1,05,000, Stock on 1-4-2008 Rs.80,000, Stock on 31-03-2009 Rs.1,00,000, Stock on 31-03-2009 was overvalued by Rs.5,000.

Problem-8

A fire occurred in the godown of Mr. Kethu on 20-05-2009 and the stock worth Rs.35,000 was salvaged. The following information was available from the books and records saved.

Purchases for the period ended 31-12-2008 Rs.3,60,000. Sales for the period ended 31-12-2008 Rs.5,65,000.

Purchases from 01-01-2009 to 19-05-2009 Rs.1,25,000.

Sales from 01-01-2009 to 19-05-2009 Rs.1,90,000.

Stock on 31-12-2007 Rs.1,60,000 and on 31-12-2008 Rs.1,90,000.

Opening stock on 01-01-2008 was overvalued by Rs.10,000. Closing stock on 31-12-2008 was undervalued by Rs.10,000.

Find out the amount of claim.

Problem-9

On 10-07-2010 a fire occurred in the premises of Mr. Budha and the entire stock except of Rs.22, 500 was destroyed by fire. The stock was fully insured. From the following particulars ascertain the amount of claim. Stock on 01-04-2010 Rs.1, 25,000, Purchases from 01-04-2010 to 10-07-2010 Rs.5, 10,000 and Sales from 01-04-2010 to 10-07-2010 R.5, 90,000.

The rate of gross profit on sales for the previous 4 years were 30%, 32%, 30%, and 32% respectively.

Problem-10

Mr. Guru had taken a fire insurance policy for Rs.80, 000 to his stock-in-trade. A fire occurred on 31-12-2008 and the stock was destroyed with the exception of Rs.21, 000. The following information is available in respect of the above.

Stock on 1-4-2008 Rs.30, 000, Sales from 1-4-2008 to 31-12-2008 Rs.90, 000,

Carriage inwards Rs.5, 000, Purchases from 1-4-2008 to 31-12-2008 Rs.1, 37,500.

Average rate of gross profit was 33 1/3%. The policy was subject to Average Clause. Calculate the loss of stock and amount of claim

5.6 Conclusion

Understanding the principles behind fire insurance accounting ensures that a business can receive fair compensation during crises. Proper documentation, timely reporting, and correct valuation methods are essential for lodging valid claims.

Check Your Understanding

1. What is the purpose of using the memorandum trading account in fire claims?

2. When is the average clause applied in claim computation?
3. How is salvage value treated in calculating stock loss?
4. Explain how gross profit rate influences the claim amount.

Let Us Sum Up

- Fire insurance reimburses actual loss based on policy terms.
- The average clause adjusts claims in underinsurance cases.
- Estimation techniques like memorandum trading accounts are key tools.
- Salvage value must be deducted from the total loss.

Glossary of Key Terms

- **Indemnity:** Compensation for actual loss, no profit element.
- **Average Clause:** Pro-rata adjustment when stock is underinsured.
- **Salvaged Stock:** Recoverable stock that reduces claim value.
- **Gross Profit Rate:** Percentage used to estimate profit component in loss.
- **Policy Amount:** The maximum amount an insurer is liable to pay.

Suggested Reading

- ICAI Material on Insurance Claims Accounting
- Shukla & Grewal: Advanced Accounts
- M.N. Mishra: Principles and Practice of Insurance
- AS 29 – Provisions, Contingent Liabilities and Contingent Asset

INVESTMENT ACCOUNT

Structure

- 5.7 Meaning of Investment
- 5.8 Nature of Investment
- 5.9 Importance of Investment
- 5.10 Investment vs. Speculation vs. Gambling
- 5.11 Classification of Investments
- 5.12: Objectives of Investment
- 5.13: Accounting for Investments
- 5.14 Journal Entries
- 5.15 Accounting Standards
- 5.16 Types of Investment Accounts
- 5.17: Investment Ledger
- 5.18 Valuation Methods
- 5.19 Investment in Shares
- 5.20: Investment in Bonds and Debentures
- 5.21: Investment in Mutual Funds
- 5.22: Risk and Return Analysis
- 5.23: Investment Policy and Strategy
- 5.24: Investment Accounting in Financial Statements
- 5.25: Limitations of Investment Accounting
- 5.26: Investment Portfolio Management
- 5.27: Conclusion

5.7 Meaning of Investment

Investment refers to the commitment of funds to one or more assets with the expectation of earning income or capital appreciation. It involves sacrificing current consumption for future benefits. In accounting, investments are classified as assets because they represent resources that can generate future economic benefits.

5.8 Nature of Investment

Investments can be tangible (land, buildings, machinery) or intangible (shares, bonds, mutual funds). They are made with the objective of earning returns and ensuring capital growth.

5.9 Importance of Investment

- Generates income and wealth.
- Promotes capital formation and economic development.
- Provides financial security and stability.
- Enables diversification of risk.
- Acts as a hedge against inflation.

5.10 Investment vs. Speculation vs. Gambling

Basis	Investment	Speculation	Gambling
Objective	Regular income and capital appreciation	Profit from price fluctuations	Quick gain without analysis
Risk	Moderate	High	Very high
Decision Basis	Research and analysis	Market trends	Chance or luck
Time Horizon	Long-term	Short-term	Instantaneous

5.11 Classification of Investments

1 Based on Duration

1. **Short-term Investments:** Held for less than one year; examples include treasury bills and short-term deposits.
2. **Long-term Investments:** Held for more than one year; examples include shares, bonds, and real estate.

2 Based on Nature

- **Fixed Income Securities:** Provide fixed returns (e.g., bonds, debentures).
- **Variable Income Securities:** Returns fluctuate (e.g., equity shares).

3 Based on Purpose

- **Trade Investments:** Made for business control or strategic purposes.
- **Non-trade Investments:** Made for earning income or appreciation.

4 Based on Ownership

- **Individual Investments:** Owned by individuals.
- **Institutional Investments:** Owned by organizations like banks, insurance companies, or mutual funds.

5.12: Objectives of Investment

1. **Safety of Principal:** Ensuring the invested capital is secure.
2. **Liquidity:** Ability to convert investments into cash easily.
3. **Income Stability:** Earning regular returns through interest or dividends.
4. **Capital Appreciation:** Increase in the value of investments over time.
5. **Tax Benefits:** Certain investments provide tax deductions or exemptions.
6. **Control and Influence:** Acquiring shares to gain control over another company.

5.13: Accounting for Investments

1 Meaning

Investment accounting involves recording, classifying, and valuing investments in financial statements.

2 Initial Recognition

Investments are recorded at **cost**, which includes purchase price, brokerage, commission, and other incidental expenses.

3 Valuation of Investments

- **Current Investments:** Valued at lower of cost or market value.
- **Long-term Investments:** Valued at cost unless there is a permanent decline in value.

4 Income Recognition

- **Interest on Bonds/Debentures:** Recognized on an accrual basis.
- **Dividends on Shares:** Recognized when the right to receive payment is established.

5 Disposal of Investments

When investments are sold, the difference between the sale proceeds and the carrying amount is treated as profit or loss.

5.14 Journal Entries

Transaction	Journal Entry
Purchase of investment	Investment A/c Dr. To Bank A/c
Receipt of income	Bank A/c Dr. To Interest/Dividend A/c
Sale of investment	Bank A/c Dr. To Investment A/c (Cost) To Profit on Sale A/c
Loss on sale of investment	Loss on Sale A/c Dr. To Investment A/c

5.15 Accounting Standards

1. AS 13 – Accounting for Investments

Issued by the Institute of Chartered Accountants of India (ICAI), AS 13 provides guidelines for recognition, classification, and valuation of investments.

Key Provisions:

- Investments are classified as current or long-term.
- Current investments are valued at lower of cost or fair value.
- Long-term investments are valued at cost unless there is a permanent decline in value.

2 Ind AS 109 – Financial Instruments

This standard aligns with IFRS 9 and provides a comprehensive framework for recognition and measurement of financial assets and liabilities.

5.16 Types of Investment Accounts

1 Individual Investment Account

Used by individuals to manage personal investments.

2 Joint Investment Account

Operated jointly by two or more persons.

3 Institutional Investment Account

Maintained by organizations such as banks, insurance companies, or mutual funds.

4 Portfolio Investment Account

Used to manage a diversified portfolio of securities.

5.17: Investment Ledger

An investment ledger records all transactions related to investments. It includes details such as date of purchase, cost, income received, and sale proceeds.

Format:

Date	Particulars	Nominal Value	Cost	Interest/Dividend	Balance
------	-------------	---------------	------	-------------------	---------

5.18 Valuation Methods

1 Cost Method

Investments are recorded at cost and carried forward at the same value unless there is a permanent decline.

2 Market Value Method

Investments are valued at market price on the balance sheet date.

3 Lower of Cost or Market Value (LCMV) Method

The lower of cost or market value is taken as the carrying amount.

- **Cum-Interest/Cum-Dividend:** Purchase price includes interest/dividend accrued up to the date of purchase.
- **Ex-Interest/Ex-Dividend:** Purchase price excludes interest/dividend accrued.

Adjustment:

Interest or dividend accrued before purchase is deducted from the total income received.

5.19 Investment in Shares

1 Equity Shares

Represent ownership in a company and provide voting rights.

2 Preference Shares

Provide fixed dividends and have preferential rights over equity shares in dividend payment and capital repayment.

3 Accounting Treatment

- Purchase recorded at cost.
- Dividend income recognized when declared.
- Sale recorded at selling price with profit or loss adjustment.

5.20: Investment in Bonds and Debentures

1 Bonds

Debt instruments issued by governments or corporations to raise funds.

2 Debentures

Long-term debt instruments issued by companies, usually carrying a fixed rate of interest.

3 Accounting Treatment

- Interest accrued is recognized periodically.
- Premium or discount on purchase is amortized over the life of the bond.

5.21: Investment in Mutual Funds

Mutual funds pool money from investors to invest in diversified portfolios.

1 Types of Mutual Funds

- Equity Funds
- Debt Funds
- Balanced Funds
- Index Funds

2 Accounting Treatment

Investments in mutual funds are recorded at cost and valued at market value at the end of the accounting period.

5.22: Risk and Return Analysis

1 Types of Risk

- Market Risk
- Credit Risk
- Liquidity Risk
- Interest Rate Risk
- Inflation Risk

2 Measurement of Return

Return = (Income + Capital Gain) / Investment × 100

5.23: Investment Policy and Strategy

An investment policy defines the framework for making investment decisions.

1 Components

- Investment objectives
- Risk tolerance
- Asset allocation
- Monitoring and review

5.24: Investment Accounting in Financial Statements

1 Balance Sheet Presentation

- Long-term investments under “Non-current assets.”
- Short-term investments under “Current assets.”

2 Income Statement Presentation

- Interest and dividend income under “Other Income.”
- Profit or loss on sale of investments under “Other Gains/Losses.”

5.25: Limitations of Investment Accounting

- Market value fluctuations affect reliability.
- Valuation methods differ across entities.
- Subjectivity in determining permanent decline in value.
- Complexities in fair value measurement.

5.26: Investment Portfolio Management

Portfolio management involves selecting and managing a mix of investments to achieve specific financial goals.

1 Objectives

- Risk minimization
- Return maximization
- Liquidity maintenance
- Diversification

2 Techniques

- Fundamental analysis
- Technical analysis
- Modern portfolio theory

5.27: Conclusion

Investment accounting forms a vital part of financial management and reporting. It ensures accurate representation of an entity's financial position and performance. For commerce students, mastering the theoretical and practical aspects of investment accounts is essential for careers in accounting, finance, and investment analysis.

A comprehensive understanding of investment principles, accounting standards, and valuation methods enables informed decision-making and contributes to sound financial planning and economic growth.