**Principles of accounting**

**Unit-4**

**Hire purchase and installment purchase system**

**Concept Of Hire Purchase System**

Purchase and sale of goods under a hire purchase system is different from cash sale and credit sale. In case of cash sale, the buyer pays the lump sum to the seller and immediately ownership is passed along with the goods. While in credit sale the payment is made in future. In these both cases the ownership and possession of goods pass on the buyer. However, hire purchase system is a special system of purchase and sale.

In hire purchase system, the buyer acquires the property by promising to pay necessary installment payment of monthly, quarterly, half yearly or any other period. The period of payment has to be fixed while, signing the hire sell agreement. Though, the buyer acquires the asset under hire purchase system after signing the agreement, the title of ownership remains with vendor until the buyer squares up his/her entire liability. When the buyer pays the final installment and any other obligation according to hire purchase agreement, only then the title of ownership of the goods would be transferred to hirer. If the hirer makes deault in the payment of any installment, the hire vendor has the right to re-possess the goods. When the vendor re-possesses the goods due to the default of payment of installment, in this case the amount already paid so far by the hirer will be forfeited.

The hire purchase price of goods is normally higher than the cash down price of article because it includes interest as well as cash price. Under hire purchase system, the vendor is responsible to repair the goods which are in the possession of buyer provided that the buyer takes the utmost proper care of the goods acquired. The risk is also borne by the vendor until the payment of last installment. The buyer has the right to return the goods to the vendor, if they are not according to the terms and condition of hire purchase agreement.

**Concept Of Installment System**

An installment system is just like a credit purchase and hire purchase system of selling and buying goods. Like hire purchase, in installment system an agreement is made between buyer and seller to purchase and sell of goods. The buyer makes certain down payment at the time of signing agreement and the balance is paying in installment over a period of time.
An installment system is a credit sale in which payments are made in installments over a period of time. In this system, the buyer gets the possession as well as ownership of the goods right at the time of signing the agreement. During the course of paying the installment, if the buyer makes default in paying the installment, the vendor cannot responses the goods. In that case, the vendor can sue the buyer for recovery of dues. Like in hire purchase even the paid installments also can not be forfeited in case of default in paying installment.
Thus, it can be said that installment system is a kind of credit sale where installments are entertained over the period and default in such payment cannot responses the goods and in that case, the vendor can only sue the buyer for the recovery of amount due.

**Features Of Installment Purchase System**

1. Installment purchase system is just like an outright credit sale of goods.
2. The buyer makes the payment in different installment over a period of time as agrees upon in the agreement.
3. Under installment purchase system, the buyer gets the immediate possession as well as the ownership of goods.
4. The seller can not responses the good if the buyer made default in the payment of installment but he/she can sue against the buyer for the recovery of amount due.
5. In case of default in the payment of installment, the total amount of installments already paid by the buyer cannot be forfeited.
6. Under installment system, the buyer can sell or mortgage the goods even before clearing all the installments.
7. Risk of goods/assets are to be borne by the buyer just after signing the agreement.
8. The buyer of the goods under installment purchase system has no right to return the goods to the seller.

**Difference**

1. **Nature Of Contract**
Hire Purchase System: It is a hiring goods agreement.
Installment System: It is an agreement of sale.

**2. Ownership**
Hire Purchase System: Ownership of goods is transferred after the payment of final installment.
Installment System: Ownership of the goods passes to the buyer just signing the agreement.

**3. Right**
Hire Purchase System: The buyer can not sell, destroy or transfer the goods.
Installment System: The buyer can sell, destroy or mortgage or transfer as his/her wish.

**4. Risk**
Hire Purchase System: All the risks are borne by the vendor before the payment of final installment.
Installment System: All the risks are to be borne by the buyer from the date of agreement.

**5. Right Of Return**
Hire Purchase System: The buyer can return the goods before making the final installment.
Installment System: The buyer can not return the goods to the seller.

**6. Repair And Maintenance**
Hire Purchase System: The liability of repair and maintenance lies with the seller provided that the buyer takes the utmost good care.
Installment System: The buyer is responsible for repair and maintenance.

**7. Forfeiture Of Installment Paid**
Hire Purchase System: In case of default in payment of installment, paid installment will be forfeited and treated as hire charges.
Installment System: The act of forfeiture can not be activated.

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***There are two methods of recording transactions under Installment System. These are:***

1. *With Opening Interest Suspense Account*
2. *Without Opening Interest Suspense Account*

*Journal entries under these two methods are as under:*

***Journal entries in the books of purchaser***

1. **For purchasing goods under installment system:**

***First Method***

Assets A/C(total cash value)…………..Dr.

Interest suspense A/C(total interest)………Dr.

To vendor A/C

***Second Method***

Assets A/C (total cash value)…………Dr.

To vendor A/c

1. ***For payment of cash down value (both method)***

Vendor A/C………………Dr.

To Bank A/C

1. ***For interest due***

*First Method*

Interest A/C…………..Dr.

To Interest suspense A/C

*Second method*

Interest A/C……………Dr.

To vendor A/C

1. ***For payment of installment (both methods)***

Vendor A/c………….Dr.

To bank A/C

1. ***For depreciation charges (both methods)***

Depreciation A/C………….Dr.

To Asset A/C

1. ***For transferring interest and depreciation***

**Royalties Accounts**

Royalty is payable by a user to the owner of the property or something on which an owner has some special rights. A royalty agreement is prepared between the owner and the user of such property or rights. If payment is made to purchase the right or property that will be treated as capital expenditure instead of a Royalty.

Payment made by the lessee on account of a royalty is normal business expenditure and will be debited to the Royalty account. It is a nominal account and at the end of the accounting year, balance of Royalty account need to be transferred to the normal Trading and Profit & Loss account. Royalty, based on the production or output, will strictly go to the Manufacturing or Production account. In case, where the Royalty is payable on sale basis, it will be part of the selling expenses.

**Types of Royalties**

There are following types of Royalties:

* **Copyright**: Copyright provides a legal right to the author (of his book/s), the photographer (on his photographs), or any such kind of intellectual works. Copyright royalty is payable by the publisher (lessee) of a book to the author (lessor) of that book or to the photographer, based on the sale made by the publisher.
* **Mining Royalty**: Lessee of a mine or quarry pays royalty to lessor of the mine or quarry, which is generally based on the output basis.
* **Patent Royalty**: Patent royalty is paid by the lessee to lessor on the basis of output or production of the respective goods.

**Basis of Royalty**

In case of the patent, publisher of the book pays royalty to the author of the book on the basis of number of books sold. So, holder of patent gets royalty on the basis of output and the mine owner gets royalty on the basis of production.

**Important Terms**

Following are the important terms, which are used in Royalty agreements:

Royalty

A periodic payment, which may be based on a sale or output is called Royalty. Royalty is payable by the lessee of a mine to the lessor, by publisher of the book to the author of the book, by the manufacturer to the patentee, etc.

Landlord

Landlords are the persons who have the legal rights on mine or quarry or patent right or copybook rights.

Tenet

An Author or publisher; lessee or patentor who takes out rights (usually commercial or personal rights) from the owner on lease against the consideration is called tenet

Minimum Rent

According to the lease agreement, minimum rent, fixed rent, or dead rent is a type of guarantee made by the lessee to the lessor, in case of shortage of output or production or sale. It means, lessor will receive a minimum fix rent irrespective of the reason/s of the shortage of production.

Payment of royalty will be minimum rent or actual royalty, whichever is higher for example:

M/s Hyderabad publication printed a book on Java on the minimum rent of Rs. 1,000,000/- per annum royalty being payable @ Rs. 20 per book sold. In the first year of publication, Hyderabad publication sold 75,000 copy of the books and in the second year, number of sold books fell down to 45,000 only. Amount of royalty will be payable as under −

|  |  |  |
| --- | --- | --- |
|   | **Minimum Rent** | **Royalty Payable** |
| **Ist Year** 75,000 Books X Rs. 20 per book = Rs. 1,5,00,000 | 1,0,00,000 | Rs. 1,5,00,000 |
| **IInd Year** 45,000 Books X Rs. 20 per book = Rs. 9,00,000 | 1,0,00,000 | Rs. 1,0,00,000 |

Shortworkings

**Difference** of minimum rent and actual royalty is known as shortworkings where payment of Royalty is payable on the basis of minimum rent due to shortage in the production or sale. For example, if calculated royalty is Rs. 900,000/- as per sale of books based on the above example, but royalty payable is Rs. 1000,000 as per minimum rent, shortworking will be Rs. 100,000 (Rs. 1,000,000 – Rs. 9,00,000).

Ground Rent

The rent, paid to the landlord for the use of land or surface on the yearly or half yearly basis is known as **Ground Rent** or **Surface Rent**.

Right of Recouping

It may contain in the royalty agreement that excess of minimum rent paid over the actual royalty (i.e. shortworkings), may be recoverable in the subsequent years. So, when the royalty is in excess of the minimum rent is called the right of recoupment (of shortworkings).

Right of recoupment will be decided for the fixed period or for the floating period. When the right of recoupment is fixed for the certain starting years from the date of royalty agreement, it is said to be fixed or restricted. On the other hand, when the lessee is eligible to recoup the shortworkings in next 2 or 3 years from the year of its commencement, it is said to be floating.

Short working will be shown on the asset side of Balance sheet up to allowable year of recouping after that it will be transferred to profit & loss account (after expiry of allowable period).

Lease Premium

An **Extra payment** in addition to royalty, if any, paid by lessee to lessor is called Lease premium and will be treated as capital expenditure and it will be written off on yearly basis through profit and loss account as per the suitable method.

TDS (Tax Deducted at source )

If there is an applicability of TDS (Tax deducted at source) as per Income Tax Act, lessee will make the payment to lessor after deducting TDS as per applicable rate and lessee is liable to deposit it to the credit of Central Government. Amount of royalty will be gross amount of royalty (inclusive of TDS), that will be charged to profit and loss account.

For example, if royalty amount is 1,000,000/-& rate of TDS is 10%, then lessee will pay Rs. 900,000/- to lessor. Amount of royalty charge to profit and loss account will be Rs. 1,000,000/- and balance amount of Rs. 100,000/- will be deposited in the credit of central Government account.

Stoppage of Work

Sometime, there may be stoppage of work due to conditions beyond control like strike, flood, etc. in this case, minimum rent is required to be revised as provided in the agreement.

Revision of the minimum rent will be:

* Reduction of minimum rent in the proportion of the stoppage of work;
* On the basis of fixed percentage; or
* By a fixed amount in the year of stoppage.

Sub Lease

Sometime, landlord or lessor allows lessee to sublet some part of the mine or land as a sub-lessee. In this case, lessee will become lessor for sub lessee and lessee for main landlord.

In such a case, as Lessee, he will maintain the following books of accounts:

|  |  |
| --- | --- |
| **As a Lessee** · Landlord account· Minimum Rent Account· Royalty Account· Shortworkings Recoupable Accounts | **As a Sub Lessor** ·  Royalties receivable Receivable account· Sub lessee Lessee accountAccount· Shortworkings allowable Allowable Account |

Accounting Entries

|  |  |
| --- | --- |
| When there is no royalty in the year | (a) Minimum Rent A/cDr To Landlord A/c(b) Shortworking A/cDrTo Minimum Rent A/c |
| Where Royalties are less than minimum rent and shortworkings are recoverable in next years. | (c) Minimum Rent A/cDr To Landlord A/c(d) Royalties A/cDrShortworkings A/cDrTo Minimum Rent A/c(e) Landlord A/cDrTo Bank A/c(f) Profit & Loss A/cDrTo Royalty A/c |
| When Short workings are recouped | (g) Royalties A/cDr To short workings A/cTo Landlord A/c(h) Landlord A/cDrTo Bank A/c |
| Transfer of irrecoverable Short workings | (i) Profit & Loss A/cDr To Short workings A/c |