Study Unit 8: Royalty Account

Definition of royalty

It is a transaction whereby an owner gives a right to other company or use to use his/her own property and in return, the user will then give a compensation which is known as a royalty.

A royalty agreement is prepared between the owner and the use of such property and rights. If payment is made to purchase the right or property that will be treated as capital expenditure instead of a royalty.

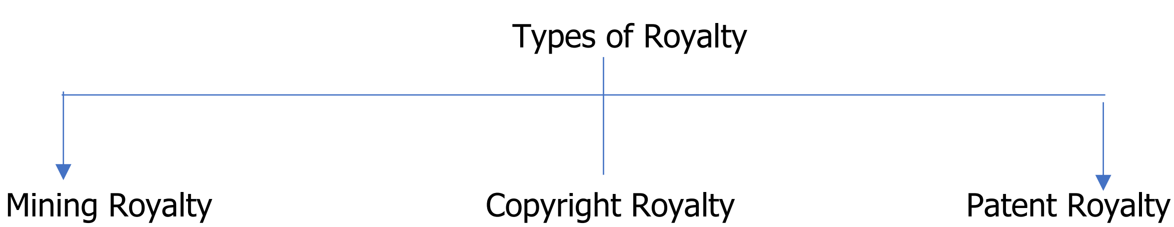
Types of royalty

Copyright. Copyright provides a legal right to the author (of his books), 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 pay royalty to the lessor of the mine or quarry, which is generally based on the output basis.

Patent r royalty. Patent royalty is paid by the lessee to the lessor on the basis of output or production of the respective goods.

Illustration



Definition of the terms used in royalty account recording.

Landlord. A landlord is the owner of the asset. The other name (term) used for landlord is lessor.

Tenant. A tenant is a person to whom the right of or a lessee.

Royalty rent. Is the amount payable by the lessee per unit of output. The landlord and the lessee agree in their contract on the length of period for which royalties must be paid.

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, the lessor will receive a minimum fix rent irrespective of the reasons(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 a minimum rent of Rs.1,000,000 er annum royalty being payable at Rs.20 per book sold. In the first year of publication, Hyderabad publications sold 75,000 copy of the books and in the 2nd year number of sold books fell down to 45,000 only. Amount f royalty will be payable as under;

	Minimum rent	Royalty payable
1st year		
75,000 book x		
Rs. 20 per book	1,000,000	
= 1,500,000		1,500,000
2nd year		
45,000 books x Rs. 20	1,000,000	1,000,000
Per book = 900,000		

Short-workings

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. 1,000,000 or per minimum rent, short workings will be Rs. 1,000,000 (Rs. 1,000,000 – Rs. 900,000).

Right of recouping

It may contain in the royalty agreement that excess of minimum rent paid over the actual royalty (i.e. short workings), 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 short workings).

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.

Shortworking will be shown on the asset side of the balance sheet up to allowable year of recouping after that it will be transferred to profit and loss account (After expiry of allowable period).

Accounting treatment in the bools of lessee

When royalty is payable:

Royalty A/C	Dr	Actual royalty
Short-workings A/C	Dr	Balancing figure
To landlord A/C		Minimum rent

For payment to landlord:

Landlord A/C	Dr	Minimum rent

To bank A/C	Minimum rent	
Trading/Profit and Loss/Manufacturing/Production A/C Dr.		Actual royalty
To royalty A/C		Royalty Amount

Note:

The journal entries given below assume that there is a clause on minimum rent and recoupment of short workings subsequently.

Royalties based on output should be debited to manufacturing or production account whereas royalty based on sales be treated as selling expenses should be debited to trading or profit and loss account.

When short-workings in recouped

Royalty A/C Dr.	Actual Royalty
To short-workings A/C	Recoupment
To landlord A/C	Actual payment

For irrecoverable short-workings to trading/profit and loss/manufacturing/production A/C:

Trading/profit and loss/manufacturing/production A/C Dr	Amount lapsed
To short-workings A/C	Amount lapsed

Accounting treatment in the books of lessor

When royalty is due:

Lessee A/C Dr.	Minimum rent
To royalty receivable A/C	Actual royalty
To short workings allowable A/C	Balancing figure

When money is received.

Bank A/C Dr	Net amount received
To lessee A/C	Minimum rent

When short-workings is recouped

Short-workings allowable A/C Dr.	Amount of short-workings recouped
To lessee A/C	Amount of short-workings recouped

For irrecoverable amount of short-workings

Profit and loss A/C	Amount lapses
To short workings allowable A/C	Amount lapses

For transferring royalty recievable to trading/ profit and loss/manufacturing/production A/C:

Royalty Receivable A/C Dr	Actual royalty
To trading / profit and loss/manufacturing/production A/C	Actual royalty

Illustration 1

A grants a mine on lease to B on 31.3.13. a royalty of £2 per tonne of the coal produced. The following is the quantum of output for each year.

For the year ended 31st March,	2014	3,000 tonnes
	2015	3,200 tonnes
	2016	4,000 tonnes
	2017	5,000 tonnes

The minimum rent is fixed at 7,000 and short-workings recoupment is allowable throughout the period of lease.

Compute the amount of royalty payable for the years ended 31st March 2014, 2015, 2016, and 2017.

Solution

Statement showing amount of royalty payable

Date	Output (in tonnes)	Royalty @ £2 per tonne	Minimum rent	Short-workings allowable	Short workings recouped	Amount payable
2014	3,000	6,000	7,000	1,000		7,000
2015	3,200	6,400	7,000	600		7,000
2016	4,000	8,000	7,000		1,000	7,000
2017	5,000	10,000	7,000		600	9,400

Workings: short-workings allowable;

2014 = Minimum rent – Actual Royalty

= 7,000 – 6,000

= £1,000

2015

= 7,000 – 6,400

= £600

Short workings recoupled

2016 = Excess of minimum rent

= (8,000 – 7,000)

= 1,000

2017 = (10,000 – 6,000)

= 1,600 – (2016 recouped short-workings)

= 1,600 – 1,000

2017 = 600

Amount payable in 2017 = (10,000 – 7,000) + (7,000 – 600)

= (3,000 + 7,000) – 600

= 10,000 – 600

= 9,400

ABC Celeries Co. Ltd took from M/S XYZ a lease of coal field for a period of 25 years from 1st April, 2010 on a royalty of `25 per tonne of coal extracted with a bead rent of `220,000 a year with power to recoup short-workings during the first five years of the leave. The company closes its books of accounts on 31st march every year.

The output in the first five years of the lease was as follows;

Year ended 31st March, 2011	2,000 tonnes
Year ended 31st March, 2012	3,600 tonnes
Year ended 31st March, 2013	9,000 tonnes
Year ended 31st March, 2014	15,000 tonnes
Year ended 31st March, 2015	20,000 tonnes

You are required to give journal entries for all the transactions relating to royalties for the five years in the books of ABC Celeries Co. Ltd.

Statement showing amount of royalty payable

Date	Output (in tonnes)	Royalty @ ’25 per tonne	Minimum rent	Short-workings	Short-workings being recouped	Short-workings irrecoverable landlord	Amount payable
31-3-11	2,000	50.000	220,000	170,000			220,000
31-3-12	3,600	90.000	220,000	130,000			220,000
31-3-13	9,000	225.000	220,000		5,000		220,000
31-3-14	15,000	375.000	220,000		155,000		220,000
31-3-15	20,000	500,000	220,000		140,000	140,000	360,000

Working:

Short-workings:

31-2-11 = Minimum rent – actual royalty

= 220,000 – 50,000 = 170,000

31-3-12 = 220,000-90,00 = 130,000

Short-workings being recouped;

31-3-13 = Excess of royalty

= (225,000-220,000)

= `5,000

31-3-14 = (375,000-220,000)

= `155,000

31-3-15 = total short-workings – total short-workings being recouped

= (170,000 + 130,000) – (155,000+5,000)

= `140,000

Amount payable on 31-3-15

= (500,000-220,000) + 220,000 – (140,000)

= (280,000+220,000) – 140,000

= 500,000-140,000

= `360,000

JOURNAL ENTRIES IN THE BOOKS OF ABC CELLERIES CO. LTD

2011 March	31	Royalties Account Short-workings Account To M/S XYZ (Royalties @ '25 per tonne on 2,000 tonnes subject to a minimum of '220,000)	Dr. Dr.	50,000 170,000	 220,000
	31	M/S XYZ To Bank………….. (payment of the sum due to the landlord)	Dr.	220,000	 220,000
	31	Profit and Loss Account To Royalties Account (Transfer of Royalties Account to Profit and Loss A/C)	Dr.	50,000	 50,000
2012 March	31	Royalties Account Short-workings To m/s XYZ (Royalties @ '25 per tonne on 3,600 tonnes plus '130,000 to landlord)	Dr. Dr.	90,000 130,000	 220,000
	31	M/S XYZ To Bank………….. (payment of the sum due to the landlord)	Dr.	220,000	 220,000
	31	Profit and Loss Account To Royalties Account	Dr.	90,000	 90,000

		(Transfer of Royalties Account to Profit and Loss A/C)			
2013 March	31	Royalties account To M/S XYZ To short-workings account (Royalties @’25 per tonne on 9,000 tonnes less ‘5,000 recovered against short-working payable to landlord)	Dr.	225,000	 220,000 5,000
	31	M/S XYZ To Bank…………. (Payment of the sum due to the landlord)	Dr.	220,000	 220,000
	31	Profit and Loss Account To Royalties Account (Transfer of Royalties Account to Profit and Loss A/C)	Dr.	225,000	 225,000
2014 March	31	Royalties account To M/S XYZ To short-workings account (Royalties @’25 per tonne on 15,000 tonnes less ‘155,000 recovered against short-working payable to landlord)	Dr.	375,000	 220,000 155,000
		M/S XYZ To Bank…………. (Payment of the sum due to the landlord)	Dr.	220,000	 220,000
	31	Profit and Loss Account To Royalties Account	Dr.	375,000	 375,000

		(Transfer of Royalties Account to Profit and Loss A/C)			
2015 March	31	Royalties account To M/S XYZ To short-workings account (royalties @’25 per tonne on 20,000 tonnes less ‘140,000,balance in short-workings, account, recouped against amount payable to landlord).	Dr.	225,000	 255,000 5,000
	31	M/S XYZ To Bank………….. (Payment of the sum due to the landlord)	Dr.	360,000	 360,000
	31	Profit and Loss Account To Royalties Account (Transfer of Royalties Account to Profit and Loss A/C)	Dr.	500,000	 500,000

Tutor Marked Assessment-Study Unit 8

a) State and explain the different types of royalties. Illustrate your answers with examples.
b) A grants a mine on lease to B on 31.3.13. a royalty of £2.5 per tonne of the coal produced. The following is the quantum of output for each year.

For the year ended 31st March,	2014	3,000 tonnes
	2015	3,200 tonnes
	2016	4,000 tonnes
	2017	5,000 tonnes

The minimum rent is fixed at 7,500 and short-workings recoupment is allowable throughout the period of lease.

Required: Compute the amount of royalty payable for the years ended 31st March 2014, 2015, 2016, and 2017.