Study Unit 10: Investment Accounts

Meaning of Investment

Investment means either buying or creating an asset with the future expectation of capital appreciation, dividends (profit), rents, interest earnings, or some combination of these returns. However, normally, investment inherent with some form of risk, such as investment in equities, property, and even fixed interest securities, among other things, are the subject to inflation risk.

Further, among all these, securities are held as long-term investment to earn income. It is said to be fixed assets, but where objective of an organization is to sell and buy securities in short term fund to utilize its surplus fund, would come under the category of current assets.

Types of securities

Fixed Interest Securities Holders of fixed interest securities get fixed rate of interest.

Variable Yield Securities Under this category, return on investment may differ from year to year.

Investment Account

Investment account is an account opened for the purpose of the investment. Further, if the number of investment is large, a separate account for each investment should be opened.

Types of Investment Accounts

There are four basic types of investment accounts:

Individual Brokerage Account (or Joint Brokerage Account)

IRA (Individual Retirement Account): Roth or Traditional

401k (and other Corporate Sponsored Accounts)

529 College Savings Account

This is not an exhaustive list, but it does cover the core types of investment accounts that take care of 90%-100°/b of investing needs.

Individual Brokerage Account

An individual brokerage account is the most basic and flexible type of investment account. In the simplest terms, a brokerage account allows you to buy and sell investments through a licensed broker with very little restrictions.

Opening an individual brokerage account has become very simple thanks to the rise of online brokers. The basic process is as follows:

Open an online brokerage account,

Deposit money into the account — there are a couple ways to do this, but the easiest is to link your checking account and electronically transfer money. You can usually mail a check as well if you prefer.

Key Benefits:

No contribution limits

No restrictions on withdrawing funds

Drawbacks:

Taxed on the way in

Taxed on the way out

Meaning of terminologies.

Taxed on the way in: Your money is taxed when you earn it (state and federal taxes on your income / checks from work).

Taxed on the way out: Your money is taxed as you withdraw it from your investment accounts. Note, for most accounts (excluding Traditional IRAs and 4Olks) this only applies to capital gains and not the money you initially contributed. Two quick examples to help illustrate:

You buy Apple stock for $1,000, sell it for $2,000, and are taxed on the capital gains of $1,000.

You contribute $1,000 to your 401k pre-tax (into various investments). It grows to $2,000 when you retire. Taxation occurs on the full $2,000 when you withdraw it.

A brokerage account shared with another individual is a joint brokerage account. For example, your spouse.

IRA

An account designed to help you save for retirement is an IRA (Individual Retirement Account) exactly what it sounds like. There are significant tax benefits to IRAs that help you keep more of your money, but also some rules on when you can withdraw your money (and penalties if you do not follow these rules).

There are several types of IRAs, but the two most common are the Roth IRA and Traditional IRA.

Roth IRA

Roth IRAs are accounts that you put post-tax income into, but you can withdraw any capital gains tax-free when you retire. In other words, you get taxed now (by using post-tax income) and get the benefit later (when you pull your money out at retirement tax-free).

Key Benefits:

Not taxed on the way out

No mandatory withdrawals

Can withdraw your contributions anytime (although not usually recommended, it is a good safety net)

Drawbacks:

Contribution limits

Penalty if capital gains withdrawal before age 59.5

Taxed on the way in

Traditional IRA

A Traditional IRA is an account that you contribute pre-tax income into*, but you get taxed on your contributions and capital gains when you withdraw. In other words, you benefit now (by using pre-tax income) and get taxed later (when you pull your money out at retirement).

Traditional IRAs operate very similarly to corporate sponsored 401 ks in that they use pre-tax income,

Technically you deduct your contributions when doing taxes.

Key Benefits:

Not taxed on the way in

Drawbacks:

Contribution limits

Penalty if withdrawal before age 59.5

Mandatory withdrawals starting at age 70.5

Additional rules when also utilizing corporate-sponsored plan (I.e. 401k)

Taxed on the way out

There are a lot of rules and drawbacks to keep in mind when dealing with these types of investment accounts, but do not let that scare you, IRAs are extremely useful tools in helping to save for retirement.

401k

A 401k is a corporate-sponsored account provided by your employer. As mentioned above, a 401k is similar to a Traditional IRA — it offers a tax break on your income now and you are taxed on your money later. With 4Olks, you designate a percent of your income (paycheck) that you want to contribute and it is automatically deducted and invested for you (based on your preselected investment vehicles).

The largest benefit of a 401k is employer match programs (as applicable). In short, some companies contributes a certain percentage of your income to your 401k in addition to your contributions (as long as you meet certain contribution thresholds). The most common example is companies matching 50% of the first 6% you contribute. Here are a couple of examples to help illustrate:

Example 1: You contribute 3%, employer contributes 1.5%. Total 4.5%.

Example 2: You contribute 6%, employer contributes 3%. Total 9%.

There are a few rules to keep in mind with 4Olks:

Max Contributions: The max contribution for any individual is $19,500 annually, while the max contribution for the individual + employer is $57,000 annually.

Withdrawal Rules: Money withdrawn before age 59.5 has a 10% additional tax.

Mandatory Withdrawals: Similar to Traditional IRAs, you must start withdrawing from the plan at age 70.5 to avoid penalties.

Key Benefits:

Not taxed on the way in

Employer matching contributions

Automatically deducted from paycheck

You can get 7 tips to maximize your 401(k) benefits here.

Drawbacks:

Contribution limits

Penalty if withdrawal before age 59.5

Mandatory withdrawals starting age 70.5

Taxed on the way out

Limited investment vehicle options: typically, there are only a handful of mutual funds to choose from when investing in a 401k (versus the unlimited options when investing through a broker in an IRA or personal brokerage account)

Check out Blooom for a free 401(k) analysis to see if your account is set up as optimally as possible.

Other Corporate Sponsored Accounts

Other, less common types of investment accounts offered by employers include:

Pension Plans: Becoming rarer for corporations to offer, but arguably one of the best retirement plans for individuals out there.

403b: Similar to a 40 1k, but typically utilized by public schools or non-profits.

457: Similar to a 40 1k, but typically utilized by local and state governments (police officers, firefighters, etc.).

Solo 401k: A 401k plan for sole proprietors.

SEP IRA: IRA Plans for small businesses.

Simple IRA: A simpler retirement account typically used by small businesses.

529 College Savings Account

Last on the list of types of investment accounts is the 529 Savings Account (specifically, the Education Savings Plan). This account is designed to help save for a beneficiary's higher education (i.e., college) and includes generous tax benefits (benefits vary slightly by state).

Key Benefits:

Not taxed on the way out

Can use at most schools nationwide (not limited to certain states)

Some states offer matching programs

Drawbacks:

Limited to only use on education expenses for a beneficiary

Taxed on the way in

Learn more about the 529 Savings Account.

Stocks

A stock is an investment in a specific company. When you purchase a stock, you're buying a share a small piece of that company's earnings and assets. Companies sell shares of stock in their businesses to raise cash; investors can then buy and sell those shares among themselves. Stocks sometimes earn high returns, but also come with more risk than other investments. Companies can lose value or go out of business. Read our full explainer on stocks.

How investors make money: Stock investors make money when the value of the stock they own goes up and they're able to sell that stock for a profit. Some stocks also pay dividends, which are regular distributions of a company's earnings to investors.

Bonds

A bond is a loan you make to a company or government. When you purchase a bond, you’re allowing the bond issuer to borrow your money and pay you l5ack with interest.

Bonds are generally considered safer than stocks, but they also offer lower returns. The primary risk, as with any loan, is that the issuer could default. U. S. government bonds are backed by the “full faith and credit” of the United States, which effectively eliminates that risk. State and city government bonds are generally considered the next-safest option, followed by corporate bonds. The safer the bond, the lower the interest rate. For more details, read our introduction to bonds.

How investors make money: Bonds are a fixed-income investment, because investors expect regular income payments. Interest is generally paid to investors in regular installment

Mutual funds

Mutual funds allow investors to purchase a large number of investments in a single transaction. These funds pool money from many investors, then employ a professional manager to invest that money in stocks, bonds or other assets.

Mutual funds follow a set strategy a fund might invest in a specific type of stocks or bonds, like international stocks or government bonds. Some funds invest in both stocks and bonds. How risky the mutual fund is will depend on the investments within the fund.

How investors make money: When a mutual fund earns money for example, through stock dividends or bond interest it distributes a proportion of that to investors. When investments in the fund go up in value, the value of the fund increases as well, which means you could sell it for a profit. Note that you’ll pay an annual fee, called an expense ratio, to invest in a mutual fund.

Index funds

An index fund is a type of mutual fund that passively tracks an index, rather than paying a manager to pick and choose investments. For example, an S&P 500 index fund will aim to mirror the performance of the S&P 500 by holding stock of the companies within that index.

The benefit of index funds is that they tend to cost less because they don't have that active manager on the payroll. The risk associated with an index fiind will depend on the investments within the fund. Learn more about index funds.

How investors make money: Index funds may earn dividends or interest, which is distributed to investors. These funds may also go up in value when the benchmark indexes they track go up in value; investors can then sell their share in the fund for a profit. Index funds also charge expense ratios, but as noted above, these costs tend to be lower than mutual fund fees.

Exchange-traded funds

ETFs are a type of index fund: They track a benchmark index and aim to mirror that index's performance. Like index funds, they tend to be cheaper than mutual funds because they are not actively managed.

Advantages of investment accounts.

A personal investment account allows you to make decisions regarding how to allocate your funds in the account, based on your assessment of risk and investment criteria. The destiny of your portfolio is in your hands.

Investment accounts give one the potential for great investment returns.

There is the possibility of long-term investment.

You can save your money tax-free.

The amount of money which you want to invest is up to you. The amount can be small or large.

Investment managers can monitor the markets in order to avoid dramatic losses.

You can specify the type of company in which you want to invest.

You can make big purchases, such as a second home, and earn income for free.

Disadvantages of investment accounts A personal investment account offers no guarantee of returns.

There is the potential loss of capital.

Depending on the type of investment account you open, long-term investment will prevent you from making early withdrawals.

There are often hidden costs and work involved. For example, when purchasing a property.

In order to make a profit, one has to usually rely on aptitude of investment manager.

The value of your investment can easily be affected by an economic crisis or market problems.

Accounting entry on the purchase of any investments are given as hereunder —

Investment account is inclusive of purchase expenses like stamp duty, Commission, and brokerage.

On Sale of investments

Cash/Bank A/cDr

To Investment A/c

(Being Investment made)

Investment account will be credited with net realized value of investment.

Interest and dividend account

Cash/Bank/Investment A/cDr

To Dividend/Interest A/c

(Being Interest/dividend received on investments)

Investments account will be credited in case, interest/dividend accrue and cash/bank account will be debited (in case) with net realized value of investment.

Investment Transactions

We normally have the following two types of investments transactions —

Cum Dividend or Cum Interest Quotations and

Ex-Dividend or Ex-Interest Quotations

Discussing these two types of investment transactions in detail.

Cum Dividend or Cum Interest Quotations

Interest and dividend on the fixed investments accrued on regular interval, but payment of those are made only on fixed dates. Dividends are always paid to the persons, who are shareholder at the time of payouts. Suppose a shareholder sold his shares after keeping those shares in his hand

up to ten months, then dividends on those shares will be paid to the buyer or we can say, to new shareholder.

So, a seller at the time of selling shares normally charge value of the accrued dividends up to the date of sale, and this is called 'CUM DIVIDEND" or "CUM INTEREST". Since, the sale price is inclusive of the value of a share and interest or dividend, therefore at the time of entry in the books of accounts, normal price of share should be booked in the investment account and the value of dividend or interest should be debited to dividend or interest account.

At the time of receiving dividend or interest, dividend or interests account will be credited, debiting cash or bank account. On the other hand, in the books of seller, normal price of the share should be credited to Investment account and the price of accrued dividend or interest should be credited to the dividend or interest account as the case may be.

Accounting Entries It can be understand through the following table.

In the Books of Buyer

On purchase of investment

Investment AJcDr

Dividend or Interest A/c

To Cash/Bank A/c

(Being Investment made)

On receipt of dividend or interest

Cash/Bank A/cDr

To Dividend or Interest A/c

(Being dividend or interest received)

for Accrued Interest

Accrued Interest A/cDr

To Interest A/c

(Being interest accrued)

In the Books of Seller

On Sale of investments

Cash/Bank AJcDr

To Investment A/c

To Dividend or Interest A/c

(Being Investment Sold)

On receipt of dividend or Interest

Cash/Bank A/cDr

To Dividend or Interest A/c

(Being dividend or interest received)

Ex-Dividend or Ex-Interest Quotations

The buyer of shares when he is quoted ex-dividend is not entitled to receive the payment. It is the interval between the record date and the payment date during which the stock trades without its dividend. Therefore, the person who owns the security on the ex-dividend date will be awarded the payment, regardless of wlocurrently holds the stock.

Difference between Cum-dividend and Ex-Dividend

Major differences between them are given as hereunder

Cum interest or dividend prices are inclusive of the interest or dividend accrued at the date of purchase, whereas in case of the ex-dividend, prices are excluding value of the dividend or interest.

The purchase price is higher than normal purchase price in case of Cum-dividend, whereas purchase price is the real price in case of ex-dividend.

Nothing is payable additional in case of Cum-Interest, whereas separate amount of the dividend or interest has to be paid in case of the ex-dividend or ex-interest.

Balancing the Investment Account

Difference of debit and credit side of the investment account is Profit or Loss in case where all the investments are sold.

In case where part of the investments are sold and the balance investments stand unsold, it should be carried forward to the next accounting period and remaining balance of the two sides (debit and credit) will represent profit or loss on the sale of investment.

In case where investments are the fixed assets, then the profit or loss will be of capital revenue or capital loss and should be treated accordingly.

Equity Share Accounts

Main features of investment account regarding the equity shares are given as hereunder — Bonus Shares Bonus shares are issued by the profitable companies to the existing shareholders of the company without any additional amount. Purpose of the bonus share is to capitalize reserves of the company.

Only number of the shares will be added in face value column, and principle or capital column will remain unchanged.

Right Shares Right shares are first offered to the existing shareholders of the company as a matter of the right, hence called as right shares. As per Companies Act, right shares can be issued after two years of the establishment of a company or after one year of first issue.