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## Financial Accounting

### Unit 4

#### ROYALTY ACCOUNTS

**Q: Write short notes on:**

*(www.prepNext.com)*

- 1) Royalty Agreement
- 2) Royalty
- 3) Minimum Rent
- 4) Shortworkings
- 5) Excess Workings
- 6) Recoupment of Shortworkings
- 7) Nazrana or Lease Premium
- 8) Copyright Royalties
- 9) Sub Lease
- 10) Ground (Surface) Rent

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**Ans.: 1) ROYALTY AGREEMENT**

A royalty agreement is an agreement between two parties, i.e., the person who gives out his special rights and the person who takes out the special right on lease for a consideration.

**2) ROYALTY**

Royalty is a periodical payment, based on output or sale, paid by one party to the owner of an asset or right (like mine, copyright or patent), for the use of the asset or right. For example, when a publisher publishes a book, he makes periodical payments (royalty) to the author which is based on the number of copies sold. The person who gives out some special right over something to another person for a consideration is called lessor or landlord or patentee or an author. The person who takes out some special right from its owner on lease for a consideration is called lessee or tenant or patentor or publisher. This right may be any of the following types:

- (i) Right to extract some mineral such as oil, coal or stone etc. from land;
- (ii) Right to use certain patents for the manufacture of articles for sale; and
- (iii) Right to publish and sell books under a copyright.

**Types of Royalties:**

There are three principal forms of royalties:

- (i) **Mining Royalty:** It is the periodical payment generally based on output, made by lessee of a mine or quarry to the lessor or the landlord (i.e. owner of the mine or quarry).
- (ii) **Patent Royalty:** It is the periodical payment based on output, made by the lessee of a patent to the lessor or the patentee (i.e. the holder of the patent right).
- (iii) **Copyright royalty.** It is the periodical payment based on sales, made by the lessee of a copyright (i.e. the publisher) to the lessor (i.e. the author).

**Note:** A lump-sum payment for the outright purchase of a patent, mine or book is not treated as royalty but is a capital expenditure and recorded as a fixed asset.

### **3) MINIMUM RENT**

It is also termed as “Dead Rent”, “Certain Rent”, “Fixed Rent” or “Rock Rent”. As the term suggests, minimum rent means the minimum periodical amount payable by the lessee to the landlord irrespective of the fact whether he has derived any benefit or not, out of the right given to him by the landlord. In other words, it is a guaranteed amount which the tenant has to pay, even if the actual royalty as calculated on the basis of actual production or sale is less than such minimum amount. It means that the sum payable is the minimum amount or actual royalties whichever is higher.

#### **Example:**

Suppose royalty per ton of production is Rs. 10 and the minimum rent is Rs. 50,000. Now, if the actual production is 3,500 tons, then actual royalty would become Rs. 35,000. In this case the minimum rent of Rs. 50,000 will have to be paid by the lessee. On the other hand, if the actual production is 6,000 tons, then the actual royalty would become Rs. 60,000. In this case Rs. 60,000 will have to be paid by the lessee. This minimum sum of Rs. 50,000, which is to be paid in any case, is minimum rent.

#### **Purpose of Fixing Minimum Rent:**

The following are the main purposes of fixing a minimum rent:

1. The landlord receives periodically at least a minimum rational amount.
2. The lessee is indirectly inspired for the sake of his own interest to reach a minimum level of performance.
3. In the absence of minimum rent, the lessee may acquire rights from different landlords to obviate (*prevent*) competition and may deliberately under-utilise such rights.

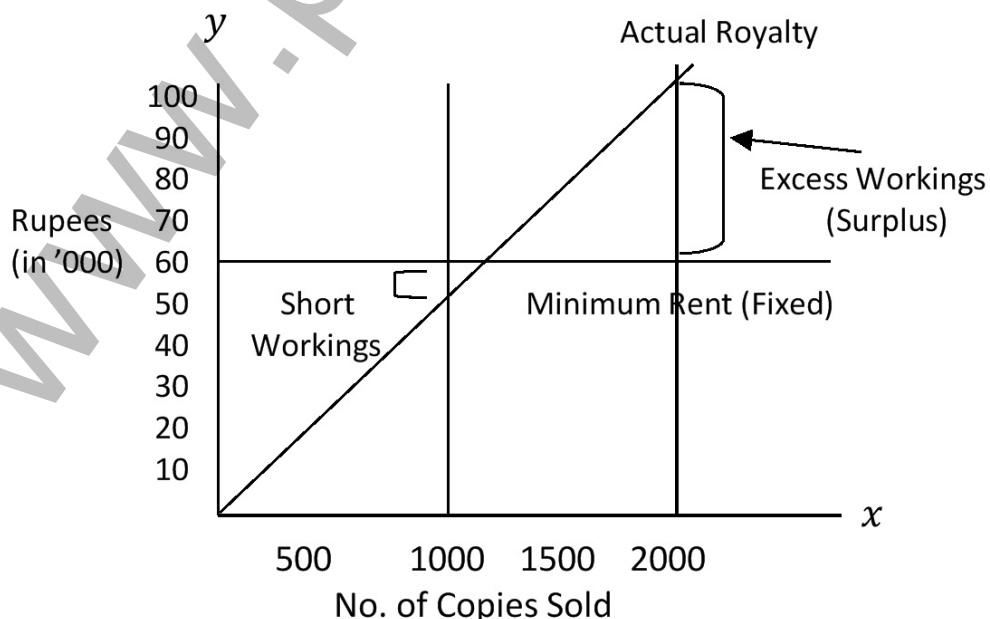
#### 4) SHORTWORKINGS: (Redeemable Dead Rent)

Shortworkings refers to the amount by which the actual royalty falls short of the minimum rent. In other words, it is the excess of minimum rent over actual royalty calculated on the basis of output or sales. Where there is shortworkings in any period the lessee is liable to pay the minimum rent and, in effect, shortworkings becomes the part of the minimum rent not represented by the use of rights.

$$\text{Shortworkings} = \text{Minimum rent} - \text{Actual royalty}$$

**For example,** ABC printed a book on Economics at a minimum rent of Rs. 60,000 per annum, royalty being payable @ Rs. 50 per copy sold and the number of copies sold in the first year is 1,000 and in the second year is 2,000. In this case, ABC will have to pay Rs. 60,000 (i.e. minimum rent) to the authors in the first year even though the royalty works out to be Rs. 50,000 for 1000 copies. *In the second year Rs. 1,00,000 as royalty for 2,000 copies @ Rs. 50 per copy sold will be paid to the authors even though the minimum rent is Rs. 60,000. In the above example, there is a shortworking of Rs. 10,000 i.e. Rs.60,000 (minimum rent) – Rs.50,000 (actual royalty for 1000 copies @ Rs.50 per copy) in the first year. There is no shortworking in the second year because actual royalty of Rs. 1,00,000 is more than the minimum rent of Rs. 60,000.*

This can be better understood with the help of the following diagram:



### **5) EXCESS WORKINGS/ SURPLUS**

It refers to the amount by which the actual royalty exceeds the minimum rent. In the above example, the excess workings is Rs. 40,000 (Rs. 1,00,000 – Rs. 60,000) if the sales is 2000 copies.

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### **6) RECOUPMENT OF SHORTWORKINGS (SHORTWORKINGS RECOVERABLE)**

Usually, along with the stipulation for a minimum rent, the royalty agreement contains a provision that should actual royalties be less than the minimum rent, the excess paid by the tenant (*i.e. shortworkings*) will be recovered by him from the landlord, out of any surplus that there may be over the minimum rent in subsequent years. In other words, recoupment of shortworkings is the right of getting back from the landlord, excess payment made by the tenants in the earlier years (when actual royalty was less than minimum rent). Thus, the shortworkings are carried forward with a view to adjust it in the future against the surplus royalty. This process of adjustment is called recoupment of shortworkings.

The contract usually mentions the period after which shortworkings cannot be recovered. As long as shortworkings are recoverable and are expected to be recovered out of the surplus royalties in future, they are an asset and should be shown in the Balance Sheet. Any amount remaining unrecovered at the end of the period, during which recovery is allowed, is written off and charged to Profit and Loss Account in the year when that specified time limit for recoupment ends.

The right of recoupment of shortworkings may be **fixed** or **fluctuating**.

**Fixed Right (i.e, restricted to a certain period):** When the lessee can recoup shortworkings within a certain period from the date of the lease, it is termed as fixed right. For example, shortworkings can be recouped, say, within first four years from the date of lease, and the shortworkings of subsequent years cannot be recouped. In case the

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tenant is not in a position to recoup the shortworkings during this period, the balance amount will be a loss to him which will be written off from the profit and loss account.

**Fluctuating or Floating (Unrestricted) Right:** When the lessee can recoup shortworkings of any year out of the royalties of the subsequent specified number of years, it is termed as fluctuating right. For example, if there is a royalty agreement with a provision that shortworkings can be recouped in the next two years subsequent to the year of shortworkings, then the shortworkings of each year, if not recovered, can be carried forward for the next two years and not more. If not recouped within next two years, on account of actual royalty being less than the minimum rent, the shortworkings not so recouped will be transferred to the Profit and Loss Account.

***Note:** Any shortworkings which cannot be recouped within the specified period becomes irrecoverable and it should be charged to Profit and Loss Account in the year in which it becomes so. However, the recoupable shortworkings should be carried forward and they are shown in the Balance Sheet as a current asset.*

## **7) NAZRANA OR LEASE PREMIUM**

In some cases, the lessee may agree to pay lumpsum amount to the lessor in addition to royalty. This extra payment in addition to royalty is known as nazrana or lease premium or goodwill. Under such a condition a Nazrana Account is opened in the books of the lessee and lessor. In the books of the lessee, the whole amount of nazrana is debited to 'Nazrana Account'. This account being a capital expenditure for the lessee, can be written off every year during the period of the lease by debiting profit and loss account and crediting nazrana account. In the books of the lessor the amount received as nazrana is credited to nazrana account and equal amount is credited to profit and loss account each year during the life of the lease. The balance in nazrana account is shown as an asset (in lessee's books) and as liability (in the books of the lessor).

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### **8) COPYRIGHT ROYALTIES (IN CASE OF BOOK PUBLISHING)**

Copyright, in case of book publishing, means the sole right granted by law to an author to publish and sell his book in the market. The author generally gives this right to a firm of publishers, who will undertake to do the production and sales of the book for a consideration. This consideration may be a lumpsum payment or a fixed percentage as agreed between the author and the publishers on the number of books sold multiplied by the printed price of the books sold. The number of copies sold can be calculated in the following manner:

			No.
	Opening Stock of Books		XX
	Add: Number of books printed		<u>XX</u>
		Books Available	XX
Less:	Specimen Books	XX	
	Waste Books	XX	
	Closing Stock of Books	<u>XX</u>	<u>XX</u>
			—

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### **9) SUB -LEASE (OR SUB- ROYALTY)**

Sometimes, the terms of the original lease may empower the lessee to sublet a part/ whole of the lease to another person as a sub lease. The transfer of a part/ whole of the right held by the lessee to another person is sub-lease. And, such a person is termed as sub-lessee or sub-tenant. Thus, in the case of sub-lease, there will be three parties:

- (i) **Landlord:** He is the actual owner of the right who will continue to get the royalty on the total production/ sales i.e., both of the Lessee as well as Sub-lessee as per the terms of contract between him and the Lessee.

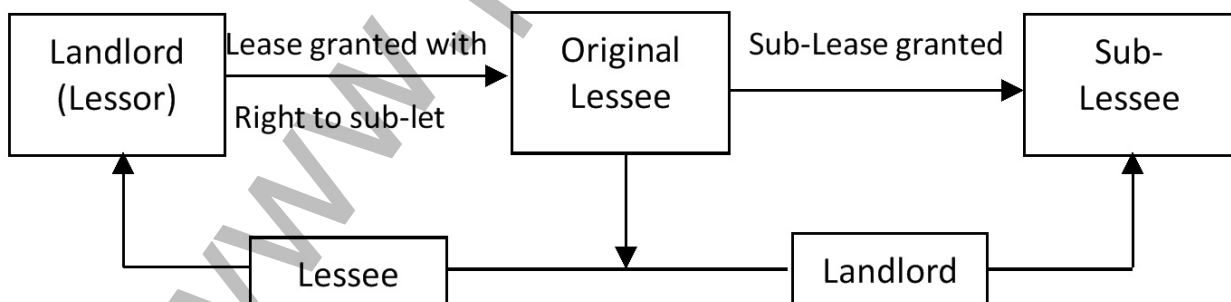
- (ii) **Lessee:** On account of granting a sub-lease, he will now be working in dual capacity - both as tenant and landlord. He is a tenant for the owner while a landlord for the sub-lessee. He will pay royalty to the owner (or original landlord) as per the terms of the contract between him and the owner. He will get royalty from the sub-lessee as per terms of the contract between him and sub-lessee.

As lessee he maintains Royalties Payable Account, Shortworkings Account and landlord's Account and as sub lessor he maintains Royalties Receivable Account, Shortworkings Suspense Account and Sub-lessee's Account.

- (iii) **Sub-lessee:** He will pay royalty to the lessee, who is the landlord for him, as per terms of the contract with him.

In case of sub-lease, the original lessee is liable to the landlord for the agreed royalty on the total output/ sale (own + sub-lessee). Production or sales by the sub-lessee under sub-lease will be considered to be production or sales under the original lease and royalties payable to the original landlord will be calculated on the basis of total production/ sales of both the lessee and the sub-lessee.

The entries in the books of sub-lessee and landlord will be in the lines of those of lessee and landlord.



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### **10) GROUND (OR SURFACE) RENT**

**Ground (or Surface) Rent** is the fixed yearly or half yearly rent payable by the lessee to the landlord in addition to the minimum rent.

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**Q: Differentiate between Rent and Royalty.** ([www.prepNext.com](http://www.prepNext.com))

**Ans.:**

**Distinction Between Rent and Royalty**

<b>Basis</b>	<b>Rent</b>	<b>Royalty</b>
<b>Nature of Assets</b>	It is the consideration payable for the use of only tangible assets as building, machinery etc.	It is the consideration payable for the use of special right for both tangible and intangible assets. (i.e patents, copy-rights, etc.)
<b>Basis of Payment</b>	It is mostly payable on the basis of time as weekly, monthly or yearly.	It is paid on the basis of production, yield or sale.
<b>Fixed or Variable</b>	The amount of rent is generally fixed with regard to time.	The amount of royalty is variable and is calculated in accordance with production or sales.
<b>Minimum Rent</b>	There is no concept of minimum rent.	It generally contains a clause in the agreement to pay minimum rent.
<b>Parties</b>	The parties are known as tenant and landlord.	The parties are known as lessee/ patentee/ publisher and lessor/ patent holder/ author etc.

**Note:**

**1)** *In the books of the user [Lessee/ Licencee/Publisher], Royalties Payable is transferred to Manufacturing/ Production or Profit and Loss Account. If the user is a manufacturer and royalties are calculated on the basis of production, the actual royalties are debited to Manufacturing Account. Where royalties are calculated on the basis of sales, they are debited to Profit and Loss Account.*

*In case of a **limited company** which does not prepare Manufacturing Account separately, the actual royalties are debited to Profit and Loss Account and they are shown in production or manufacturing section of the Profit and Loss Account. It should be noted that as per the provision of Schedule VI to the Companies Act, 1956 a limited company is required to prepare only Profit and Loss Account and Balance Sheet.*

**2)** *In the event of a strike or lockout, the minimum rent can be reduced if there is an agreement between the parties.*