
UNIT 4 HIRE PURCHASE ACCOUNTS I

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4.0 OBJECTIVES

After studying this unit you should be able to :

- explain what a hire purchase agreement is,
- describe the legal position of a hire purchase agreement,
- calculate interest and cash price in relation to a hire purchase agreement,
- pass the basic accounting entries in the books of both purchaser and vendor.

4.1 INTRODUCTION

When the goods are sold the purchaser may either make the full payment at one time or may defer the payment. When the payment is deferred, the amount may be paid in monthly, quarterly or yearly instalments. When the price of an article is paid by instalments, the total amount paid is higher than the actual cash price of the article. The excess price is the charge for interest and the risk involved. This arrangement of making the payment in instalments is beneficial to both the seller and the buyer. The seller is able to sell more goods and the buyer can buy expensive items with his limited resources. There are two systems of deferred payments, namely, (i) Hire Purchase System, and (ii) Instalment Payment System. In this unit we will learn in detail about the Hire Purchase System.

4.2 NATURE OF HIRE PURCHASE AGREEMENT

A hire purchase agreement is one under which the buyer takes delivery of goods, promising to pay the price in certain number of instalments and until full payment is made, to treat the payment as hire charges for using the said goods. In fact, a hire purchase agreement stipulates that (i) the delivery of goods will be given by the owner of goods to the hire purchaser, (ii) payment will be made in instalments, (iii) each instalment will be treated as hire charge so that if default in respect of payment of even the last instalment is made, the seller will be entitled to take away the goods without compensating the hire purchaser in any form, and (iv) if all instalments are paid and the other conditions are fulfilled, the ownership of the goods will pass to the buyer.

Therefore in case of hire purchase, the seller i.e., the hire vendor gives only the possession of the goods and retains the ownership with him until the last instalment is paid. In other words, the hire purchaser is only the user of the goods and not the

owner. In case he fails to pay any of the instalments the vendor will take his goods back. Apart from that the vendor will not pay back the amount received from the purchaser. Such an amount will be treated as hire charge for the goods. Therefore till the last instalment is paid the hire purchaser has got an option, whether to purchase that particular article or not.

As mentioned earlier, the payment made by the hire purchaser under this system is always more than what he pay if he decided to go in for cash purchase. The reason is that, apart from the cash price, the hire purchase price includes

- i) interest for payment being made over a period of time,
- ii) the payment for the risk taken by the seller,
- iii) expenditure on the registration, insurance and delivery of goods, etc.

4.3 LEGAL POSITION

4.3.1 Definition

According to Section 2(c) of the Hire Purchase Act, 1972 the hire purchase agreement is an agreement under which the goods are let on hire and the hirer has an option to purchase them in accordance with the terms of the agreement and includes an agreement under which

- i) possession of goods is delivered by the owner thereof to a person on condition that such person pays the agreed amount in periodical instalments,
- ii) the property in the goods is to pass to such person on the payment of the last of such instalments, and
- iii) such person has a right to terminate the agreement at any time before the property so passes.

4.3.2 Characteristics of Hire Purchase Agreement

Following are the characteristics of the hire purchase agreement.

- i) It must be in writing and must be signed by all the parties thereto (Section 3).
- ii) According to Section 4 of Hire Purchases Act, 1972, the agreement must state
 - a) the hire purchase price of the goods to which the agreement relates;
 - b) the cash price of the goods, that is to say, the price at which the goods may be purchased by the hirer for cash;
 - c) the date on which the agreement shall be deemed to have commenced;
 - d) the number of instalments by which the hire purchase price is to be paid, the amount of each of those instalments and the date (the mode of determining the date upon which it is payable) and the person to whom and the place where it is payable; and
 - e) the goods to which the agreement relates, in a manner sufficient to identify them.

Apart from the above mentioned conditions, a full description of the amount to be paid in cash or by cheque, if any, should be given in the agreement.

4.3.3 Rights of Hirers

As per the Hire Purchase Agreement the hirer has got the right to return the goods to the vendor. Apart from this, the Hire Purchase Act gives the following rights to the hirer.

- 1) The owner (or the vendor) cannot terminate the hire purchase agreement for default in payment of hire or due to an unauthorised act or breach of expressed conditions unless a notice in this regard in writing is given to the hirer. The notice period is (i) one week where the hire is payable at weekly or less than that, interval, and (ii) two weeks in other cases.
- 2) In the following cases, the right to repossess the goods will not exist unless it is sanctioned by the court.
 - i) Where the hire-purchases price is less than Rs. 15,000 and one half of the hire purchase price has been paid.
 - ii) Where the hire purchase price is higher, three-quarters of the hire purchases price has been paid. However, the right of repossession will lapse in case of

motor vehicles where the hire purchase price is less than Rs. 5,000 and one-half of the amount has been paid. In other cases (where H.P. price is Rs. 5,000 or more), it happens if three-quarters of the hire purchase price has been paid. The Central Government has the power of raising the limit to nine-tenths where the hire purchase price is Rs. 15,000 or more.

- 3) The hirer has the right of receiving from the owner, on payment of Re. 1 for expenses, a statement showing the amount paid by or on behalf of the hirer, the amount which has become due under the agreement which remains unpaid together with the dates concerned and the amount which has not yet become payable under the agreement and the dates and the modes concerned.
- 4) If the amount paid by the hirer till the date of the repossession of the goods and the value of the goods on the date of the repossession taken together exceeds the hire purchase price, the excess is payable to the hirer. For ascertaining the value of the goods, the owner or the vendor has the right of deducting reasonable expenses for repossessing the goods, for storing the goods or repairing them, for selling them, and for payment of arrears of taxes.

Check Your Progress A

- 1) Fill in the blanks
 - i) A contract for sale of goods may be either a sale or an to sell.
 - ii) A hire purchase sale is an agreement to
 - iii) The ownership of goods, under a hire purchase agreement is to upon fulfilment of certain
 - iv) Under a hire purchase agreement payments are made in
 - v) Each instalment payment is treated as
 - vi) If the purchaser fails to pay even the last instalment, the seller will be entitled to the goods.
 - vii) From the legal point of view a hire purchase agreement should be made in
 - viii) A hirer has the right to the agreement before payment of the last instalment by paying the seller the agreed amount.
 - ix) A hirer may assign his,, and interest under a hire purchase agreement.
- 2) State whether the following statements are True or False.
 - i) A hire purchase agreement is an 'outright' sale transaction.
 - ii) If the hirer fails to pay the last instalment, the amounts paid earlier are considered as hire charges.
 - iii) A hire purchase agreement is an 'executed contract' and an instalment sale is an 'executory contract'.
 - iv) If the hirer opts for full payments before the due dates, a rebate should be available to him.
 - v) A seller cannot repossess the goods if the purchaser fails to pay the last instalment only.
 - vi) The Hire Purchase Act, 1972 is in operation now.

4.4 ASCERTAINING THE INTEREST/CASH PRICE

As mentioned earlier, when the goods are sold on hire purchase, the price so charged by the vendor is always higher than the cash price. The excess price i.e., the difference between the hire purchase price and the cash price, includes the interest charges and the compensation for risk. However for accounting purposes the difference between the two prices is treated as the payment for interest. Thus, the hire purchase price includes :

- i) the cash price, which is a capital expenditure for purchase of an asset, and
- ii) the interest, which is an item of revenue nature. Since the cash price is of capital nature and the interest payment is of revenue nature, both will be treated in a

different manner in the books of account. It is, therefore, **necessary** to separate the hire purchase price into cash price and interest. However, it may be noted that **the Cash Down Payment made immediately after signing the agreement will not include the element of interest.** Another point to be kept in mind is that the interest element in each instalment is not same. It keeps on reducing with every instalment. This is so because the interest is charged on the balance of the principal amount due and not on the full amount. For proper allocation therefore we must know the cash price, the hire purchase price and the amount of interest.

4.4.1 Ascertainment of Interest

While calculating interest we may be faced with the following two situations.

- a) **When** rate of interest, total cash price and instalments are given
- b) When total cash price and instalments are given but the rate of interest is not given.

In both the above mentioned cases, the interest has to be calculated. Let us now take them one by one.

a) **When Rate of Interest, Total Cash Price and Instalments are given.**

In this situation, before calculating the element of interest included in each instalment, it will be helpful to ascertain the total amount of interest involved. This will be ascertained by subtracting the Total Cash Price from the hire purchase price. Then the following steps should be followed for calculating the amount of interest on each instalment..

- i) Calculate the outstanding cash price at the time of first instalment by subtracting down payment from the total cash price.
- ii) Calculate interest on the first instalment. This is to be calculated on the outstanding cash price at the time of first instalment by applying the given rate of interest. In this connection, you should keep in view the mode of instalment i.e., whether the instalment is **annual**, half-yearly or quarterly. **Usually**, in case of purchases for heavy equipment the instalment is annual,
- iii) Calculate the amount of cash price included in the first instalment by subtracting the amount of interest as calculated in step (ii) from the amount of the first instalment.
- iv) Calculate the **outstanding** cash price at the time of second instalment by subtracting the amount of cash price of the first instalment from the outstanding cash price at the time of first instalment i.e., **(i) — (iii)**.
- v) Calculate, interest on the second instalment by applying the rate of interest to the outstanding cash price at the time of second instalment.

The amount of the subsequent instalments can be worked out in the same manner i.e., by first calculating the outstanding cash price at the time of the instalment due and then applying the rate of interest to this amount. However, the amount of interest on the last instalment is worked out differently. This can be done by **simply** subtracting the outstanding cash price at the time of last instalment from the amount of the last instalment, Alternatively, you can work it out by subtracting the sum of interests of all **previous** instalments from the total amount of interest included in the hire purchase price. The amount of interest so calculated can also be verified by applying the rate of interest to the outstanding cash price at the time of last instalment. Of course, there may be a small difference due to the fact **that** the hire purchase price is not **fixed** by inclusion of the exact amount of interest. It is usually fixed as a round **figure**. If however the difference happens to be a large amount, you should check all calculations of interest and outstanding cash price at the time of each instalment.

Illustration 1 will help you to calculate the interest with the help of the above mentioned procedure.

Illustration 1

A Ltd. purchased a machine on hire purchase from Z Ltd. on January 1, 1989, paying Rs. 8,000 immediately and agreeing to pay three annual instalments of Rs. 8,000 each on December 31, every year. The cash price of the machine is Rs. 29,800 and the vendors charge interest @ 5% per annum. Calculate the amount of interest paid by the buyer to the seller every year.

Solution :

The total interest is = Hire Purchase Price – Cash Price

$$\begin{aligned}\text{Hire Purchase Price} &= \text{Cash Down Payment} + \text{Instalments} \\ &= 8,000 + 3(8,000) \\ &= 8,000 + 24,000 \\ &= \text{Rs. } 32,000\end{aligned}$$

$$\text{Cash Price} = \text{Rs. } 29,800$$

$$\text{So Total Interest} = 32,000 - 29,800 = \text{Rs. } 2,200.$$

Now, we can calculate the interest on each instalment as follows.

i) **Outstanding Cash Price at the time of first instalment**

$$\begin{aligned}\text{Total Cash Price} - \text{Down Payment} \\ &= 29,800 - 8,000 \\ &= \text{Rs. } 21,800\end{aligned}$$

ii) **Interest on first instalment**

$$\begin{aligned}\text{Outstanding Cash Price} \times \frac{\text{Rate of Interest}}{100} \\ &= 21,800 \times \frac{5}{100} \\ &= \text{Rs. } 1,090\end{aligned}$$

iii) **Cash Price of first instalment**

$$\begin{aligned}\text{Instalment} - \text{Interest on first instalment} \\ &= 8,000 - 1,090 \\ &= \text{Rs. } 6,910\end{aligned}$$

iv) **Outstanding Cash Price at the time of second instalment**

$$\begin{aligned}\text{Outstanding Cash Price at} \\ \text{the time of 1st instalment} - \text{Cash Price of the first Instalment} \\ &= 21,800 - 6,910 \\ &= \text{Rs. } 14,890\end{aligned}$$

v) **Interest on second instalment**

$$14,890 \times \frac{5}{100} = \text{Rs. } 745$$

vi) **Cash Price of second instalment**

$$= 8,000 - 745 = \text{Rs. } 7,255$$

vii) **Outstanding Cash Price at the time**

$$= 14,890 - 7,255 = \text{Rs. } 7,635$$

viii) **Interest on the last instalment**

$$\begin{aligned}&= \text{Instalment} - \text{Outstanding Cash Price at the time of last instalment} \\ &= \text{Rs. } 8,000 - 7,635 \\ &= \text{Rs. } 365\end{aligned}$$

$$\begin{aligned}\text{Alternatively, Total Interest} - \text{Sum of Interest of all previous years} \\ &= 2,200 - (1,090 + 745) \\ &= 2,200 - 1,835 \\ &= \text{Rs. } 365\end{aligned}$$

Verification

$$\begin{aligned}\text{Outstanding Cash Price at the time of last inst.} \times \frac{\text{Rate of Instalment}}{100} \\ &= 7,635 \times \frac{5}{100} \\ &= \text{Rs. } 382\end{aligned}$$

As indicated earlier, the amount calculated above is not the same as calculated in step (viii). But the difference is small i.e., Rs. 17 (382 – 365).

For Steps from (i) to (viii) following table would be helpful,

	(1) Total Cash Price	(2) Instalments Paid	(3) Interest Paid	(2-3) Cash Price of the Instalments
Total Cash Price	29,800			
Less Down Payment	<u>-8,000</u>	8,000		8,000
Amount outstanding at the time of 1st instalment	21,800	8,000	$(21,800 \times \frac{5}{100})$	(8,000 - 1,090)
	<u>-6,910</u>		1,090	6,910
Amount outstanding at the time of 2nd instalment	14,890	8,000	$(14,890 \times \frac{5}{100})$	(8,000 - 745)
	<u>-7,255</u>		745	7,255
Amount outstanding at the time of 3rd (last) instalment	7,635	8,000	(8,000 - 7,635)	
	<u>-7,635</u>		365	7,635

You should calculate interest and cash price with the help of the above table. It makes your task easier.

b) When Total Cash Price and Instalments are given, but rate of interest is not given :

When the total cash price, down payment and the amount of each instalment is given, but the rate of interest is not given, the interest will be calculated by procedure mentioned below.

- Calculate the total interest by subtracting the total cash price from the total hire purchase price.
- Calculate the amounts of hire purchase outstanding at the beginning of each year after subtracting the down payment.
- Find out the ratio of outstanding amounts calculated in step (ii). If the amount of each instalment is equal, the ascertainment of ratio is simple. For example, if there are four instalments of equal amounts the ratio will be 4 : 3 : 2 : 1 and if there are three instalments of equal amounts, it will be 3 : 2 : 1.
- Apply this ratio to the total interest and calculate the interest on each instalment.

Let us now take an example and clarify the calculation of interest included in each instalment.

Illustration 2

Taking the relevant data from Illustration 1 excluding the rate of interest, element in each instalment.

Hire Purchase Price	Rs. 32,000	[8,000 + 3 (8,000)]
Cash Price	Rs. 29,800	
Down Payment	Rs. 8,000	

Solution :

$$\begin{aligned} \text{Total Interest} &= 32,000 - 29,800 \\ &= \text{Rs. } 2,200 \end{aligned}$$

Beginning of the year	Amount outstanding	Ratio	Interest
	Rs.	Rs.	Rs.
1	24,000 (32,000 - 8,000)	24 (3)	1,100 $(2,200 \times \frac{3}{6})$
2	16,000 (24,000 - 8,000)	16 (2)	733 $(2,200 \times \frac{2}{6})$
3	8,000 (16,000 - 8,000)	8 (1)	367 $(2,200 \times \frac{1}{6})$
		<u>48 (6)</u>	<u>2,200</u>

You will observe that the amounts of interest for each instalment calculated with the help of ratio is almost the same as calculated with a given rate of interest.

4.4.2 Ascertainment of Total Cash Price

Sometimes, the total cash price is not given. In such a situation we cannot proceed with the accounting for hire purchase transaction because in the books of the buyer, the amount to be capitalised cannot be more than the cash price. The different methods of calculation of cash price are as below :

- i) Without the help of annuity table
- ii) With the help of annuity table

Let us now discuss both the methods

i) Without the Help of Annuity Table

Under this method interest is calculated starting with the last instalment. Suppose there are three instalments. The interest will be calculated first on the third instalment, then on the second and lastly on the first instalment. No interest is calculated on down payment as it does not involve any element of interest.

You know that the interest is to be calculated on the outstanding amount of cash price. But since it is not known, it will have to be calculated with the help of total amount due on hire purchase price. For this purpose we will have to use the following formula for calculating first the interest involved in each instalment and then subtract this amount of interest from the total amount due, so as to work the outstanding amount of cash price.

$$\text{Interest} = \text{Total amount due at the time of instalment} \times \frac{\text{rate of interest}}{100 \div \text{rate of interest}}$$

Let us now see what steps are followed for the calculation of Cash Price due at the time of each instalment assuming there are three yearly instalments.

- a) Calculate the interest on the instalment of the third year, Deduct interest from this instalment. The resultant figure is the outstanding cash price at the time of third (last) instalment.
- b) Add the cash price calculated under (a) above to the instalment amount of the second year. Calculate the interest on the sum so obtained and subtract it from the total amount due at the end of the second year to get the outstanding cash price at the time of second instalment.
- c) Add the cash price calculated under (b) above to the instalment amount of the first year and calculate the interest on the sum so obtained. Deduct this amount of interest from the total amount due at the end of the first year. The resultant figure is the cash price due at the time of the first instalment.
- d) Add the cash price calculated under (c) above to the down payment, if any. The sum so obtained will be the total cash price.

Illustration 3 will help you to understand the calculation of cash price.

Illustration 3

Renuka purchased a machine on January 1, 1986 on hire purchase basis for Rs. 5,000 payable as under :

	Rs.
Down Payment	930
At the end of 1st year (1st instalment)	1,426
At the end of 2nd year (2nd instalment)	1,804
At the end of 3rd year (3rd instalment)	840
Rate of Interest 5% p.a.	

Calculate the Cash Price of the machine and interest paid with each instalment.

Solution :

	Amount	Interest
Total Amount Due on 3rd Instalment (last)	840	
Less Interest	40	$(840 \times \frac{5}{105})$
Outstanding Cash Price of 3rd Instalment	800	
Add 2nd Instalment	1,804	
Total Amount due on 2nd Instalment	2,604	
Less Interest	124	$(2,604 \times \frac{5}{105})$
	2,480	
Add 1st Instalment	1,426	
Total Amount due on 1st Instalment	3,906	
Less Interest	186	$(3,906 \times \frac{5}{105})$
	3,720	
Add Down Payment	930	
Total Cash Price	4,650	350

So Total Cash Price is Rs. 4,650 and Total Interest Rs. 350.

Note : This calculation can be verified by following the procedure given for calculation of interest on each instalment when the cash price, instalments, down payment and rate of interest are given.

ii) With the Help of an Annuity Table

If the annuity table is available, the calculation of interest involved in each instalment is simplified. In the annuity table the rate of interest is given in the rows and the years in the columns. With reference to the table, the present value of each instalment can be calculated. The sum of these present values as calculated, if added to the cash down payment gives us the cash price. The procedure is as follows :

- See the given rate of interest in the row and the year in the column and find out the corresponding figure to the interest and year in the table.
- This figure is the present value of Re. 1
- Multiply the present value of Re. 1 with the amount of the instalment.
- The resulting figure is the present value of the instalment. This is nothing but the amount of cash price included in the instalment.
- Calculate the present values of all the instalments in same manner.
- Add the present values of all the instalments to the down payment if any. The resultant figure will be the total cash price.

Illustration 4 will help us to understand the calculation of total cash price with the help of the annuity table.

Illustration 4

X Ltd. purchased a machine on hire purchase system. The payment is made as follows :

	Rs.
Down Payment	232.50
1st Instalment	356.50
2nd Instalment	451
3rd Instalment	210

The payments are made at the end of 1st year, 2nd year and 3rd year respectively. The rate of interest is 5% p.a. The annuity table shows that the present value of Re. 1 for one, two and three years is .9524, .9070 and .8639 respectively. Calculate the cash price of the machine.

	(1) Instalment	(2) Present Value of Re. 1	(1 × 2) Present Value of the Instalment
Cash Down	232.50	1	232.50
1st Instalment	356.50	.9524	339.53
2nd Instalment	451.00	.9070	409.08
3rd Instalment	210.00	.8639	189.42
Total	1,250.00		1,162.53

So the Total Cash Price is Rs. 1,162.53

Check Your Progress B

- 1) Calculate total interest and interest on each instalment for the following cases.
 - i) Cash Price of a machinery is Rs. 349. Down payment is Rs. 100 to be followed by three annual instalments of Rs. 100 each. The rate of interest is 10%.
 - ii) Cash price of a machine is Rs. 1900. Payment is to be made in 3 equal instalments of Rs. 800 each.

1) Calculate cash price for each of the following cases.

- i) The price of a machinery is to be paid in four instalments of Rs. 5,000 each, the first one being made as initial payment. The rate of interest is 5% p.a. and the instalment is paid annually.

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- ii) The price of a machinery is to be paid in five annual instalments of Rs. 10,000 each. The rate of interest is 5% p.a. The first instalment is to be paid at the end of the first year. At 5% interest the present value of Re. 1 payable at the end of each year for 5 years is Rs. 4.3294.

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4.5 ACCOUNTING RECORDS IN THE BOOKS OF THE PURCHASER

You know there are two parties to a hire purchase agreement, i.e., the Vendor and the Purchaser. Both these parties have to maintain books of account and record all the transactions relating to that particular hire purchase.

Before explaining the accounting records let us first see what information is required for recording the hire purchase transaction in the books of account. The list of items required for accounting records is as follows :

- 1 Date of Purchase and down payment
- 2 Date at which the instalments become due
- 3 Date of closure of accounts
- 4 Cash Price
- 5 Hire Purchase Price
- 6 Number, Amount and Mode of each instalment
- 7 Rate of Interest
- 8 Rate of Depreciation
- 9 Method of Depreciation

Let us now see how accounting records are maintained in the books of the purchase. There are two methods by which the purchaser can record the hire purchase transaction in the books of account. These are as follows :

- i) When the asset is recorded at full cash price, and
- ii) When the asset is recorded at the cash price actually paid.

Let us now discuss these methods in detail.

4.5.1 When the Asset is Recorded at Full Cash Price

In this method when the asset is purchased on hire purchase, it is assumed that the purchaser has full intention of paying all the instalments. It is believed that hire purchase is just a method of financing fixed assets. Under this method, on purchase of plant and machinery, the Plant & Machinery Account (Fixed Asset) is debited with the total amount of Cash Price, and the corresponding credit is given to Hire Vendor's Account. Interest is recognised and accounted for at the time of instalments becomes due by debiting the Interest Account and crediting the Hire Vendor's Account. For the purpose of accounting for initial cash down payment and annual instalments, the Hire Vendor's A/c is debited on the relevant date, and the credit is given to Bank Account. The following journal entries are passed in the books of the purchaser.

- 1 **When the asset is purchased on hire purchase**

Asset A/c	Dr
To Hire Vendor	
(With the total cash price)	
- 2 **For cash down payment**

Hire Vendor	Dr.
To Bank A/c	
- 3 **When the first instalment becomes due**

Interest A/c	Dr.
To Hire Vendor	
- 4 **When the first instalment is paid**

Hire Vendor	Dr.
To Bank A/c	
- 5 **For Depreciation Charge** (at the end of accounting period)

Depreciation	Dr.
To Asset A/c	
- 6 **For transfer of interest and depreciation to Profit & Loss A/c**

Profit & Loss A/c	Dr.
To Interest A/c	
To Depreciation A/c	

Entries 3 and 4 will be repeated for all subsequent instalments.

With the help of the journal entries we can easily prepare the Asset Account and the Hire vendor's Account. Look at Illustration 5 and see how the journal entries are passed and ledger accounts made in the books of the purchaser.

Illustration 5

ABC Ltd. bought on 1.1.86 a machine from XYZ Ltd. Under a hire purchase system of payment under which three annual instalments of Rs. 2,412 would be paid. There is no down payment and the cash price is Rs. 6,000, The rate of interest would be 10% and depreciation @ 20% p.a. would be charged on straight line basis.

Solution :

Let us first find out all the information required.

- 1) Date of Purchase – January 1, 1986; No down payment.
- 2) Date at which the instalments become due – December 31, 1986, 1987 and 1988.
- 3) Date of closure of accounts – December 31.
- 4) Cash Price – Rs. 6,000.
- 5) Hire Purchase Price – Rs. 2,412 x 3 = Rs. 7,236.
- 6) Number, amount and mode of each instalment 3 instalments of – Rs. 2,412 each payable annually.
- 7) Rate of Interest – 10% p.a.
- 8) Rate of Depreciation – 20% p.a.
- 9) Method of Depreciation – Straight Line.

Date	Particulars	Amount (Dr.)	Amount (Cr.)
1986 Jan. 1	Machinery A/c Dr. To XYZ Ltd. (Being a machine purchased on hire purchase)	Rs. 6,000	Rs. 6,000
Dec. 31	Interest A/c Dr. To XYZ Ltd. (Being the charge of interest @ 10% on Rs. 6,000)	600	600
Dec. 31	Depreciation A/c Dr. To Machinery A/c (Being the charge of depreciation)	1,200	1,200
Dec. 31	XYZ Ltd. A/c Dr. To Bank A/c (Being the payment of annual instalment)	2,412	2,412
Dec. 31	Profit & Loss A/c Dr. To Interest A/c To Depreciation A/c (Being the annual charges transferred to Profit & Loss A/c)	1,800	600 1,200
1987 Dec. 31	Interest A/c Dr. To XYZ Ltd. (Being the charge of interest @ 10% on Rs. 4,188)	418	418
Dec. 31	Depreciation A/c Dr. To Machinery A/c (Being the annual charge of depreciation)	1,200	1,200
Dec. 31	XYZ Ltd. A/c Dr. To Bank A/c (Being the payment of annual instalment)	2,412	2,412
Dec. 31	Profit & Loss A/c Dr. To Interest A/c To Depreciation A/c (Being the transfer of annual charges to Profit & Loss A/c)	1,618	418 1,200
1988 Dec. 31	Interest A/c Dr. To XYZ Ltd. (Being the charge of interest @ 10% on Rs. 2,194)	218	218
Dec. 31	Depreciation A/c Dr. To Machinery A/c (Being the annual charge of depreciation)	1,200	1,200
Dec. 31	XYZ Ltd. A/c Dr. To Bank A/c (Being the 3rd and final instalment paid)	2,412	2,412
Dec. 31	Profit & Loss A/c Dr. To Interest A/c To Depreciation A/c (Being the transfer of annual charges to Profit & Loss A/c)	1,418	218 1,200

Machinery Account

Dr.			Cr.		
1986 Jan. 1	To XYZ Ltd.	Rs. 6,000	1986 Dec. 31 Dec. 31	By Depreciation A/c By Balance c/d	Rs. 1,200 4,800
		<u>6,000</u>			<u>6,000</u>
1987 Jan. 1	To Balance b/d	4,800	1987 Dec. 31 Dec. 31	By Depreciation A/c By Balance c/d	1,200 3,600
		<u>4,800</u>			<u>4,800</u>
1988 Jan. 1	To Balance b/d	3,600	1988 Dec. 31 Dec. 31	By Depreciation A/c By Balance c/d	1,200 2,400
		<u>3,600</u>			<u>3,600</u>

XYZ Ltd. (Hise Vendor) Account.

Dr.			Cr.		
1986 Dec. 31 Dec. 31	To Bank A/c To Balance c/d	Rs. 2,412 4,188	1986 Jan. 1 Dec. 31	By Machinery A/c By Interest A/c	Rs. 6,000 600
		<u>6,600</u>			<u>6,600</u>
1987 Dec. 31 Dec. 31	To Bank A/c To Balance c/d	2,412 2,194	1987 Jan. 1 Dec. 31	By Balance b/d By Interest A/c	4,188 418
		<u>4,606</u>			<u>4,606</u>
1988 Dec. 31	To Bank A/c	2,412	1988 Jan. 1 Dec. 31	By Balance b/d By Interest A/c	2,194 218
		<u>2,412</u>			<u>2,412</u>

Working Notes:

	Re.
Cash Price	6,000
Add Interest on 1st Instalment $(\frac{10}{100} \times 6,000)$	600
	<u>6,600</u>
Less 1st Instalment	2,412
Amount outstanding at the time of 2nd Instalment	4,188
Add Interest on 2nd Instalment $(\frac{10}{100} \times 4,188)$	418
	<u>4,606</u>
Less 2nd Instalment	2,412
Amount outstanding at the time of 3rd Instalment	2,194
Add Interest on 3rd Instalment	218
	<u>2,412</u>

Date	Particulars	Amount (Dr.)	Amount (Cr.)
1987			
Dec. 31	Machinery A/c Interest A/c To XYZ Ltd. (Being second instalment due)	Dr. Dr. 1,994 418	2,412
Dec. 31	XYZ Ltd. To Bank A/c (Being second instalment paid)	Dr. 2,412	2,412
Dec. 31	Depreciation A/c To Asset A/c (Being annual depreciation charged)	Dr. 1,200	1,200
Dec. 31	Profit & Loss A/c To Depreciation A/c To Interest A/c (Being annual charges transferred to Profit & Loss A/c)	Dr. 1,618	1,200 418
1988			
Dec. 31	Machinery A/c Interest A/c To XYZ Ltd. (Being third instalment due)	Dr. Dr. 2,194 218	2,412
Dec. 31	XYZ Ltd. To Bank A/c (Being third instalment paid)	Dr. 2,412	2,412
Dec. 31	Depreciation A/c To Asset A/c (Being annual depreciation charged)	Dr. 1,200	1,200
Dec. 31	Profit & Loss A/c To Depreciation A/c To Interest A/c (Being annual charges transferred to Profit & Loss A/c)	Dr. 1,418	1,200 218

Note: Depreciation has been charged on straight line method @ 20% p.a. at the full cash price of Rs. 6,000.

4.6 ACCOUNTING RECORDS IN THE BOOKS OF VENDOR

So far as the vendor is concerned a hire purchase sale is just like an ordinary sale with the exception that payment is deferred over a period of time for which the vendor charged interest. He debits the Hire Purchaser's A/c with full cash price and credit is given, to Sales A/c. The interest amount is debited to Hire Purchaser's A/c as and when the instalments become due. Instalment amounts received are credited to the Hire Purchaser's A/c and debited to Bank A/c. The journal entries passed are as follows:

- 1 On sale of goods under hire purchase
Hire Purchaser Dr.
 To Sales A/c (with full cash price)
- 2 On receiving cash down payment
Bank A/c Dr.
 To Hire Purchaser
- 3 On instalment becoming due
Hire Purchaser Dr.
 To Interest A/c

Check Your Progress C

- 1) Enlist the information required before solving the hire purchase problem.

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- 2) State whether following statements are True or False.

- i) When the asset is recorded at full cash price, the hire purchase becomes a **method of financing** the fixed asset.
- ii) When the asset is recorded at the price actually paid the Asset **A/c** is debited and the Hire Vendor's **A/c** is credited with full cash price.
- iii) The Hire Vendor debits the hire purchaser and credits the sales on sale of goods with cash price.
- iv) When the asset is recorded at cash price actually paid no entry is passed when the instalment becomes due.
- v) The Hire Vendor's **A/c** is in the nature of a personal account.

4.7 LET US SUM UP

In the hire purchase agreement the buyer takes the delivery of the goods and promises to pay the price in instalments. Under this agreement, though the buyer takes the possession of the goods, but he does not have the ownership. The ownership of the goods passes only after the last instalment has been paid. In case the buyer fails to pay any of the instalments, the seller can take back the possession of the goods.

The hire purchase price is always more than the cash price, the difference between the two is the interest charged for deferred payment. If two of the three items of information i.e., hire purchase price, cash price and interest, are given, the third can be found out with the help of the formula $HP = CP + \text{Interest}$ (HP is hire purchase price and CP is cash price).

Both the parties to hire purchase agreement i.e., the vendor and the purchaser record the hire purchase transactions in their books.

The purchaser can prepare accounting records in two ways : (i) When the asset is recorded at full cash price, or (ii) When the asset is recorded at the cash price actually paid.

The purchaser mainly maintains two accounts i.e., the Hire Vendor Account and the Asset Account. The vendor on the other hand maintains the Hire Purchaser's Account and the Interest Account.

4.8 KEY WORDS

Agreement to Sell : In a contract of sale, when the **ownership** of goods sold is to pass to the buyer subject to **fulfilment** of certain conditions, such sale is termed as an agreement to sell.

Cash Price : The amount to be paid in outright sale on cash.

Down Payment : Initial payment made at the time of purchase under hire purchase agreement.

Hire Charges : If the hirer in a hire purchase agreement fails to pay even the last instalment, the amounts he has paid so far, will be **treated** as hire charges for using the asset.

Hire Purchase : An agreement to sell under which the buyer takes the delivery of goods promising to pay the price in instalments and until full payment is made, to treat payment as hire charges for using the goods.

Hire Purchaser : The purchaser in a hire purchase contract.

Hire Vendor : The seller in a hire purchase agreement who agrees to receive the price in instalments, and has the right to treat the amounts paid by the hirer as hire charges if the hirer fails to pay the last instalment.

Instalment Payment System : When the price in a contract of sale is paid over a period of time, but at fixed intervals the system of payment is called instalment payment.

4.9 ANSWERS TO CHECK YOUR PROGRESS

- A 1 i) agreement, / ii) sell, iii) pass, conditions, iv) instalment, v) hire charges, vi) repossess, vii) writing, viii) terminate, ix) right, title
- 2 i) False ii) True iii) False iv) True v) False vi) False
- B 1 i) Total interest = Rs. 51(25+17+9)
ii) Total interest = Rs. 500 (264+178+58)
- 2 i) Cash Price = Rs. 18,616, ii) Cash Price = 43,294
- C 1 i) True ii) False iii) True iv) False v) True

4.10 TERMINAL QUESTIONS AND EXERCISES

Questions

- 1) What are the characteristics of a hire purchase agreement?
- 2) Describe the rights of a hirer under hire purchase agreement.
- 3) What steps would you take to calculate the interest when the total cash price and instalments are given?

Exercises

- 1 Based on particulars given below, give entries in the books of the purchaser and the seller both under the hire purchase system :
 - a) **Rarnesh & Co. - Purchaser**
Date of Purchase - Jan. 1, 1989 goods purchased - Trucks; Cash Price - Rs. 1,49,000. Instalments Rs. 40,000 on signing of the agreement, Rest in three instalments of Rs. 40,000 each, Rate of interest - 5%. Depreciation - 10% on the diminishing balance.
 - b) All particulars as above except that the rate of interest is not given,
 - c) All particulars as in (a) above except that the cash price is not given.
- 2 **Hire Purchases Ltd.** purchased motor car on hire purchase system Rs. 12,000 was payable on delivery i.e., on 1.1.89 and the rest in four, equal instalments of Rs. 12,000 each payable at the end of each year. The seller, Hire Vendors Ltd. agreed to charge interest @ 5% on the yearly balances, The cash price of the car was Rs. 54,551. Depreciation @ 25% on written down values was to be written off in each year.
Give the necessary journal entries and ledger accounts in the books of Hire Purchasers Ltd.
(Answer : Total Interest Rs. 5,449. The written down value of the car at the end of fourth year is Rs. 17,260)
- 3 **Dinesh Ltd.**, on 'April 1, 1989, purchased a machine from **Rajesh Ltd.**, on hire purchase basis. The cash price of the machine was Rs. 25,000. The payment was to be made Rs. 5,000 on the date of the contract and the balance in four annual instalments of Rs. 5,000 each plus interest at 5% per annum payable on December 31 each year, and the first such instalment being payable on 31.12.89. Depreciation is to be charged @ 10% on original cost,
Show the journal entries and ledger accounts in the books of both the parties.
(Answer : The amount of total interest Rs. 2,500, balance of Machinery A/c on 1.1.93 Rs. 15,000).

- 4 An engineering company purchased machine on Hire Purchase System over a period of three years paying Rs. 846 as initial payment on 1.1.89 and further annual **payments** of Rs. 2,000 due on 31.12.89, 31.12.90 and 31.12.91. The cash price of the machine was Rs. 6,000 and the vendor company was to charge **interest** at 8% p.a. on outstanding balances.

Show the appropriate ledger accounts in the books of the hire purchaser assuming depreciation @ 10% p.a. was to be charged on the machine. **Assume** that capitalisation was to be done at the time of payment of each instalment.

(Answer : Interest (total) Rs. 846).

Note: These questions and exercises will help you to understand the unit better. Try to write answers for them. Do not send your answer to the University, these are for your practice only.