

FINANCIAL ACCOUNTING - III

UNIT – I

Fire insurance claims – Loss of stock – Loss of profit policy – Application of average clause.

FIRE INSURANCE CLAIMS

- ✘ Every business entity keeps sufficient stock as per the need and size of its respective business for smooth running of the business, but at the same time **risk of loss by fire** or by means is also there. To safeguard the businesses from any unforeseen circumstantial loss, most of the business entities buy insurance policy, which covers loss of stock (by fire) – is known as **stock policy**.

FIRE INSURANCE CLAIMS

- ✘ In consideration of the premium, insurance company takes the responsibility to compensate — if any loss occurs by fire or by other means, applicable under the insurance terms. It is in the best interest of the firm to take fire insurance policy because it covers wide range of losses (by fire) including Building damage, Furniture and Fixture loss, Plant & Machinery destruction, etc.

HOW TO BE CONSIDERED FOR THE ESTIMATION OF STOCK

Gross Profit on Sale :

Gross profit is calculated by deducting net sales from the cost of goods sold. To know the gross profit of the last year, “Trading” account of the last year should be referred to determine the gross profit ratio of the last year.

Percentage of gross profit to sales =

$$\frac{\text{Gross profit}}{\text{Sales}} \times 100$$

HOW TO BE CONSIDERED FOR THE ESTIMATION OF STOCK

Trading Account format:

Trading Account			
(For the year ended...)			
Dr.			Cr.
Particulars	Amount	Particulars	Amount
To Opening stock	Xxx	By Sales	xxx
To Purchases	xxx	Less: Return Inwards	<u>(xxx)</u>
Less: Return Outwards	<u>(xxx)</u>	By Closing stock	Xxx
To Wages	Xxx	By Gross Loss	Xxx
To Carriage Inwards	Xxx		
To Freight Inwards/cartage	Xxx		
To Gross Profit c/d	Xxx		
	<u>xxx</u>		<u>xxx</u>

HOW TO BE CONSIDERED FOR THE ESTIMATION OF STOCK

Memorandum Trading Account (for Current Year) :

In case of fire, Memorandum Trading account is required to find the value of estimated Stock. It is prepared with the help of Gross Profit ratio of the last year, Opening Stock, Purchase, Sale, and Direct Expenses.

HOW TO BE CONSIDERED FOR THE ESTIMATION OF STOCK

Memorandum Trading Account format

Particulars	Amount	Particulars	Amount
To Opening stock	xxx	By Sales	xxx
Purchase	Xxx	Stock on the date of	xxx
Gross profit c/d (Sales x Gross profit ratio)	xxx	fire (balancing figure)	
Total	xxx		xxx

HOW TO BE CONSIDERED FOR THE ESTIMATION OF STOCK

Value of Salvaged Stock:

Value of stock as calculated at step-2 will be reduced by the value of salvaged stock to arrive at the value of Insurance Claim.

HOW TO BE CONSIDERED FOR THE ESTIMATION OF STOCK

Other Important Points:

In case, where stock is not valued at the cost, first it will be valued at the cost in the last year trading account and then in the memorandum account of the current year.

For example:

If it is given that stock of Rs. 80,750 is valued at 85% of the cost in the last year, then

first it should be valued as

$$(80,750 \div 100 \times 85) = 95,000$$

in the last year and then in the current year memorandum Trading account.

HOW TO BE CONSIDERED FOR THE ESTIMATION OF STOCK

Cost of the sample given free of cost or withdrawal of stock by proprietor or partner of the firm for personal use, it should be adjusted in the Trading Account of the last year as well as in the current year's memorandum trading account.

To find out the gross profit on normal sales, poor selling sale should be eliminated from the sale of the current year. Similarly, poor selling items should be eliminated from the opening and closing stock of the last years to prepare the trading account of the current year.

HOW TO BE CONSIDERED FOR THE ESTIMATION OF STOCK

In case, where gross profits of the last several years are given, average gross profit should be taken to determine the gross profit of the current year. However, in case where clear upward trend of the gross profit or downward trend of the gross profit is identified, **weighted average gross profit** or reasonable trend of upward or downward trend should be applied to determine the gross profit of the current year.

HOW TO BE CONSIDERED FOR THE ESTIMATION OF STOCK

Average Clause:

An average clause is applied to find out the value of a claim where value of the stock on the date of fire is more than the value of insured stock. Average clause is applied by the insurance companies to discourage the under insurance of stock or any other assets.

Claim admitted by insurance company:

$$\text{Value of stock destroyed} \quad \times \quad \frac{\text{Value of Insurance company}}{\text{Value of stock on the date of fire}}$$

HOW TO BE CONSIDERED FOR THE ESTIMATION OF STOCK

For example --

Problem:

value of insurance policy is Rs. 1,500,000 and at the date of fire, value of stock in hand is Rs1,800,000, out of which approx. worth of 1,200,000 stock is destroyed, then the value of the claim admitted will be –

Answer:

Value of Claim

$$=1,200,000 \times 1,500,000/1,800,000=1,000,000$$

Value of stock of Rs. 1,200,000 will not be admissible to the insured, rather admissible claim will be Rs. 1,000,000.

Illustration 1:

Fire occurred on the business premises of 'Style India' on 1st April, 2014 and most of the stock destroyed. Please ascertain the insurance claim from the following given particulars –

Particulars	Amount (Year 2013)	Amount (01 Jan to 31 st March 2014)
Sale	2,500,000	750,000
Purchases	1,800,000	350,000
Opening Stock (01-01-2013)	270000	
Closing Stock (31-12-2013)	498,750	
Direct Expenses (Freight & wages)	150,000	30,000

- Stock as on 01-01-2013, valued 10% less at the cost.
- Stock as on 31-12-2013 value 5% more at the cost.
- Value of stock salvaged Rs. 45,000.
- Insurance policy (for fire) was for Rs. 300,000.

Solution

Trading Account of M/s Style India (For the year ending on 31st December, 2013)

Particulars	Amount	Particulars	Amount
To Opening Stock	300,000	By Sales	2,500,000
{ $270,000 \times 90 \div 100$ } { $270,000 \times 90 \div 100$ }		By Stock = $500,000 \div 105 \times 100$	475,000
To Purchases	1,800,000		
To Direct Expenses	150,000		
To Gross Profit (29%)	725,000		
	2,975,000		2,975,000

Memorandum Trading Account of M/s Style India (Up to 01-4-2014)

Particulars	Amount	Particulars	Amount
To Opening Stock	475,000	By Sales	750,000
To Purchases	350,000	By Stock (Balancing Figure)	322,500
To Direct Expenses	30,000		
To Gross Profit (29% of 750,000)	217,500		
	1,072,500		1,072,500

Value of Stock= Rs. 322,500

Less: Stock Salvage= Rs.45,000

Insurance Claim to be lodged will be –

Value of Claim= $300,000/322,500 \times 277,500 = 258,140$

Here an average clause will be applied because the value of insurance policy (Rs.300,000) is less than the value of stock (Rs. 322,500) on the date of fire.

INSURANCE CLAIMS

ILLUSTRATION 5. Fire occurred in the premises of A & Company on 1st September, 2009 and stock of the value of Rs. 5,05,000 was salvaged and the business books and records were saved.

Following information was obtained :

	Rs.
Purchases for the year ended 31-3-2009	35,00,000
Sales for the year ended 31-3-2009	55,00,000
Purchases from 1-3-2009 to 1-9-2009	12,00,000
Sales from 1-3-2009 to 1-9-2009	18,00,000
Stock on 31-3-2008	15,00,000
Stock on 31-3-2009	17,00,000

Further information is also given that the stock on 31-3-2009 was overvalued by Rs. 1,00,000.

Calculate the amount of the claim to be presented to the Insurance Company in respect of losses. Rate of Gross Profit is to be based on the year ended 31-3-2009.

SOLUTION

TRADING ACCOUNT OF A & COMPANY
for the year ending 31st March, 2009

To Opening Stock	Rs. 15,00,000	By Sales	Rs. 55,00,000
To Purchases	35,00,000	By Closing Stock (Rs. 17,00,000 – Rs. 1,00,000 over valued)	16,00,000
To Gross Profit	21,00,000		71,00,000
	<u>71,00,000</u>		<u>71,00,000</u>

$$\text{Rate of Gross Profit on Sale} = \frac{\text{Rs. } 21,00,000}{\text{Rs. } 55,00,000} \times 100 = 38.18\%$$

MEMORANDUM TRADING ACCOUNT OF A & COMPANY
for the period from April 1, 2009 to September 1, 2009

	Rs.		Rs.
To Opening Stock (at cost)	16,00,000	By Sales $\left(\text{Rs. } 18,00,000 \times \frac{5}{6} \right)$	15,00,000
To Purchases $\left(\text{Rs. } 12,00,000 \times \frac{5}{6} \right)$	10,00,000	By Closing Stock (Balancing figure)	16,72,700
To Gross Profit (38.18% of Rs. 15,00,000)	5,72,700		
	<u>31,72,700</u>		<u>31,72,700</u>

Purchases and sales for 6 months from 1-3-2009 to 1-9-2009 include purchases and sales of March 2009, so these have been reduced to 5 months' sales and purchases from April 1, 2009 to September 1, 2009 by multiplying the given figures by $\frac{5}{6}$.

STATEMENT SHOWING THE AMOUNT OF CLAIM

Value of stock on 1-9-2009 <i>i.e.</i> , on the date of fire	Rs. 16,72,700
Less : Stock salvaged	5,05,000
Claim to be lodged	<u>11,67,700</u>

ILLUSTRATION 6. A fire occurred in the premises of a businessman on 31st January, 2009, which destroyed most of the stock. However, stock worth Rs. 5,940 was salvaged. The insurance policy for stock destroyed was for Rs. 4,50,000.

The summarised Trading Account for the year ended 31st December, 2008 is as follows :

	Rs.	Rs.
Turnover		15,00,000
Closing Stock		3,93,750
		<u>18,93,750</u>
Less: Opening Stock	3,09,375	
Purchases	<u>13,59,375</u>	<u>16,68,750</u>
Gross Profit		<u><u>2,25,000</u></u>

The transactions for the month of January, 2009 were as under :

	Rs.
Turnover	75,000
Payment to creditors	80,010
Creditors as on 1-1-2009	1,13,000
Creditors as on 31-1-2009	1,15,490

You are required to submit claim for insurance for loss of stock.

SOLUTION

$$\text{Rate of Gross Profit for 2008} = \frac{\text{Gross Profit for 2008}}{\text{Turnover for 2008}} \times 100 = \frac{\text{Rs. 2,25,000}}{\text{Rs. 15,00,000}} \times 100 = 15\%$$

MEMORANDUM TRADING ACCOUNT *for the month ending 31st January, 2009*

To Opening Stock	-	Rs. 3,93,750	By Sales	Rs. 75,000
To Purchases as per Total			By Closing Stock (Balancing figure)	4,12,500
Creditors A/c	(1)	82,500		
To Gross Profit @ 15% on Rs. 75,000		11,250		
		<u>4,87,500</u>		<u>4,87,500</u>

STATEMENT SHOWING THE AMOUNT OF CLAIM

	Rs.
Closing stock on 31-1-2009 (<i>i.e.</i> , the date of fire)	4,12,500
Less : Stock salvaged	5,940
Claim to be lodged	4,06,560

There is no need of applying average clause because the amount of policy Rs. 4,50,000 is more than the value of stock Rs. 4,12,500 on the date of fire.

Working Note :

(1) Calculation of the Value of Purchases for January, 2009

TOTAL CREDITORS ACCOUNT

	Rs.		Rs.
To Bank	80,010	By Balance b/d	1,13,000
To Balance c/d	1,15,490	By Purchases (Balancing figure)	82,500
	1,95,500		1,95,500