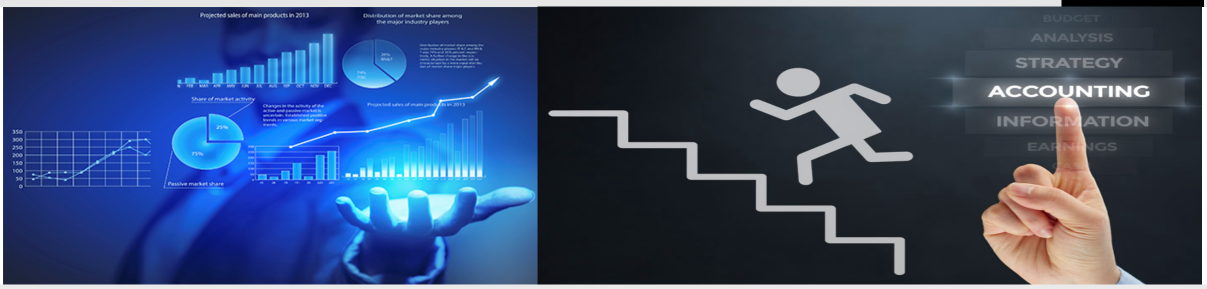
Chapter...... 2



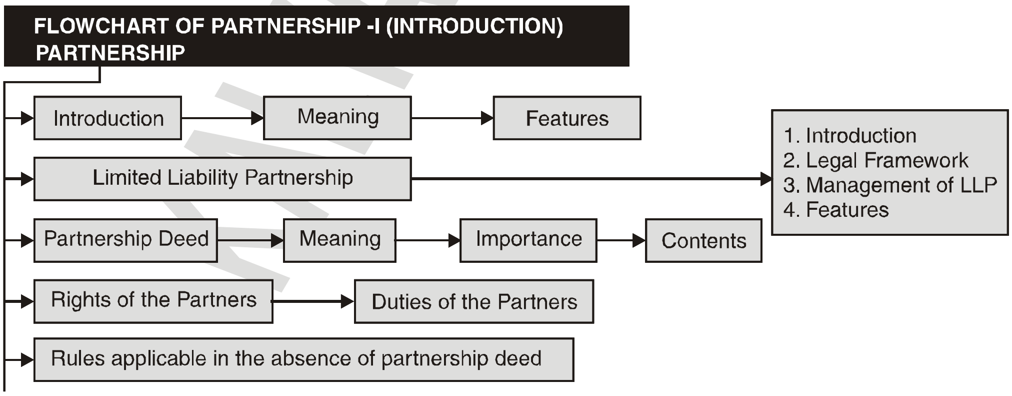
Partnership Accounts–I
(Introduction)

Learning Objectives

AFTER STUDYING THIS CHAPTER YOU SHOULD BE ABLE TO REPLY

❑ What is Partnership? ❑ What are its Characteristics? ❑ What is Limited Liability Partnership? ❑ Meaning of Partnership Deed ❑ Importance of Partnership Deed ❑ Contents of Partnership Deed ❑ Rights & Duties of Partners ❑ Rules applicable in the absence of Partnership Deed ❑ Meaning and Purpose of Profit & Loss Appropriation Account ❑ How to Prepare Profit & Loss Appropriation Account ❑ Meaning and Types of Partners Capital Account ❑ Interests on Capital ❑ Interest on Drawings ❑ Interest on Partner Loan ❑ Rent paid to Partner ❑ Partner's Salary, Commission, etc. ❑ Capital Ratio ❑ Treatment of Past Adjustments ❑ Admission of Manager as Partners ❑ Guarantee of Profits

FLOW CHART



- Profit & Loss Appropriation A/c: Meaning, Purpose, Features, Difference between P&L A/C and P&L App A/c
  - **Accounting Treatment**
    - Journal Entries
    - Specimen of P &L App. A/c
- Recording of Partnership transactions
- Capital Accounts
  - Fixed (Current A/c opened)
  - Fluctuating (Current A/c not opened)
  - Features
  - Difference between Fixed Capital A/c and fluctuating Capital A/c.
    Difference between Partner's fixed capital A/c and current A/c
    Difference between current A/c & Drawings A/c
- Interest on Capital → Accounting Treatment : Journal entries
  - Interest as an appropriation → Provisions relating to Interest on Capital
  - Interest as a charge → When opening capital is missing
- **Drawing A/c → Interest on Drawings**
  Accounting Treatment: Journal entries
  Methods of calculation of Interest on Drawings (9 Cases)
- Interest on Partners loan: Accounting Treatment
- Partner's Salaries, Fee, Commission: Accounting Treatment
- Treatment of Rent Payable to Partner
- Distribution of Profit in Capital Ratio
- **Past Adjustments** - Meaning and Examples,
  - Through P&L Adj A/C
  - By Passing Single Entry
- Admission of Manager as Partner: Accounting Treatment
- **Guarantee of Minimum Profit**
  – By one of the Partners
  – By two or more Partners in Profit Sharing Ratio
  – By two or more Partners ratio other than Profit sharing Ratio
  – By all the Partners in profit Ratio
- Accounting Treatment at a Glance

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INTRODUCTION

In a sole trading concern only one man invests capital, undertakes the risk of business and manages the affairs of the business. But there is a limit of resources of sole trader. To over come the resources, the sole trader has to join hands with others. As a result, he gets more capital, more managerial skill, more persons to share risk of business. Thus, partnership form of organisation is formed.

MEANING OF PARTNERSHIP

When two or more than two persons agree to carry on business for mutual distribution of profits or losses, they are said to have formed a partnership. They act both as an agent and principal of the firm.

The Indian Partnership Act, 1932 governs the working of partnership firms in India. According to Section 4 of this Act, "*Partnership is the relation between persons who have agreed to share the profits of the business carried on by all or any of them acting for all.*"

"A contractual relationship, based upon a written, oral or implied agreement between two or more persons who combine their resources and activities in a joint enterprise and share in varying degrees and by specific agreement in the management and in the profits or losses." ***—Eric L. Kohler***

"Partnership is the relation existing between persons, competent to make contracts who have agreed to carry on a lawful business in common with a view to private gain." ***—Prof. L.H. Haney***

From the above definitions it may be concluded that partnership is an association of two or more than two persons to share profits or losses in specific ratio of a business carried on by them. The persons who are entered in to partnership with one another are called individually '*partners' and collectively as 'firm'*.

Features of Partnership

The following are the essential features of a partnership firm :

1. **Agreement.** In order to have a partnership, it is necessary that there must be an agreement between partners. In other words partnership does not come in to existence by any natural relationship rather contractual relationship is required for creating partnership. The agreement to form a partnership may be in writing or oral.
2. **Plurality of Persons.** To form a partnership atleast two persons are required. The maximum number of persons is hundred.
3. Section 464 of the Companies Act, 2013 empowers the Government to prescribe maximum number of partners in a firm subject to maximum of 100 but the Government has prescribed maximum number of partners in a firm to be 50 vide Rule 10 of the Companies (Miscellaneous) Rules, 2014.
4. **Lawful Business.** It is essential that the partnership is formed for doing lawful business to earn profits. Any agreement to do unlawful activity or to own a joint property is not a business.
5. **Voluntary Association.** A partnership is a voluntary association of individuals. The partnership firm has no separate legal existence. The partners and firm are treated as one and the same.
6. **Sharing of Profits.** It is essential that the partners share profits of the firm according to predetermined ratio. Clubs, charitable institutions, religious bodies etc., which are constituted primarily for non-business activities do not share profits, therefore, they are not partnership firms.
7. **Non-transferability of Interest.** No partner can transfer his share in the partnership without the prior consent of all other partners.
8. **Unlimited Liability.** The liability of the partners (not minor partner) is unlimited. In case firms assets are not sufficient to meet the liabilities of firm, they are liable to pay the claims of the firm out of their personal assets.
9. **Collective Management.** In case of partnership firms, the ownership is not separated from management. Each partner is an owner and also a part of management. Each one is entitled to take part in the management of day-to-day business of the firm. However, the partners may give the right of management to any one partner of the firm. In this case such a partner will act as an agent on behalf of other partners.

10. **Act.** The Partnership business is governed by Partnership Act 1932.
11. **Registration.** Registration of partnership firm is not compulsory. However, if the partners so decide they may get it registered with the 'Registrar' of firms.
12. **Business can be carried on by all or any of the partner acting for all.** The business of the partnership can be carried on by all the partners or by any one of the partner on behalf of other partners.

Understanding

Q. 1. A and B are doing smuggling together across the Indo-Nepal border. They have earned ₹ 1,50,000 in one year. Is it a partnership ?

Ans. Relationship existing between the partners must be for doing lawful business. In this case A and B are doing unlawful business of smuggling from Indo-Nepal border. Therefore, it is not a partnership.

Q. 2. X and Y jointly purchased a restaurant and incurred expenses for purchasing utensils and crockery contributing the necessary amount equally. They subsequently leased out the restaurant on rent basis, the rent was to be shared by them equally. State is it is partnership ?

Ans. For partnership it is essential that the partners must have business relations. In this case X and Y have purchased a restaurant jointly. They are co-owners and not partners as they never carried on any business. Therefore, X and Y are not having any partnership.

LIMITED LIABILITY PARTNERSHIP

Introduction

Limited liability partnerships became available in the UK in April 2001 as a half-way-house between a partnership and a limited company. They are made available to combine the flexibility of partnerships with the protection of limited liability. Although still not widely used, many professional partnerships have chosen to convert to an LLP.

Legal Framework

The Limited Liability Partnership (LLP) is governed by Limited Liability Partnership (LLP) Act, 2008 and Limited Liability Partnership Rules, 2009. The LLP Rules, 2009 contains administrative provisions for formation, management, reconstruction and winding up of LLPs. Central Government can make applicable any provision of Companies Act to LLP with suitable modifications by issuing a notification by issuing a notification.

The Indian Partnership Act, 1932 shall not be applicable to LLPs.

Management of LLP

- Subscribers to Incorporation Document will be the Partners of LLP and new partners shall be admitted as per the Provisions of LLP agreement.
- The mutual rights and duties of the partners of LLP and the mutual rights and duties of LLP and its partners shall be governed by LLP agreement between the partners or between LLP and its partners.

- In the absence of such agreement relationship of Partners and LLP would be governed as per Schedule 1 to LLP Act, 2008.

Features of LLP

Main Features of LLP Act are as follows :

- LLP shall be a body corporate and a legal entity separate from its partners. It will have perpetual succession; like a corporation;
- LLP can be formed by any two or more person, associated for carrying on a lawful business, by subscribing their names to incorporation document.
- There shall not be any upper limit on number of partners in an LLP unlike an ordinary partnership firm where the maximum number of partners can not exceed 100.
- While the LLP will be a separate legal entity, the liability of the partners would be limited to their agreed contribution to the LLP. Further, no partner would be liable on account of independent or unauthorized actions of other partners, thus allowing individual partners to be shielded from joint liability created by another partner's wrongful business decisions or misconduct;
- The framework of LLP is not restricted to professional services alone. Several business activities can be undertaken using the LLP structure;
- The LLP shall be under an obligation to maintain annual accounts reflecting true and fair view of its state of affairs.
- A firm private company or an unlisted company is allowed to convert itself into LLP.
- The Act provides for the winding up of LLP which may be either voluntary or by the tribunal.
- The provisions of the Indian Partnership Act, 1932 are not applicable to LLP.

PARTNERSHIP DEED

Meaning

Partnership is a commercial relationship among the partners. There must be an agreement among the partners for the practical application of this relationship. This agreements may be in writing or oral. According to Kohler *"Partnership agreement (Deed) is an instrument drafted and signed by partners for defining the various rules and regulations of the firm"*.

It is always preferred to have partnership deed in writing because of the various advantages. It serves as a legal document in the court of law to settle disputes among the partners.

Importance of Partnership Deed

Partnership deed is not required under law. It is an optional document/instrument which is prepared by the partners mutually. It serves the following purposes :

(a) It defines the rights, duties and liabilities of each partners. This helps in smooth functioning of the firm.

(b) It is a legal document which help in settling the dispute which may arise amongst partner in future.

(c) Accounting record becomes more genuine and transperant, as the partnership deed guides about the various issues of accounting such as, interest on capital, interest on drawing, salary commission etc. payable to partners.

Contents of Partnership Deed

Partners are free to include any provision in the partnership deed which is essentially not inconsistent with the Indian Partnership Act, 1932. Partnership deed is not a public document. It primarily covers all those material points which are likely to arise in the course of running the partnership business. But the contents of partnership deed vary according to the nature of business.

The following clauses may be contained in a partnership deed :

1. **Name of the Firm.** The name of the firm must not be identical to the name of existing firms.
2. **Place of Business.** The address of the firm where business is to be carried out must be given.
3. **Nature of Business.** Partners must decide what type of business they would do collectively.
4. **Duration of Partnership.** The period of partnership must be decided.
5. **Contribution of Capital.** How much capital will be contributed by each partner must be decided. The capital may be contributed by partners in profit ratio or otherwise.
6. **Profit Sharing Ratio.** The partners must decide their mutual profit sharing ratio. In the absence of this the partners will distribute profits/losses in equal ratio.
7. **Partners Drawings.** The right of partners to make withdrawl from business must be mentioned in the 'Partnership Deed' along with the limit of withdrawl.
8. **Interest on Drawings.** The rate of interest to be charged from the partners on their drawings must be stated.
9. **Interest on Capital.** What will be the rate of interest on capital of partners must be written in Partnership Deed. It should also preferably be stated that in the event of loss will partners get interest on capital.
10. **Partners Salaries, Fees, Bonus Commission.** Will the partners get salaries, fees, bonus, commission from the firm for the work done by them. If yes, then the amount must be specified in the agreement.
11. **Method of Keeping Accounts.** The accounts of the firm may be kept on cash basis or mercantile system or hybrid system.
12. **Duties, Powers and Functions of Partners.** The partnership deed must mention the powers, duties, rights, and functions of the partners.
13. **Valuation of Goodwill.** The method of valuation of goodwill on admission, retirement, death of a partner and disSolution of firm must be decided.
14. **Bank Account.** The operation of bank account will be done by which partner(s) should be written in the deed.
15. **Refund to Retiring Partner.** How the firm would refund the share to retiring partner should be mentioned in the deed.
16. **Valuation of Assets.** The manner in which assets of the firm shall be valued in the case of its reconstitution.
17. **Accounting Period.** The date on which the books of accounts will be closed every year.
18. **Arbitration Clause.** In case of dispute among the partners, how the matter would be resolved ? Who will be the arbitrator ? How the arbitrator will be appointed ?

HOTS

Q. Amit and Aman are doing a trade of buying and selling steel furniture. They have the understanding that the act of Amit will not bound Aman and vice versa. Does partnership exists ?

Ans. In partnership one of the requirement is that the business must be carried on by all the partners or some of them acting for all. In other words there should be a binding contract of mutual agency between the partners. In case of Amit and Aman this mutual relationship of binding each other does not exist. Therefore this is not a partnership.

RIGHTS OF THE PARTNERS

1. Every partner has a right to take part in the conduct and management of the business.
2. Every partner has a right to be consulted and heard in all matters affecting the business of partnership.
3. Every partner has the right to have access to and to inspect and copy any one of the books of the firm.
4. The partners are entitled to share equally in the profits earned and shall contribute equally to the losses sustained by the firm unless otherwise decided in deed.
5. A partner making, any advance beyond the amount of the capital is entitled to interest thereon at the rate of six per cent per annum.
6. Every partner has a right to be indemnified by the firm in respect of payments made and liabilities incurred by him in the ordinary and proper conduct of the business.
7. A partner has the right not to allow the admission of a new partner.

DUTIES OF THE PARTNERS

1. Every partner is bound to attend diligently to his duties in the conduct of the business.
2. A partner is not entitled to receive any remuneration for taking part in the conduct of the business.
3. A partner shall indemnify the firm for any loss caused to it by his wilful neglect in the conduct of the business of the firm.
4. A partner shall be liable to account for and pay to the firm any private profits derived from the transactions of the firm or from the use of the property or goodwill of the firm.
5. If a partner carries on any business of the same nature as and competing with that of the firm, he is bound to account for and pay to the firm all profits made by him in that business.
6. No partner can act outside the parameters of his authority.
7. No partner can assign or transfer the interest of the firm to any other person.

Understanding

Q. 1. Slow and Fast are running a Fast Food Centre under the brand name 'Macdonnel'. Slow on his own started another fast food outlet using 'Macdonnel' name with his own capital. He earned individually ₹ 80,000 from this business. State whether Slow is liable to return the profit to the firm.

Ans. A partner is prohibited under law for setting up a rival business and competes with the business of the firm without the consent or knowledge of his co-partners. In case he violates with the provision of law, he is liable to pay all profits made by him to the firm. In this case Slow is doing a competitive business without the consent of other partners using the name (Goodwill) of the firm. Therefore, he is liable to return profits ₹ 80,000 to the firm.

RULES APPLICABLE IN THE ABSENCE OF PARTNERSHIP DEED (OR DEED IS SILENT ON ANY PROVISION)

Normally a partnership deed covers all matters relating to the mutual relationship amongst the partners. But if the deed is silent on certain matters or in the absence of any deed, the relevant provisions of the partnership Act shall become applicable. It is therefore necessary to know the provisions of the Act which have a direct bearing on the accounting treatment of certain items.

These are as follows :

S.No.	*Item*	*Rules in the absence of partnership deed (or Provisions of Indian Partnership Act, 1932)*
1	**Profit sharing**	The partners shall share the profits and losses of the firm equally irrespective of their capital contribution.
2	**Interest on capital**	No interest is allowed to partners on the capital contributed by them. Where, however the agreement provides for interest on capital,, such interest is payable only out of profits of the business.
3	**Interest on drawings**	No interest will be charged on drawings made by the partners.
4	**Interest on loan**	If any partner, apart from his share of capital advances money to the firm as a loan,, he is entitled to interest on such amount at the rate of 6 per cent per annum. Such interest shall be paid even out of assets of the firm.
5	**Remuneration to partners**	No partner is entitled to any renumeration (salary or commission) for participating in the business of the firm.

It should be remembered that the above rules are applicable only in the absence of any provision to the contrary in the partnership agreement.

ILLUSTRATION 1. **(Rules applicable in the absence of Partnership Deed)** Ranjit and Reddy are partners in a firm. They do not have any partnership deed. Settle their following disputes according to law.

(a) Ranjit invested capital ₹ 70,000 and Reddy ₹ 1,00,000. They claimed interest on capital @ 10% p.a.

(b) Reddy was incharge of sales, he demanded commission on sales @ 6%.

(c) Ranjit advanced loan ₹ 40,000 to the firm and claimed interest @ 9% p.a.

(d) Reddy and Ranjit withdrew ₹ 12,000 and ₹ 10,000 respectively during the year, they were charged interest @ 6% p.a.

Solution

Ranjit and Reddy don't have a partnership deed. So, in the absence of deed, following provisions of parnership Act, 1932 will apply to solve the disputes :

(a) Ranjit and Reddy are not entitled to get interest on capital in the absense of partnership deed.

(b) Reddy has claimed 6% commission on sales. It is denied because there is no agreement.

(c) Ranjit is to get 6% p.a. instead of 9% interest on loan advanced by him.

(d) No interest on drawing is to be charged from partners in the absence of deed.

ILLUSTRATION 2. **(Rules applicable in the absence of Partnership Deed)** Settle the following claims of partners as per law in the absence of deed.

(a) Ganga and Yamuna invested ₹ 1,00,000 and ₹ 1,50,000 as capital in the business. They want the profits to be distributed in the ratio of capital.

(b) Yamuna' spent more time for the business, She demanded salary ₹ 25,000.

(c) Ganga paid ₹ 12,000 as taxi charges for going on business tours. The amount is reasonable. He claims reimbursement of this amount.

(d) Yamuna's Son Krishna is helping Yamuna in the business. Yamuna wants a compensation of ₹ 20,000 in the form of salary for his son.

(e) Ganga wants that his son Bhramputra who is MBA to be inducted in the business for 25% share.

Solution

Ganga and Yamuna don't have a partnership deed. So, in the absence of deed, following provisions of parnership Act, 1932 will apply to solve the disputes :

(a) Profit between Ganga and Yamuna can not be shared in capital ratio. In the absence of partnership deed the profits will be shared in equal ratio.

(b) Yamuna can not claim salary in the absence of deed.

(c) Expenses incurred by Ganga on behalf of firm on touring are reimbursable as the reimbursement of reasonable expenses have nothing to do with partnership deed.

(d) Salary ₹ 20,000 as claimed by Yamuna for his son cannot be paid in the absence of any agreement.

(e) Ganga's son who is MBA can not be taken in to business without the consent of Yamuna.

ILLUSTRATION 3. **(Rules applicable in the absence of Partnership Deed)** Anna Hazare and ManMohan are partners in a business. They do not have any deed. The following disputes have come up in their business. You are required to settle them in the light of provisions of law.

(a) Firm was facing shortage of funds therefore ICICI Bank was approached. Bank rate of interest on loan was 12%. Anna gave loan to firm @ 10%. He claims interest @ 10%.

(b) ManMohan through his contracts brought business of ₹ 3,00,000 to the firm. He claimed commission @ 10% on this amount.

(c) ManMohan has let out his building to the firm and asked for rent of ₹ 5,000 p.m. which is reasonable.

(d) Anna claimed interest on capital @ 12% p.a. ManMohan objected. He said it cannot be more than 6% p.a.

(e) Firm earned profit of ₹ 40,000 Anna and ManMohan claimed the profits to be shared in 3: 2 ratio.

(f) ManMohan spends twice the time that Anna devoted to business. ManMohan claims that he should get salary ₹ 10,000 p.m. for extra time spent by him.

(g) ManMohan wants to purchase goods from Sony company but Anna objects to it.

Solution

As partners do not have partnership deed, So following provisions of Partnership Act, 1932 will be applicable to settle disputes :

(a) Anna will get interest on loan @ 6% p.a.

(b) ManMohan is not entitled to get commission on sales.

(c) ManMonan is entitled to get rent ₹ 5,000 p.m. which is reasonable because firm is using the building for business purposes.

(d) No interest on capital will be given to Anna.

(e) Profit ₹ 40,000 will be shared by Anna and ManMohan equally.

(f) ManMohan is not entitled to get salary in the absence of deed.

(g) Anna has objected for the purchase of goods from Sony Ltd. therefore, the goods can not be purchased.

ILLUSTRATION 4. **(Rules applicable in the absence of Partnership Deed)** Goyal and Agarwal are partners with capital of ₹ 90,000 and ₹ 70,000 respectively. On 30 September 2018 Goyal gives loan of ₹ 20,000 and Agarwal introduces ₹ 10,000 as additional capital. Profit for the year ended 31st March, 2019 was ₹ 25,000. There is no partnership agreement. Both Goyal and Agarwal demand 10% p.a. interest on loan and on additional capital. Show how the profits will be divided. Give reasons.

Solution

Goyal and Agarwal do not have any partnership deed. Therefore no interest on capital will be allowed. However, interest on loan will be allowed @ 6% p.a.

Interest on loan to Goyal at 6% p.a. for 6 months

$20,000 \times \frac{6}{100} \times \frac{6}{12}$	= ₹ 600
Profit earned	₹ 25,000
Less : Interest on loan	₹ 600
Profit after interest	₹ 24,400

Goyal and Agarwal will share profits equally

Goyal's share : ½ of ₹ 24,400 = ₹ 12,200

Agarwal's share : ½ of ₹ 24,400 = ₹ 12,200

PROFIT & LOSS APPROPRIATION ACCOUNT

Meaning

The Trading Account and Profit and Loss Account show gross profit and net profit respectively. All indirect expenses are debited to profit and loss account and all indirect incomes are credited to this account. The function of profit and loss account is over once the profits are ascertained. After this Profit & Loss appropriation account is prepared. This account is an extension of Profit & Loss account. The net profit as disclosed by this account is transferred to Profit & Loss appropriation account. All appropriations *i.e. distributions payable to the partners as per partnership deed are recorded in this account.*

PURPOSE

1. To know the distribution of profit among partners.
2. To show how much is payable to partners in the form of salary, bonus, commission, interest on capital etc. These all are debited to Profit & Loss Appropriation A/c.
3. To show interest on drawings on the credit side of Profit & Loss Appropriation A/c.
4. To create reserve from the profits for future.
5. To distribute profits among partners in profit ratio.

FEATURES/CHARACTERISTICS OF PROFIT AND LOSS APPROPRIATION ACCOUNT

Profit and Loss Appropriation Account is prepared in accordance with the partnership deed. The following are the features of Profit and Loss Appropriation Account.

1. It is prepared after the Profit and Loss Account
2. It is prepared for the appropriations (distribution) of profits among partners.
3. It is not required as per the provisions of Income tax law
4. It is prepared in accordance with the provisions of partnership deed.
5. Reserves required for the future are created from this account.

HOTS

Q. **Is it mandatory under law for a partnership firm to prepare Profit and Loss Appropriation Account ?**

Ans. Profit and Loss Appropriation Account is prepared to show appropriations (distribution) of profits among partners. This is done in accordance with the partnership deed. It is important to note that the law does not compell the firm to prepare Appropriation Account. However, it must be noted that the preparation of Profit and Loss Account is a legal requirement.

DIFFERENCE BETWEEN PROFIT AND LOSS ACCOUNT AND PROFIT AND LOSS APPROPRIATION ACCOUNT

Basis	*Profit and Loss A/c*	*Profit and Loss Appropriation A/c*
• Stage	It is prepared after Trading Account.	It is prepared after Profit and Loss Account.
• Purpose	The purpose is to calculate net profit.	The purpose is to appropriate profits.

• Expenses	All indirect expense and losses are debited to this account.	Expenses of direct and indirect nature are not shown here.
• Partnership	Partnership deed is not of much use here.	Partnership deed is the basis of preparing this account.
• Income tax	For income tax calculation the profit and loss account is the basis.	No use of this account for tax purposes.

RECORDING OF PARTNERSHIP TRANSACTIONS

All the transactions in a partnership firm are recorded on the basis of double entry book-keeping system as we do in case of a sole proprietorship concern. As the owners of the firm are more than one, therefore, a slight change would be there in preparing their capital accounts. In the partnership firm profits of the business are divided among the partners in a fixed ratio. Entries for interest on capital, drawings, salary to partners and division of profits among the partners are passed in a newly opened Profit and Loss Appropriation Account.

ACCOUNTING TREATMENT

(i) For interest on capital **(a) For Allowing Interest on Capital** Interest on Capital A/c Dr. To Partners Capital A/c **(b) On transfer of interest on capital to Profit & Loss Appropriation A/c** Profit and Loss Appropriation A/c Dr. To Interest on Capital A/c	(Gain for Partner Hence Capital A/c credited) (Expense for business Hence Profit and Loss App. A/c debited)
(ii) For interest on drawings **(a) For Charging Interest on drawings** Partner's Capital A/c Dr. To Interest on Drawings A/c **(b) On transfer of interest on drawings to Profit and Loss Appropriation A/c** Interest on Drawings A/c Dr. To Profit and Loss Appropriation A/c	(Reduces Capital, hence Partnership Capital A/c Debited) (Income of the business, P & L App. A/c Credited)
(iii) For Salary and Commission to Partners **(a) For allowing salary and commission to partner.** The following entry will be made for the same :- Partner's salary/commission A/c Dr. To Partner's Capital A/c **(b) On transferring salary/commission to Profit and Loss Appropriation A/c** Profit and Loss Appropriation A/c Dr. To Partner's salary/commission A/c	(Gain for Partner, hence Partnership Capital A/c Debited) (Expense for business, P & L App. A/c Credited
(iv) For Transfer to Reserve Profit and Loss Appropriation A/c Dr. To Reserve A/c	(Profits are apportioned hence Profit and Loss appropriation A/c is debited)

(v) For Distribution of Profits Profit and Loss Appropriation A/c Dr. To Partners' Capital A/c	(to be divided in agreed ratio as per deed, if no deed then equally)
Note. Whenever partners' capital accounts are fixed, then instead of debiting or crediting parnter's capital account, Partner's current account will be debited or credited as the case may be.	

DR. **SPECIMEN OF PROFIT & LOSS APPROPRIATION ACCOUNT FOR THE YEAR ENDED -----** **CR.**

Particulars	₹	Particulars	₹
To Interest on Capital	—	By Net Profit as per P & L A/c	—
To Salaries to Partners	—	By Interest on Drawings	—
To Fees to Partners	—		
To Commission to Partners	—		
To Bonus to Partners	—		
To Transfer to Reserves	—		
To Profits Transferred to :			
Partner's Capital/Current A/c	—		

Note. While writing 'Net Profit as per P & L A/c' on credit side of P & L Appropriation A/c, we may also use 'By profit b/d' or 'By balance b/d'. These words have alternatively been used in various questions.

HOTS

Q. Where will you show salary payable to staff and salary payable to partner ? Give answer with reasons.

Ans. Salary payable to staff is a charge (expense), therefore, it is shown in the debit of Profit and Loss Account where as salary payable to partner is an appropriation of profit therefore, it appears on the debit of Profit and Loss Appropriation Account.

Remembering (Knowledge Based)

- Students must remember that amount payable to the partners in the form of interest on capital, fees, bonus commission, salary are debited to Profit and Loss Appropriation Account.
- However, interest payable on partner's loan and rent on building of the parnter are not debited to Profit and Loss Appropriation Account. These are debited to Profit and Loss Account, because these are expenses.
- Reserves to be created for future are debited to Profit and Loss Appropriation Account.
- Interest on partners' drawings and fines, if any charged from partners are credited to Profit and Loss Appropriation Account.

ILLUSTRATION 5. **(Profit and Loss Appropriation A/c in the absence of Partnership Deed)** X and Y are partners. X's capital is ₹ 10,000 and Y's capital is ₹ 6,000. Interest is payable @ 6% p.a. Y is entitled to a salary of ₹ 300 per month. Profit for the current year before charging any Interest and Salary to Y is ₹ 8,000. Transfer to general reserve 10% of profits before any appropriation. Divide the profit between X & Y.

Solution

PROFIT AND LOSS APPROPRIATION ACCOUNT
DR. ***FOR THE YEAR ENDING ...*** **CR.**

Particulars		₹	Particulars	₹
To Transfer to General Reserve (10% on 8,000)		800	By Profit (before adjustments)	8,000
To Interest on Capital A/c :				
— X (10,000 × 6/100)	600			
— Y (6,000 × 6/100)	360	960		
To Salary A/c (Y) (300 × 12)		3,600		
To Net Profit transferred to :				
— X's Capital A/c (1/2)	1,320			
— Y's Capital A/c (1/2)	1,320	2,640		
		8,000		8,000

Note. In the absence of any information, Profit & Losses are always dividend equally.

ILLUSTRATION 6. **(Journal Entries/Profit & Loss Appropriation A/c)** Pappu and Munna are partners in a firm sharing profits in the ratio of 3 :2. The Partnership Deed provided that Pappu was to be paid salary of ₹ 2,500 per month and Munna was to get a commission of ₹ 10,000 per year. Interest on capital was to be allowed @ 5% p.a. and Interest on drawings was to be charged @6% p.a. Interest on Pappu's drawings was ₹ 1,250 and on Munna's drawing ₹ 425. Capital of the Partners were ₹ 2,00,000 and ₹ 1,50,000 respectively and were fixed. The firm earned a Profit of ₹ 90,575 for the year ended 31st March, 2019. Prepare the Profit and Loss Appropriation Account of the firm.

Solution

PROFIT AND LOSS APPROPRIATION ACCOUNT
FOR THE YEAR ENDED 31ST MARCH 2019

Particulars		₹	Particulars		₹
To Pappu's Salary (2,500 × 12 Months)		30,000	By Profit and Loss A/c (Profit for the year)		90,575
To Munna's Commission		10,000	By Interest on Drawings : (given)		
To Interest on Capitals :			Pappu	1,250	
Pappu (2,00,000 × 5/100)	10,000		Munna	425	1,675
Munna (1,50,000 × 5/100)	7,500	17,500			
To Profit transferred to :					
Pappu's Current A/c (3/5)	20,850				
Munna's Current A/c (2/5)	13,900	34,750			
		92,250			92,250

Working Notes :

1. Capital account of partners are fixed, hence current accounts have been used.
2. Although rate of interest on drawings is given, but exact amount of drawings is also given. Hence rate of interest on drawings is irrelevant here.

ILLUSTRATION 7. **(Profit and Loss Appropriation A/c/Interest on Loan to Partner/ Fine)** Parnter A advanced ₹ 50,000 to the firm on 1 July, 2018. Partner B is to get Salary ₹ 2000 p.m. from 1 May, 2018 and ₹ 3,000 from 1 January, 2019. Interest on Loan is @ 12% p.a. A fine of ₹ 5,000 was charged from B for committing irregularities in the business. Profits earned ₹ 80,000 by A and B before the above adjustments.

Prepare Profit and Loss Appropriation Account for the year ending 31.3.19.

Solution

PROFIT AND LOSS APPROPRIATION ACCOUNT
DR. FOR THE YEAR ENDED 31 MARCH, 2019 CR.

Particulars		₹	Particulars	₹
To Salary to B			By Profit b/d (80,000–4,500) **(WN1)**	75,500
(2,000 × 8 + 3,000 × 3)		25,000	By B's Capital A/c	5,000
To Profit Tranferred to :			(Fine)	
A's Capital A/c (1/2)	27,750			
B's Capital A/c (1/2)	27,750	55,500		
		80,500		80,500

Working Note

(1) Interest on loan payable to A for 9 months on ₹ 50,000 @ 12% p.a. i.e. ₹ 4,500 is a charge therefore, it is an item of Profit and Loss Account. That is why interest on loan ₹ 4,500 has been deducted from profits.

(2) Salary to B	– From May, 2018 to Dec. 31, 2018 (2,000 × 8)	16,000
	– From Jan. 1, 2019 to Mar. 31, 2019 (3,000 × 3)	9,000
		25,000

ILLUSTRATION 8. **(Profit and Loss Appropriation A/c in the absence of Partnership Deed)** K, L and M are partners in a business. They do not have any partnership agreement (Partnership Deed).

The following is the Profit and Loss Appropriation Account for the year is as follows :

PROFIT AND LOSS APPROPRIATION ACCOUNT

Particulars		₹	Particulars		₹
To K's Capital A/c–Salary		20,000	By Profit b/d		2,00,000
To L's Capital A/c–Salary		25,000	By Interest on Drawings :		
To M's Capital A/c–Commission		35,000	K	4,000	
To Interest on Capital @ 6%			L	2,000	
K on ₹ 1,00,000	6,000		M	1,000	7,000
L's on ₹ 50,000	3,000	9,000			

To Interest on Loan @ 6% on ₹ 2,00,00(	12,000		
To Profit transferred to			
K's Capital A/c	35,333		
L's Capital A/c	35,333		
M's Capital A/c	35,334		
	2,07,000		2,07,000

Solution

PROFIT AND LOSS ACCOUNT

Particulars	₹	*Particulars*	₹
To Interest on Loan (6% of ₹ 2,00,000)	12,000	By Profit b/d (before adjustements)	2,00,000
To Profit transferred to Profit and Loss App. A/c	1,88,000		
	2,00,000		2,00,000

PROFIT AND LOSS APPROPRIATION ACCOUNT

Particulars		₹	*Particulars*	₹
To Profit transferred to Capital A/c			By Profit and Loss A/c (Profit for the year)	1,88,000
(equally)				
K (1/3)	62,666			
L (1/3)	62,667			
M (1/3)	62,667	1,88,000		
		1,88,000		1,88,000

Notes:

In the absence of partnership deed, following rules are applied :

(i) Profits are shared equally by K, L and M.

(ii) Interest on capital and salary to partners is not allowed.

(iii) Interest on Drawing is not charged.

(iv) Interest on Loan is allowed @ 6% p.a. and will be charged in Profit and Loss A/c.

ILLUSTRATION 9. **(Journal Entries/P&L Appropriation A/c)** X and Y are partners sharing profit/loss in 2:1 ratio. They earned ₹ 1,40,000 during the year ended 31st March, 2019. As per the partnership deed the following accounting treatment is to be made :

(a) Allow interest on capital ₹ 4,000 to X and ₹ 5,000 to Y.

(b) Salary to X is ₹ 20,000 and Commission to Y is ₹ 15,000.

(c) Interest on drawings is charged ₹ 3,000 from X and ₹ 1,500 from Y.

(d) Transfer ₹ 25,500 to general reserve.

Pass necessary journal entries and prepare Profit & Loss Appropriation Account.

Solution

JOURNAL

Date	Particulars		Debit ₹	Credit ₹
1.	Interest on Capital A/c	Dr.	9,000	
	To X's Capital A/c			4,000
	To Y's Capital A/c			5,000
	(Being interest on capital allowed)			
2.	Profit & Loss Appropriation A/c	Dr.	9,000	
	To Interest on Capital A/c			9,000
	(Being interest on capital transferred)			
3.	X's Salary A/c	Dr.	20,000	
	To X's Capital A/c			20,000
	(Being salary paid to X)			
4.	Y's Commission A/c	Dr.	15,000	
	To Y's Capital A/c			15,000
	(Being commission paid to Y)			
5.	Profit & Loss App. A/c	Dr.	35,000	
	To X's Salary A/c			20,000
	To Y's Commission A/c			15,000
	(Being salary and commission transferred)			
6.	X's Capital A/c	Dr.	3,000	
	Y's Capital A/c	Dr.	1,500	
	To Interest on Drawings A/c			4,500
	(Being interest on drawings charged)			
7.	Interest on Drawings A/c	Dr.	4,500	
	To Profit & Loss Appropriation A/c			4,500
	(Being interest on drawing transferred)			
8.	Profit & Loss Appropriation A/c	Dr.	25,500	
	To General Reserve A/c			25,500
	(Being amount transferred to reserve)			
9.	Profit & Loss Appropriation A/c	Dr.	75,000	
	To X's Capital A/c			50,000
	To Y's Capital A/c			25,000
	(Being profits distributed in 2 : 1 ratio)			

DR. **PROFIT & LOSS APPROPRIATION A/C** **CR.**

Particulars		₹	Particulars		₹
To Interest on Capitals A/c :			By Profit and Loss A/c (Profit for the year)		1,40,000
X	4,000		By Interest on Drawings A/c:		
Y	5,000	9,000	X	3,000	
To Salary A/c (X)		20,000	Y	1,500	4,500
To Commission A/c (Y)		15,000			
To General Reserve		25,500			
To Profit transferred to :					
X's Capital A/c (2/3) 75,000 × 2/3		50,000			
Y's Capital A/c (1/3) 75,000 × 1/3		25,000			
		1,44,500			1,44,500

Understanding

Q. Salary ₹ 15,000 is paid to partner A and salary ₹ 8,000 is paid to Accountant of the firm. Explain how these two are different and what is their accounting treatment?

Ans. Salary paid to A ₹ 15,000 is an appropriation of profits therefore it is debited to Profit & Loss Appropriation A/c, where as salary paid ₹ 8,000 to Accountant is an expense (charge on profit) therefore, it is debited to Profit & Loss A/c

CAPITAL ACCOUNT

Capital account is a personal account of proprietor. In case of sole trader, there is only one proprietor, therefore, only one capital account is opened. But in case of partnership, the capital account of all the partners is opened separately on their name. Suppose, there are three partners in a firm *viz., Mohan, Harish and Manjit. Capital account for each partner will be opened. In this case there will be Mohan's Capital Account, Harish's Capital Account, and Manjit's Capital Account.*

Whatever share of capital is contributed or invested by partners into the business that is credited to their respective capital account. The partners may contribute their share of capital in to the business in the form of cash or asset or goodwill or all these. The share of capital invested by each partner is decided by all the partners mutually. It may be equal or in the profit ratio or in some other ratio.

Suppose in a firm Mukesh and Mamta are partners. Mukesh brings ₹ 10,000 cash as capital and Mamta brings ₹ 8,000 cash as capital, the journal entry will be:

Cash A/c	Dr.	18,000	
To Mukesh's Capital A/c			10,000
To Mamta's Capital A/c			8,000

Capital Account

↓

Fixed Capital Account (Current account is opened)	Fluctuating Capital Account (Current account is not opened)

FIXED CAPITAL ACCOUNT

A partnership firm can maintain the capital account of partners as 'Fixed Capital Account' or 'Fluctuating Capital Account'. In case capital account is fixed, the capital of partner remains intact in most of the cases during the continuance of partnership. The opening and closing balances of capital account normally remain unchanged. However, in case some additional capital is introduced during the accounting year then closing capital will differ from opening capital.

CURRENT ACCOUNT

When the fixed capital account is operated in the firm, all the transactions between firm and partner such as : salary, fees, bonus, commission, interest on capital, share in profits, reserves, goodwill etc., payable to partners, and drawings, interest on drawings, share in losses, all these are recorded in *Current Account. So, current account is opened for each partner separately when the capital account is fixed. It should be remembered that current account is also a personal account. It is a supportive account of capital account. It may have debit or credit balance. If the sum of drawings and share in loss is more than the amount of salary, fees, bonus, interest on capital, share of profit etc., then the excess is called debit balance which appears on the assets side of balance sheet, in vice versa situation the excess is called credit balance which appears on the liabilities side of balance sheet.*

DR. SPECIMEN OF FIXED CAPITAL ACCOUNT CR.

Particulars	₹	*Particulars*	₹
To Cash/Bank A/c	. . .	By Balance b/d (In case of old firms)	. . .
(Permanent withdrawl of capital)	. . .	By Cash/Bank A/c (Additional capital)	. . .
To Balance c/d	. . .		
(Closing balance, appear on liabilities side)			
	. . .		. . .

DR. SPECIMEN OF CURRENT ACCOUNT CR.

Particulars	₹	***Particulars***	₹
To Balance b/d (if debit balance)		By Balance b/d (if credit balance)	
To Drawings A/c	. . .	By Salaries A/c	. . .
To Interest on Drawings A/c	. . .	By Interest on Capital A/c	. . .
To Profit & Loss A/c (Loss)	. . .	By Fees A/c	. . .
To Balance c/d (It is a credit balance, it will	. . .	By Commission A/c	. . .
appear on liabilities side)		By Bonus A/c	. . .
		By Profit & Loss Appropriaton A/c (Profit)	. . .
		By Balance c/d (It is a debit balance, it will	. . .
		appear on asset side)	

FLUCTUATING CAPITAL ACCOUNT

A partnership firm may keep fluctuating capital account of partners, if it is provided in the partnership deed. Fluctuating capital account of partners means where in all the transactions relating to partners *e.g., salary, fees, bonus, commission, interest on capital, share in profits, goodwill, reserves, drawings, interest on drawings etc., are recorded along with the opening balance of capital and additional capital introduced in the firm.* ***In case of fluctuating capital account, current account of partners is not opened.***

The opening and closing balances of fluctuating capital account generally do not remain same due to fact that all the aforesaid transactions pertaining to partners are recorded in the capital account itself.

The specimen of fluctuating capital account is given below :

DR. **SPECIMEN OF FLUCTUATING CAPITAL ACCOUNT** CR.

Particulars	₹	Particulars	₹
To Balance b/d (debit opening balance)	...	By Balance b/d (Credit opening balance)	...
To Drawings A/c	...	By Cash/Bank A/c (Additional capital)	...
To Interest on Drawings A/c	...	By Salaries A/c	...
To Profit & Loss A/c (Loss)	...	By Fees A/c	...
To Balance c/d (It is a credit balance, it will appear on liabilities side)	...	By Commission A/c	...
		By Bonus A/c	...
		By Interest on Capital A/c	...
		By Profit & Loss Appropriation A/c (Profit)	...
		By Balance c/d (It is a debit balance, it will appear on assets side)	
	...		...

Remembering (Knowledge Based)

1. Partner's capital account and current account are personal account.
2. If in the examination partner's current account is given then it should always be presumed that capital accounts are fixed.
3. Debit balance of partner's current account and capital account appears on the assets side of balance sheet, whereas the credit balance appears on the liabilities side of balance sheet.

FEATURES/CHARACTERISTICS OF CAPITAL ACCOUNT

1. Capital account is a personal account of partners.
2. It may have debit balance or credit balance.
3. Credit balance in capital account indicates that firm owes amount to partner and in contrary to his, debit balance indicates that partner owes amount to firm.
4. Debit balance of partner capital account is shown on asset side where as credit balance is shown on liabilities side.
5. Increase in capital is always credited *e.g.* interest on capital, salary, commission etc.
6. Decrease in capital is always debited *e.g.* interest on drawings, drawings, losses etc.

Remembering (Knowledge Based)

Q. Give one advantage to a partner of having fixed capital account.

Ans. Balance in fluctuating capital account of a partner may increase or decrease due to the items credited and debited to this account. Accordingly interest on capital is also decreased and increased on this balance. However, when capital account is fixed the partner is certain to get fixed interest on capital. Secondly, in case of fixed capital account, the partner can not have excessive drawings from the firm. Thus, the out flow of excessive capital is saved.

DIFFERENCE BETWEEN FIXED CAPITAL ACCOUNT AND FLUCTUATING CAPITAL ACCOUNT

Basis of Difference	*Fixed Capital Account*	*Fluctuating Capital Account*
Opening and Closing Balance	* Opening and Closing balances normally remains same.	* Opening and closing balances change due to adjustment in capital account.
Current Account	* Current account of partners are opened in this case.	* Current account of partners are not opened in this case.
Adjustment relating to capital	* All adjustments relating to partners capital account such as : drawings, interest on drawings, salary of partners, bonus, fees, commission etc., are made in the current account.	* All such adjustments are made in capital account itself.
Position of capital account	* Capital Account in this case mostly has a credit balance.	* Capital account in this case may have debit or credit balance. If partner has withdrawn money from the business more than the amount credited to his account, then it will have debit balance and in *vice versa condition it will have credit balance.*

DIFFERENCE BETWEEN PARTNERS FIXED CAPITAL ACCOUNT AND CURRENT ACCOUNT

Basis of Difference	*Fixed Capital Account*	*Current Account*
Capital Contribution	The Capital contributed by partners is shown in this account.	It does not show the capital contributed by partners.
Adjustments	Adjustments relating to salary, fees, commission interests on capital, drawings etc. are not shown in this account.	All such adjustment are shown in current account
Closing Balance	The closing balance is always a credit balance.	The closing balance of current may be debit or credit.

DIFFERENCE BETWEEN CURRENT ACCOUNT AND DRAWINGS ACCOUNT

Basis of difference	*Current Account*	*Drawings Account*
When Opened ?	Current Account is opened when the capital account is fixed.	Drawing account can be opened in both the cases when capital are fixed and fluctuating.
Accounting Treatment	In current Account we record, drawings, Salary, Commission, fees, bonus, interest on capital etc.	In drawings account only drawings are recorded.
Balance of Account	It may have debit or credit balance.	It always has debit balance.
Closing of Account	It is balanced at the end of every accounting period and the balance is carried to next year.	It is closed every year by transferring to partner capital account or current account.

ILLUSTRATION 10. ***(Fixed Capital Account).*** Write up the capital and current accounts of the partners Gobind and Krishan from the following details :

	Gobind	*Krishan*
	₹	₹
Capital on 1-4-2018	75,000	80,000
Gobind current account on 1-4-2018	4,000 (Cr.)	—
Krishan current account on 1-4-2018	—	1,500 (Dr.)

Drawings during 2018 -19	3,000	5,000
Interest on capital at 10%	7,500	8,000
Interest on drawings	200	400
Share of profits for 2018-19	7,000	6,000
Salary for the year	6,000	3,000

Solution

DR. GOBIND'S CAPITAL ACCOUNT CR.

Date	Particulars	₹	Date	Particulars	₹
31-3-19	To Balance c/d	75,000	1-4-18	By Balance b/d	75,000
			1-4-19	By Balance b/d	75,000

DR. KRISHAN'S CAPITAL ACCOUNT CR.

Date	Particulars	₹	Date	Particulars	₹
31-3-19	To Balance c/d	80,000	1-4-18	By Balance b/d	80,000
			1-4-19	By Balance b/d	80,000

DR. GOBIND'S CURRENT ACCOUNT CR.

Date	Particulars	₹	Date	Particulars	₹
31-3-19	To Drawings A/c	3,000	1-4-18	By Balance b/d	4,000
31-3-19	To Interest on Drawings A/c	200	31-3-19	By Interest on Capital A/c (10% of 75,000)	7,500
31-3-19	To Balance c/d	21,300	31-3-19	By Profit & loss Appropriation A/c—(Share of profit)	7,000
			31-3-19	By Salary A/c	6,000
		24,500			24,500

DR. KRISHAN'S CURRENT ACCOUNT CR.

Date	Particulars	₹	Date	Particulars	₹
1-4-18	To Balance b/d	1,500	31-3-19	By Interest on Capital (10% of 80,000)	8,000
31-3-19	To Drawings A/c	5,000	31-3-19	By Profit and loss Appropriation A/c	
31-3-19	To Interest on Drawings A/c	400		—(Share of profit)	6,000
31-3-19	To Balance c/d	10,100	31-3-19	By Salary A/c	3,000
		17,000			17,000

ILLUSTRATION 11. **(Profit and Loss Appropriation A/c and Fluctuating capital)**

Sun and Moon are partners in 3:2 ratio. Their capital are ₹ 30,000 and ₹ 10,000. As per the partnership agreement Sun is to get salary ₹ 1,500 pm and Moon's commission @5% on sales of ₹ 80,000. The profit earned by them are ₹ 90,000. They are to get interest on capital @10%. It was decided to transfer 1/8th of net profit to general reserve.

Prepare Profit and Loss Appropriation Account and Capital Account.

Solution

DR. PROFIT AND LOSS APPROPRIATION ACCOUNT CR.

Particulars		₹	Particulars	₹
To Interest on Capital A/c :			By Profit and Loss A/c	90,000
Sun (10% of ₹ 30,000)	3,000		(Profit for the year)	
Moon (10% of ₹10,000)	1,000	4,000		

To Salary to A/c (Sun) (1500 ×12)		18,000		
To Commission A/c (Moon)				
(5% on 80,000)		4,000		
To General reserve (1/8 of 64,000) ***(WN1)***		8,000		
To Profit transferred to :				
Sun's Capital A/c (3/5)	33,600			
Moon's Capital A/c (2/5)	22,400	56,000		
		90,000		90,000

CAPITAL ACCOUNT

Particulars	*Sun*	*Moon*	*Particulars*	*Sun*	*Moon*
To Balance c/d	84,600	37,400	By Balance b/d	30,000	10,000
			By Interest on Capital A/c	3,000	1,000
			By Salary A/c	18,000	–
			By Commission A/c	–	4,000
			By P and L App. A/c (Share of Profit)	33,600	22,400
	84,600	37,400		84,600	37,400
			By Balance b/d	84,600	37,400

Working Note : 1. Transfer to General Reserve

1/8th of net Profits i.e. 1/8 of (90,000 – 3,000 – 1,000 – 18,000 – 4,000) = 1/8th of 64,000 = ₹ 8,000)

ILLUSTRATION 12. **(Profit and Loss App. A/c/Fixed & Fluctuating Capital A/c)** Ram and Sham entered into partnership with a capital contributed of ₹ 2,00,000 and ₹ 1,00,000 respectively as on 1.4.2018. The net profit earned during the year 2018-19 was ₹ 50,000.

Partnership Deed provided that :

(i) Sham is entitled to a salary of ₹ 10,000 per annum.

(ii) Interest on Capital to be allowed to the partners @ 5% per annum.

(iii) Partners draw ₹ 800 and ₹ 500 per month from the firm as drawings.

Prepare the Profit and Loss Appropriation Account and Partner's Capital Account in the following cases :

(i) When Partners capitals are fixed

(ii) When Partners capitals are fluctuating.

Solution

PROFIT AND LOSS APPROPRIATION ACCOUNT
FOR THE YEAR ENDING 31ST MARCH 2019

Particulars		₹	*Particulars*	₹
To Interest on Capitals A/c :			By Profit & Loss A/c (Profit for current year)	50,000
–Ram (2,00,000 × 5/100)	10,000			
–Sham (1,00,000 × 5/100)	5,000	15,000		
To Sham A/c (Salary)		10,000		

To Profit transferred to Partner's Capital/ Current A/c :				
Ram (1/2)	₹ 12,500			
Sham (1/2)	₹ 12,500	25,000		
		50,000		50,000

Case–(i) When Partner's Capitals are Fixed

PARTNER'S CAPITAL ACCOUNT

Date	Particulars	Ram ₹	Sham ₹	Date	Particulars	Ram ₹	Sham ₹
31.3.19	To Balance c/d	2,00,000	1,00,000	1.4.18	By Bank A/c (Capital)	2,00,000	1,00,000
		2,00,000	1,00,000			2,00,000	1,00,000
				1.4.19	By Balance b/d	2,00,000	1,00,000

PARTNER'S CURRENT ACCOUNT

Date	Particulars	Ram ₹	Sham ₹	Date	Particulars	Ram ₹	Sham ₹
31.3.19	To Drawing A/c	9,600	6,000	31.3.19	By Interest on capital A/c	10,000	5,000
	(Ram) (800 × 12)			31.3.19	By Salary A/c	–	10,000
	(Sham) (500 × 12)				By Profit and Loss		
31.3.19	To Balance c/d	12,900	21,500	31.3.19	Appropriation A/c (Profit)	12,500	12,500
		22,500	27,500			22,500	27,500
				1.4.19	By Balance b/d	12,900	21,500

Case–(ii) When Partner's Capital are Fluctuating :

PARTNER'S CAPITAL ACCOUNTS

Date	Particulars	Ram ₹	Sham ₹	Date	Particulars	Ram ₹	Sham ₹
31.3.19	To Drawings A/c	9,600	6,000	1.4.18	By Bank A/c (Capital)	2,00,000	1,00,000
31.3.19	To Balance c/d	2,12,900	1,21,500	31.3.19	By Interest on Capital A/c	10,000	5,000
				31.3.19	By Salary A/c		10,000
				31.3.19	By Profit and Loss		
					Appropriation A/c (Profit)	12,500	12,500
		2,22,500	1,27,500			2,22,500	1,27,500
				1.4.19	By Balance b/d	2,12,900	1,21,500

INTEREST ON CAPITAL

Interest on capital is allowed to the partners only when it has been provided in the partnership deed. In the absence of the provision for interest on capital, the partners are not entitled for the interest and they can not claim this as a matter of their right. Interest on capital is an appropriation of profits and as per Section 13 of the Indian Partnership Act, 1932, it is allowed to the partners only when the profits exist in the business. However, the partners may waive this limitation, by an agreement, and in such a case, the resultant business loss shall be shared by the partners in the profit ratio.

> Interest on capital is calculated at the prescribed rate on the opening balance of capital. If additional capital is contributed by partners during the year then interest on additional capital is also allowed on time basis.

Purpose of Interest on Capital. Generally, the idea for providing the interest on capital is to accord justice to the partners contributing capital in excess of their proportionate share of profit. In the absence of interest on capital, if the capital of all the partners is equal and profit ratio is unequal, the partner with smaller share of profits suffers because he contributes proportionately more capital without any extra return. If the capital of all the partners is unequal and profit ratio is equal, the partner with larger capital contribution loses because he gets proportionately smaller share of profits.

Let us study the following example :

X and Y are partners sharing profits equally with capital of ₹ 30,000 and ₹ 10,000 respectively as on 1st April, 2017. During the year the business earned a profit of ₹ 10,000. Distribute the profits between partners when :

(i) Interest on capital is allowed @ 10% p.a. (ii) Interest on capital is not allowed.

Solution

(i) When interest is allowed :

DR. **PROFIT & LOSS APPROPRIATION ACCOUNT** **CR.**
FOR THE YEAR ENDED 31ST MARCH, 2018

Particulars	₹	Particulars	₹
To Interest on Capital :		By Profit & Loss A/c	10,000
X (10% on ₹ 30,000)	3,000	(Profit for the year)	
Y (10% on ₹ 10,000)	1,000		
To Share in Profits :			
(10,000—4,000) = 6,000			
X (1/2 of 6,000)	3,000		
Y (1/2 of 6,000)	3,000		
	10,000		10,000

X gets total share from firm ₹ 3,000 + ₹ 3,000 = ₹ 6,000

Y gets total share from firm ₹ 1,000 + ₹ 3,000 = ₹ 4,000

(ii) When Interest is not allowed :

DR. **PROFIT & LOSS APPROPRIATION ACCOUNT** **CR.**
FOR THE YEAR ENDED 31ST MARCH, 2018

Particulars	₹	Particulars	₹
To Share in Profit :		By Profit & Loss A/c	10,000
X 1/2 of ₹ 10,000	5,000	(Profit for the year)	
Y 1/2 of ₹ 10,000	5,000		
	10,000		10,000

X and Y get ₹ 5,000 each in this case.

Readers must have observed that in the example given above, the partners share profits equally but their capital contribution is unequal, *i.e.,* 'X' contributes ₹ 30,000 and Y contributes ₹ 10,000. When interest on capital is allowed 'X' gets total ₹ 6,000 and 'Y' gets total ₹ 4,000 and when interest on capital is not allowed X and Y get ₹ 5,000 each. So, in the absence of interest on capital 'X' who has contributed more capital, loses because he gets ₹ 5,000 which is equal to Y's share, who has contributed ₹ 10,000 as capital. Therefore, to accord justice to partner 'X' who contributed more capital as compared to 'Y', the interest on capital is allowed. In this situation 'X' gets ₹ 6,000 and 'Y' gets ₹ 4,000.

ACCOUNTING TREATMENT

Interest on capital is normally not given to the partners in cash. It is credited to the partner's capital or current account. It is an appropriation of profit, therefore, it is finally transferred to profit and loss appropriation account.

Entries for interest on capital	
(i) For allowing interest on capital : Interest on Capital A/c Dr. To Partner's Capital/Current A/c	(Gain for partners, hence partners' Capital A/c Credited)
(ii) For transfer of interest on capital : Profit & Loss Appropriation A/c Dr. To Interest on Capital A/c	(Profits are apportioned hence, P&L App. A/c Debited)
The effect of above two entries is that the partners get the benefit of interest on capital by increase in their capital/current account and profit of the firm is distributed (*i.e. appropriation) between the partners.*	

ILLUSTRATION 13. (Interest on Capital) X and Y are partners in 2 : 1 ratio. Their total capital on 1st April, 2018 was ₹ 3,00,000 which was in profit ratio. On 1st January, 2019 X made contribution in capital amounting ₹ 50,000. They earned profit ₹ 60,000 during the year ending 31-3-2019. Find out interest on capital @ 12% p.a.

Solution

Partner X

Interest @ 12% p.a. on ₹ 2,00,000 for one year (2,00,000 ×12/100)	24,000
Interest @ 12% p.a. on ₹ 50,000 for three months (50,000 × 12/100 × 3/12)	1,500
	25,500

Partner Y

Interest @ 12% p.a. on ₹ 1,00,000 for one year (1,00,000 × 12/100)	12,000

Working Notes

1. Total capital is ₹ 3,00,000. It is divided in 2 : 1 ratio between X & Y.

   ∴ X's Capital = 3,00,000 × 2/3 = ₹ 2,00,000

   Y's Capital = 3,00,000 × 1/3 = ₹ 1,00,000
2. There is no treatment of profit ₹ 60,000 for the calculation of interest on capital.

ADDITIONAL CAPITAL AND WITHDRAWL

A partner may make additions to and withdrawl from capital during the year. Interest on capital is calculated on the amount which remained invested in the business. Due to introduction of fresh capital and withdrawl, the amount of capital will go on changing during the year.

For example : On 1-4-16 Ravi had capital of ₹ 50,000. On 1-10-16 he deposited further ₹ 10,000 in the business as capital and on 1-1-17 he withdrew ₹ 5,000 from the business.

In this case the amount of capital remained in the business is as follows :

- ₹ 50,000 from 1-4-16 to 1-10-16 ***i.e. for 6 months.***
- ₹ 50,000 + 10,000 ₹ = 60,000 from 1-10-16 to 1-1-17 for 3 months.
- ₹ 60,000 – 5,000 = ₹ 55,000 from 1-1-17 to 31-3-17 for 3 months.

Note. Students must have observed that due to additions and withdrawl capital did not remain same throughout the year.

ILLUSTRATION 14. **(Interest on Capital/Additional Capital and Withdrawl)** S and T are partners in a firm in 2:1 ratio. They have capital of ₹ 1,00,000 and ₹ 1,30,000 on 1-4-16.

On 1-5-16 S introduced ₹ 10,000 and T withdrew ₹ 40,000 on the same date.

On 31-07-16 S withdrew ₹ 20,000 while T introduced ₹ 10,000 on the same date.

On 28-2-17 T further deposited ₹ 30,000 as capital. Calculate interest on capital @ 12% p.a. for the year ending 31-3-17.

Solution

Calculation of Interest on Capital

Partner S

(i)	On ₹ 1,00,000 for one month (From 1-4-2016 to 1-5-2016)	₹
	(₹ 1,00,000 × 1/12 × 12/100)	1,000
(ii)	On ₹ 1,10,000 (i.e. 1,00,000 + 10,000) for three months (From 1-5-2016 to 31-7-2016)	
	(1,10,000 × 3/12 ×12/100)	3,300
(iii)	On ₹ 90,000 (i.e. 1,10,000–20,000) for eight months (From 1-8-2016 to 31-3-2017)	
	(90,000 × 8/12 × 12/100)	7,200
		11,500

Partner T

(i)	On ₹ 1,30,000 for one month (From 1-4-2016 to 1-5-2016)	
	(1,30,000 × 1/12 × 12/100)	1,300
(ii)	On ₹ 90,000 (i.e. 1,30,000–40,000) for three months (From 1-5-2016 to 31-7-2016)	
	(90,000 × 3/12 × 12/100)	2,700
(iii)	On ₹ 1,00,000 (i.e. ₹ 90,000 + 10,000) for 7 months (From 1-8-2016 to 28-2-2017)	
	(1,00,000 × 7/12 × 12/100)	7,000
(iv)	On ₹ 1,30,000 for one month (From 1-3-2017 to 31-3-2017)	
	(1,30,000 × 1/12 × 12/100)	1,300
		12,300

PROVISIONS RELATING TO INTEREST ON CAPITAL

Case	*Provision*
(i) If the partnership agreement is silent as to interest on Capital.	(i) Not allowed.
(ii) If the partnership agreement provides for interest on capital but is silent as to the treatment of interest as a charge or appropriation.	(ii) Allowed only if there are profits. [Sec 13(c)] **(a) In case of loss—**Not allowed. **(b) In case profit before interest is equal to or more than the interest—**Full Interest allowed. **(c) In case profit before interest is less than the interest—** Profit will be distributed in the ratio of interest on capital of each partner up to extent of profit.
(iii) If the partnership agreement provides for interest on capital as a charge.	(iii) Full Interest allowed irrespective of profits or losses.

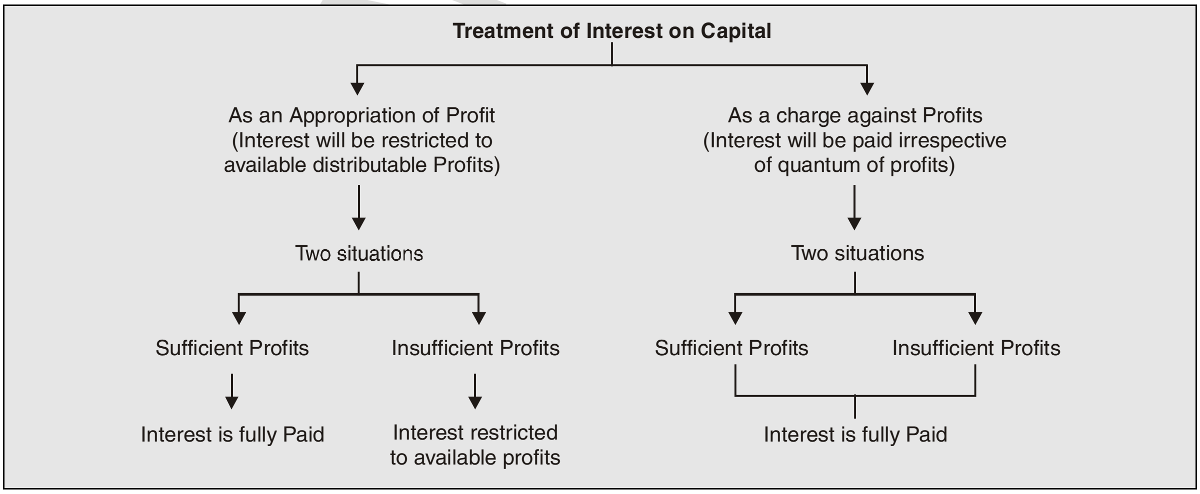
INTEREST ON CAPITAL IS AN APPROPRIATION OR A CHARGE

Interest on capital may be treated in the books of accounts in the following manner :

1. As an apropriation of profit.
2. As a charge against profit.

1. **Meaning of Appropriation :-** It means interest will only be allowed if there are profits. Even if there are insufficient profits, Interest will be allowed up to extent of profits. Also Interest will be shown in Profit and Loss Appropriation A/c in this case.
2. **Meaning of Charge :-** It means Interest will be allowed whether profits are there or not. Moreover, Interest will be shown in profit & Loss A/c in this case.

Following diagram shows treatment in the above two cases :



EXAMPLE

Profits available are ₹ 40,000, X's capital is ₹ 1,00,000 and Y's capital is ₹ 80,000. Interest on capital is allowable @ 10%.

In this case interest on capital is as follows.

X $\quad 1,00,000 \times \frac{10}{100} = 10,000$

Y $\quad 80,000 \times \frac{10}{100} = 8,000$

Profit available is ₹ 40,000, which is sufficient for distribution of interest on capital of ₹ 18,000. Therefore, this is a case of appropriation. Interest on capital will be debited to Profit & Loss appropriation A/c in this case.

ILLUSTRATION 15. **(Interest as an Appropriation/Profits are Insufficient).** X and Y are partners in the ratio of 3:2. Their capitals were ₹ 5,00,000 and ₹ 3,00,000. The rate of interest on capital is 10% p.a. Profits are ₹ 64,000 before interest on capital. Show Profit & Loss Appropriation A/c treating the interest on capital as an appropriation.

Solution

DR. **PROFIT AND LOSS APPROPRIATION A/C** **CR.**
FOR THE YEAR ENDING - - - -

Particulars	₹	*Particulars*	₹
To Interest on Capital : ***(WN1)***		By Profit & Loss A/c	64,000
X	40,000	(Profit for the year)	
Y	24,000		
	64,000		64,000

Working Note

1. Interest on capital

X $\quad —5,00,000 \times \frac{10}{100} = ₹\ 50,000$

Y $\quad —\ 3,00,000 \times \frac{10}{100} = ₹\ 30,000$

Total interest for X & Y = 50,000 + 30,000 = ₹80,000.

Profits are ₹ 64,000, therefore, the interest on capital to be distributed will be restricted to ₹ 64,000 and it will be distributed between X and Y in 5:3 ratio (i.e. ratio of actual interest 50,000 : 30,000).

X's Share in Interest on capital = $\frac{5}{8} \times 64,000 = ₹\ 40,000$

Y's Share in Interest on capital = $\frac{3}{8} \times 64,000 = ₹\ 24,000$

ILLUSTRATION 16. **(Interest on Capital is a Charge and Profits are Sufficient)** A and B are partners in 2 : 1 ratio. They have ₹ 1,00,000 and ₹ 80,000 in their capital account on 1-4-2019. As per deed the interest on capital @10% is a charge and it has to be paid even if there is a loss. The deed also provides to create reserve at 10% for future contingencies relating to cases pending in the court. Show distribution of profit of ₹ 1,20,000.

Solution

DR. PROFIT & LOSS A/C CR.

Particulars		₹	Particulars	₹
To Interest on Capital:			By Net Profit (before adjustment)	1,20,000
A (1,00,000 × 10/100)	10,000			
B (80,000 × 10/100)	8,000	18,000		
To Net Profit transferred to P & L App. A/c		1,02,000		
		1,20,000		1,20,000

DR. PROFIT & LOSS APPROPRIATION A/C CR.

Particulars		₹	Particulars	₹
To Reserve for Contingencies (10% of ₹ 1,02,000)		10,200	By Profit & Loss A/c (Profit for the year)	1,02,000
To Net Profit transferred to :				
A's Capital A/c (2/3)	61,200			
B's Capital A/c (1/3)	30,600	91,800		
		1,02,000		1,02,000

ILLUSTRATION 17. ***(When Interest is a Charge and Profits are not Sufficient).*** X, Y and Z are partners in 3:2:1 ratio. Interest on capital is allowed as charge @ 10% on capital of ₹ 50,000 (X); ₹ 40,000 (Y) and ₹ 20,000 (Z). Profits for the year ended 31-3-2019 before interest were ₹ 2,000. Show distribution profits.

Solution

DR. PROFIT & LOSS ACCOUNT CR.
FOR THE YEAR ENDING 31ST MARCH, 2019

Particulars	₹	Particulars		₹
To Interest on capital :		By Net Profit (before Adjustments)		2,000
X (50,000 × 10/100)	5,000	By Loss :		
Y (40,000 × 10/100)	4,000	X (3/6 × 9,000)	4,500	
Z (20,000 × 10/100)	2,000	Y (2/6 × 9,000)	3,000	
		Z (1/6 × 9,000)	1,500	9,000
	11,000			11,000

ILLUSTRATION 18. **(Comprehensive illustration on Interest on Capital/various cases).** X and Y are partners sharing profits and losses in the ratio of 2:1. Their capital were ₹ 40,000 and 30,000 respectively.

Show distribution of profit in each of the following cases.

Case A. Profits are ₹ 15,000 and deed in silent as regards to interest on capital.

Case B. Profits are ₹ 15,000 and deed provides for interest @10% p.a. on capital.

Case C. Profits are ₹ 5,600 and deed provides for interest on capital @ 10% p.a.

Case D. Profits are ₹ 5,600 and the deed provides for interest on capital @ 10% p.a. even if there is a loss.

Case E. Loss is ₹ 2000 and the deed provides for interest on capital @ 10% p.a. even if there is a loss.

Solution

Case (A) : When deed is Silent

No interest on capital is allowed if partnership deed is silent.

DR. **PROFIT & LOSS APPROPRIATION A/C** **CR.**

Particulars	₹	Particulars	₹
To Profit transferred to :		By Profit & Loss A/c	15,000
X's Capital A/c (2/3)	10,000	(Profit for the year)	
Y's Capital A/c (1/3)	5,000		
	15,000		15,000

Case (B) : When deed provides for Interest @ 10% p.a.

Interest will be allowed as per deed subject to availability of profits through appropriation A/c.

DR. **PROFIT & LOSS APPROPRIATION A/C** **CR.**

Particulars		₹	Particulars	₹
To Interest on Capital :			By Profit & Loss A/c	15,000
X (40,000 × 10/100)	4,000		(Profit for the year)	
Y (30,000 × 10/100)	3,000	7,000		
To Profit transferred to :				
X' Capital A/c (2/3)	5,333			
Y's Capital A/c (1/3)	2,667	8,000		
		15,000		15,000

Case (C) : When deed provides Interest @ 10% p.a.

Interest will be allowed as per deed subject to availability of profits through appropriation A/c.

DR. **PROFIT & LOSS APPROPRIATION A/C** **CR.**

Particulars		₹	Particulars	₹
To Interest on Capital (in 4:3 ratio) :			By Profit & Loss A/c	5,600
X = $\frac{4}{7} \times 5{,}600$	3,200		(Profit for the year)	
Y = $\frac{3}{7} \times 5{,}600$	2,400	5,600		
		5,600		5,600

Here Profits before Interest = ₹ 5,600

Interest on Capital as calculated in Case (B) = ₹ 7,000

Which is more than profit before interest. Hence it will be distributed among partners in the ratio of interest i.e. 4 : 3 (4,000 : 3,000) upto the extent of profit.

Case (D) : Interest on Capital is 10% p.a. and deed provides it even if there is a loss

In this case, Interest will be charged in Profit & Loss Account whether there are sufficient profits or not.

DR. PROFIT & LOSS A/C CR.

Particulars		₹	Particulars		₹
To Interest on Capital			By Net Profit (before Adjustments)		5,600
X	4,000		By Loss transferred to :		
Y	3,000	7,000	X's Capital A/c $\frac{2}{3} \times 1,400$	933	
			Y's Capital A/c $\frac{1}{3} \times 1,400$	467	1,400
		7,000			7,000

Case (E) : Deed provides Interest on Capital @ 10% p.a. even if there is a loss

Same treatment as done is (D) Part.

DR. PROFIT & LOSS A/C CR.

Particulars		₹	Particulars		₹
To Net Loss (before Adjustments)		2,000	By Loss transferred to :		
To Interest on Capital			X's Capital A/c (2/3)	6,000	
X	4,000		Y's Capital A/c (1/3)	3,000	9,000
Y	3,000	7,000			
		9,000			9,000

Note. In case (D) and (E) Profit and Loss A/c is opened because interest on capital is treated as a charge.

INTEREST ON CAPITAL WHEN OPENING BALANCE OF CAPITAL IS MISSING

Usually interest on capital is calculated on the opening balance of capital account. The opening balance of capital may be missing in certain cases. The following is the procedure to calculate opening balance of capital.

Procedure to Calculate Opening Capital	₹
Closing balance of capital	....
Add : Drawings made during the year..	....
Add : Interest on Drawings..	....
Add : Losses debited to capital..	....
Less : Profits credited to capital..	....
Less : Additional capital introduced during the year..	....
Opening capital	....

Infact, in the above procedure, only the procedure of calculating closing capital is reversed.

Procedure of Calculating closing Capital

		₹
	Opening Capital	
Add :	Additional Capital introduced	
Add :	Profit credited to capital	
Less :	Losses debited to capital	
Less :	Interest on drawings	
Less :	Drawings made during the year	
	Closing Capital	

ILLUSTRATION 19. **(Interest on Capital/Opening Capital Missing)** Plant and Seed are partners in 2 : 1 ratio. Their capital on 31st March, 2019 was ₹ 6,00,000. Plant's capital was one and half times more than that of Seed. Profit ₹ 60,000 was credited to them for the year. Their drawings were ₹ 30,000 and ₹ 10,000 respectively. Plant had contributed ₹ 40,000 on 31st March, 2019. Interest on capital @ 10% p.a. has been omitted. Calculate opening capital and interest there on.

Solution

CALCULATION OF OPENING CAPITAL

Particulars	*Plant* ₹	*Seed* ₹
Closing Capital **(WN1)**	3,60,000	2,40,000
Add Drawings	30,000	10,000
	3,90,000	2,50,000
Less : Profit (60,000 in 2 : 1)	40,000	20,000
Less : Additional Capital	40,000	—
Opening Capital	3,10,000	2,30,000
Interest on Capital 10%	31,000	23,000

Working Notes :

1. Closing Capital of Plant & Seed

Total Capital ₹ 6,00,000

Let Capital of Seed $= a$

$\therefore$ Capital of Plant $= a \times 1.5 = 1.5a$

$\therefore a + 1.5a = 6{,}00{,}000$

$2.5\,a = 6{,}00{,}000$

a i.e. capital of seed $= \dfrac{6{,}00{,}000}{2.5}$

$= 2{,}40{,}000$

$\therefore$ Capital of Plant $= 2{,}40{,}000 \times 1.5$

$= 3{,}60{,}000$

ILLUSTRATION 20. **(Gain to partners with and without interest).** A, B and C are partners with capitals of ₹ 20,000, ₹ 10,000 and ₹ 6,000 respectively and share profits and losses equally. The net profit for the year 2019 before charging interest on capital amounted to ₹ 10,800. Show the amount of each partners gain from the firm.

(a) if no interest is calculated on capital and

(b) where 5% interest on capital is brought into account, before adjustment of profits.

Solution

(a) If no interest is calculated on capital

The profits prior to the calculation of interest on capital will be divided as under :

A = 1/3rd of ₹ 10,800 = ₹ 3,600

B = 1/3rd of ₹ 10,800 = ₹ 3,600

C = 1/3rd of ₹ 10,800 = ₹ 3,600

(b) When 5% interest on capital's brought into account before adjustment of profits

Where interest on capital is calculated prior to division of profits, the profit and loss appropriation account will appear thus.

DR. PROFIT AND LOSS APPROPRIATION ACCOUNT CR.

Particulars		₹	Particulars	₹
To Interest on Capitals :			By Profit & Loss A/c	10,800
A (20,000 × 5/100)	1,000		(Profit for the year)	
B (10,000 × 5/100)	500			
C (6,000 × 5/100)	300	1,800		
To Net profit transferred to Capital A/c :				
A (1/3)	3,000			
B (1/3)	3,000			
C (1/3)	3,000	9,000		
		10,800		10,800

Therefore, after calculation of interest on capital, the total gain for each partner will be as follows :

Particulars	Interest ₹	Profit ₹	Total ₹
A	1,000	3,000	4,000
B	500	3,000	3,500
C	300	3,000	3,300

ILLUSTRATION 21. **(Interest on Capital/Preparation of Revised Capital Account)** Ram and Preet were partners in 7 : 3 ratio. Their capitals as on 31st March, 2019 were
₹ 2,50,000, of which Ram's share was 50% more than the share of Preet. The firm earned profit of ₹ 40,000 (before allowing interest on capital @ 10% but after allowing salary ₹ 8,000 to Ram, and ₹ 12,000 to Preet. Drawing of Partners were ₹ 13,000 and ₹ 7,000 respectively. Interest on drawings charged was ₹ 300 (Ram) and ₹ 200 (Preet).

You are required to calculate interest on capital and prepare revised capital account.

Solution

CALCULATION OF OPENING CAPITAL AND INTEREST ON CAPITAL

Particulars	Ram ₹	Preet ₹
Closing Capital (150 :100)	1,50,000	1,00,000
Less : Profit ₹ 40,000 (7:3)	28,000	12,000
Less : Salary	8,000	12,000
	1,14,000	76,000
Add: Drawings	13,000	7,000
Add : Interest on Drawings	300	200
Opening Capital	1,27,300	83,200
Interest on Capital @10%	12,730	8,320

REVISED PROFIT AND LOSS APPROPRIATION ACCOUNT

Particulars		₹	Particulars		₹
To Interest on Capital :			By Loss :		
Ram (10% of 1,27,300)	12,730		Ram (21,050 × 7/10)	14,735	
Preet (10% of 83,200)	8,320	21,050	Preet (21,050 × 3/10)	6,315	21,050
		21,050			2,1050

CAPITAL ACCOUNT

Particulars	Ram (₹)	Preet (₹)	Particulars	Ram (₹)	Preet (₹)
To Profit and Loss			By Balance b/d	1,50,000	1,00,000
Appropriation A/c (Share of Loss)	14,735	6,315	By Interest on Capital	12,730	8,320
To Balance c/d	1,47,995	1,02,005			
	1,62,730	1,08,320		1,62,730	1,08,320

ILLUSTRATION 22. **(Calculation of Interest on Capital when Balance Sheet is Given)**

A and B are Partners. The Balance Sheet as at 31st March 2017 is given below :

BALANCE SHEET AS AT 31ST MARCH 2017

Liabilities	₹	Assets	₹
A's Capital	50,000	Sundry Assets	1,00,000
B's Capital	30,000		
Profit and Loss Appropriation A/c (for the year 2016-17)	20,000		
	1,00,000		1,00,000

During the year, the drawings of B were ₹ 5,000 and Profit for year 2016-17 were ₹ 28,000. Calculate Interest on Capital of B @ 5% p.a.

Solution

Calculation of Interest on Capital of B

B's Capital (Closing)	30,000
Add : Drawing (Already Adjusted)	5,000
	35,000
Less : Profit already adjusted ½ × (₹ 28,000 – ₹ 20,000) **(WN1)**	4,000
B's Capital in the beginning	31,000

Interest on Capital for B @5% p.a. on ₹ 31,000.

Interest on Capital = ₹ 31,000 × 5/100

= **₹ 1,550**

Working Note :

1. Profit for the year are ₹ 28,000 whereas ₹ 20,000 profits are still appearing in Balance Sheet. It means only ₹ 8,000 (i.e. 28,000–20,000) profit have been distributed. Hence only ₹8,000 profits will be adjusted.
2. In the absence of any profit sharing ratio, profits and losses will be shared equally.

ILLUSTRATION 23. **(Calculation of Interest on Capital when Balance Sheet is Given)**

A and B are Partners their balance sheet as at 31st March 2017 is given below :

BALANCE SHEET
AS AT 31ST MARCH 2017

Liabilities	₹	*Assets*	₹
A's Capital	50,000	Sundry Assets	90,000
B's Capital	30,000	Drawing of A	6,000
Profit and Loss Appropriation A/c (for the year 2016–17)	20,000	Drawing of B	4,000
	1,00,000		1,00,000

During the year the drawings of A and B were ₹ 7,000 and ₹ 4,000 respectively. Profit for the year 2016-17 are ₹ 28,000. Calculate Interest on Capital of A and B @ 5% p.a.

Solution

CALCULATION OF INTEREST ON CAPITAL OF A AND B

	A (₹)	B (₹)
Closing Capital as per Balance Sheet	50,000	30,000
Add : Drawing Already Adjusted **(WN1)**	1,000	–
	51,000	30,000
Less : Profit Already Adjusted ½ of (₹ 28,000– ₹ 20,000) **(WN2)**	4,000	4,000
Capital in the beginning	47,000	26,000
Interest on Capital @ 5% p.a.	2,350	1,300

Working Notes :

1. Drawings of A and B are ₹7,000 and ₹4000 respectively whereas given in Balance Sheet are ₹6000 and ₹4000 respectively. Drawings shown in Balance Sheet indicate that they are still not adjusted from capital. Hence they are not to be added back for calculating

opening capital. In this case, Drawings adjusted are 7,000-6,000 = ₹1,000 and ₹ (4000-4000) = NIL for A and B respectively. Only ₹1000 is to be added back for A.

2. Just like drawings, Profits of ₹ 20,000 are not adjusted because they are still appearing in Balance Sheet. Hence out of ₹28000 profits for current year, only ₹8,000 i.e. (28,000–20,000) profits are adjusted.
3. In the absence of profit sharing ratio, it will always be assumed as equal.

DRAWINGS ACCOUNT

Where withdrawls of money are made at frequent intervals, it is usual practice to open 'Drawing Account' for each partner. This facilitates in keeping the capital and current account uncongested. The drawing account, at the end of the year is transferred to capital or current account.

Drawing in the Form of Goods. Sometimes, partners withdraw goods from business for their personal use. It helps them to have the goods at cost price. The accounting treatment for the goods withdrawn by partner for personal use is very simple. The 'Drawings Account' is debited and 'Purchases Account' is credited with the amount of goods withdrawn. *It should be remembered that Sales Account is never credited when the goods are withdrawn for personal use.* One more thing which students should always keep in mind is that the Drawings Account is never charged against the profits. Drawings whether in the form of cash or goods must be debited to the Capital Account or Current Account.

INTEREST ON DRAWINGS

Interest on drawings is charged from the partners at the fixed rate written in the partnership deed. In the absence of this clause in the partnership deed no interest is charged on drawings.

Interest on drawings is the income of the firm and is an expense for the partner. Usually it is not received by the firm in cash. It is important to note that if the drawings of the partners are not in their mutual profit sharing ratio, one partner may overdraw and gain at the cost of others. Therefore, to avoid this, interest on drawings is charged so that one who draws more would not gain and is brought at par with the partner whose drawings are less.

It is calculated on the amount of cash and goods withdrawn by the partners for their personal use. Partners are entitled to make drawings from the business against their claim of salaries, commission, interest on capital etc. In addition to this, they can withdraw money from business in anticipation of their share of profits to be earned by the business during the accounting period.

Remembering (Knowledge Based)

Q. What is the purpose of interest on drawings ?

Ans. If the drawings of the partners are not in their mutual profit share ratio one partner may overdraw and gain at the cost of others. Therefore, to avoid this, interest on drawings is charged so that one who draws more would not gain and is brought at par with the partner whose drawings are less. Secondly, the interests on drawing keeps a check on unnecessary drawing and this helps in out flow of funds.

ACCOUNTING TREATMENT

(i) For Drawings :

Partner's Drawings A/c Dr.
    To Cash/Purchases A/c

Note. Students should note that 'Drawings Account' is a personal account.

(ii) For Interest on Drawings :

Partner's Drawings/Current A/c Dr.
    To Interest on Drawings A/c

(iii) For transfer of interest on drawings to Profit & Loss Appropriation Account :

Interest on Drawings A/c Dr.
    To Profit & Loss Appropriation A/c

Methods of Calculating Interest on Drawings :-

Interest on drawings may be calculated from any of the two methods discussed as below :-

(1) Simple Method :- Under this method, interest on drawing is calculated separately on each amount of drawing, from the date of drawing till the close of accounting period. Interest on each amount of drawing is calculated with the help of the follwing formula :

$$\text{Interest on Drawings} = \text{Amount of Drawings} \times \frac{\text{Rate of Interest}}{100} \times \frac{\text{Total Months}}{12}$$

(2) Product Method :- Under this method, products are calculated by multiplying the each set of drawings with its duration. Thereafter, the different products are added and the interest is calculated on the total of products so arrived at for one month. The advantage of this system is that separate calculations are not required each time. Following formula is used for the calculation of interest under this method :-

$$\text{Interest on Drawings} = \text{Total of products} \times \frac{\text{Rate of Interest}}{100} \times \frac{1}{12}$$

Note : With both the methods, amount of interest will remain same.

Important Fact: Whenever interest on drawing's given withoutstanding words "per annum" or "p.a." It is always calculated for full year.

CALCULATION OF INTEREST ON DRAWINGS

The partners may make drawings from the firm in different manners. Interest on drawings under different situations may be calculated as follows :

$$\text{Interest on Drawings} = \text{Total Drawings} \times \frac{\text{Rate of Interest}}{100} \times \frac{\text{Average Period}}{12}$$

$$\text{Average Period} = \frac{\text{Time left after first drawings} + \text{Time left after last drawings}}{2}$$

(1) When a Fixed Amount is Withdrawn on the First Day of Every Month :

If a partner withdraws a fixed amount on the first day of every month then interest on total amount of drawings is calculated for 6½ months.

$$\text{Interest on Drawings} = \text{Total Drawings} \times \frac{\text{Rate of Interest}}{100} \times \frac{6\frac{1}{2}}{12}$$

Note. How the average period of 6½ months has been arrived at.

$$\frac{\text{Time left after first drawings + Time left after last drawings}}{2}$$

i.e. $\dfrac{\text{12 months + 1 month}}{2} = 6\dfrac{1}{2}$ months.

Note. Alternatively, $6\frac{1}{2}$ months is average of months from 12, 11, 10, 9, 8, 7, 6, 5, 4, 3, 2, 1÷12.

ILLUSTRATION 24. **(Withdrawl on First day of each Month)** Ranjit withdraws ₹ 1,000 pm. on the first day of every month during 2016-17 Interest on drawings is charged @ 12% p.a. Find out interest.

Solution

Total Drawings = ₹ 1,000 × 12
= ₹ 12,000

Interest on ₹ 12,000 @ 12% p.a. for $6\frac{1}{2}$ months will be calculated for $6\frac{1}{2}$ months as drawings are made evenly on the first day of every month as follows :

$$12{,}000 \times \frac{12}{100} \times \frac{6\frac{1}{2}}{12} = ₹\ 780.$$

Alternative Solution (Product Method)

CALCULATION OF INTEREST ON DRAWINGS

Date of Withdrawl	*Amount* ₹	*Period of Interest* (Upto March 31)	*Product i.e. Amount × Period* ₹
1-4-2016	1,000	12 Months	1,000 × 12 = 12,000
1-5-2016	1,000	11 Months	11,000
1-6-2016	1,000	10 Months	10,000
1-7-2016	1,000	9 Months	9,000
1-8-2016	1,000	8 Months	8,000
1-9-2016	1,000	7 Months	7,000
1-10-2016	1,000	6 Months	6,000
1-11-2016	1,000	5 Months	5,000
1-12-2016	1,000	4 Months	4,000
1-1-2017	1,000	3 Months	3,000
1-2-2017	1,000	2 Months	2,000
1-3-2017	1,000	1 Month	1,000
	12,000		78,000

$$\text{Interest on Drawings} = \text{Total of Products} \times \frac{\text{Rate of Interest}}{100} \times \frac{1}{12}$$

$$= ₹\ 78{,}000 \times \frac{12}{100} \times \frac{1}{12} = ₹\ 780.$$

(2) When a Fixed Amount is Withdrawn on the Last Day of Every Month :

If a partner withdraws a fixed amount on the last day of every month then interest on total amount of drawings is calculated for $5\frac{1}{2}$ months.

$$\frac{11 \text{ months} + \text{nil}}{2} = 5\frac{1}{2} \text{ months months.}$$

$$\frac{\text{Time left after first drawings} + \text{Time left after last drawings}}{2}$$

i.e. $\frac{12 \text{ months} + 1 \text{ month}}{2} = 6\frac{1}{2}$ months.

$$\text{Interest on Drawings} = \text{Total Drawings} \times \frac{\text{Rate of Interest}}{100} \times \frac{5\frac{1}{2}}{12}$$

Alternatively

If Product Method is followed

$$\text{Interest on Drawings} = \text{Total of Products} \times \frac{\text{Rate of Interest}}{100} \times \frac{1}{12}$$

ILLUSTRATION 25. **(Withdrawl on last day of each month)** Sushma Swaraj withdraws ₹ 2,000 on the last day of every month during the year 2016. Interest on drawings is charged @ 9% p.a. Calculate the amount of interest on Drawings.

Solution

Total Drawings = ₹ 2,000 × 12
= ₹ 24,000

Interest on ₹ 24,000 @ 9% p.a. for months will be calculated for $5\frac{1}{2}$ months as drawings are made evenly on the last day of every month be as follows :

$$24{,}000 \times \frac{9}{100} \times \frac{5\frac{1}{2}}{12}$$

$$24{,}000 \times \frac{9}{100} \times \frac{11}{2 \times 12} = ₹\ 990.$$

Alternative Solution (Product Method)

Date of Withdrawls	Amount ₹	Period of Interest (Upto Dec. 31)	Product i.e., Amount × Period
31-01-2016	2,000	11 Months	22,000
29-02-2016	2,000	10 Months	20,000
31-03-2016	2,000	9 Months	18,000
30-04-2016	2,000	8 Months	16,000
31-05-2016	2,000	7 Months	14,000
30-06-2016	2,000	6 Months	12,000
31-07-2016	2,000	5 Months	10,000
31-08-2016	2,000	4 Months	8,000
30-09-2016	2,000	3 Months	6,000

31-10-2016	2,000	2 Months	4,000
30-11-2016	2,000	1 Month	2,000
31-12-2016	2,000	0 Month	0
	24,000		1,32,000

Interest on Drawings $= \text{Total of Product} \times \dfrac{\text{Rate of Interest}}{100} \times \dfrac{1}{12}$

$= 1{,}32{,}000 \times \dfrac{9}{100} \times \dfrac{1}{12} = ₹\ 990.$

(3) When Withdrawls are Made with Different Amount on Different Dates :

In case a partner makes withdrawls from the business on different dates with different amount, the interest on drawings is **calculated on the basis of product method.** Each withdrawl is multiplied by the period from the date of withdrawl to the date of calculating the interest. The interest on drawing is calculated for one month by multiplying the product with rate of interest. The following illustration will make this point clear :

ILLUSTRATION 26. **(Withdrawls on different dates with different amounts)**
Sonu is a partner in a firm. He withdraws the following amounts during the year 2016-17.

Date	Amount ₹
01.06.2016	8,000
01.08.2016	12,000
30.09.2016	15,000
31.1.2017	22,000
31.03.2017	25,000

Interest on drawings is to be charged @ 10% p.a. by using product method.

Calculate the amount of Interest to be charged on Sonu's drawings for the year 2016-17.

Solution

Here the drawings are made on different dates and with different amounts. Therefore only product method can be used here.

INTEREST ON DRAWINGS (PRODUCT METHOD)

Date	*Amount ₹*	*Period from date of drawing to 31-3-2017 (Months)*	*Product*
01.06.2016	8,000	(June–Mar.) 10	8,000 × 10 = 80,000
01.08.2016	12,000	(Aug.–Mar.) 8	96,000
30.09.2016	15,000	(Oct.–Mar.) 6	90,000
31.1.2017	22,000	(Feb.–Mar.) 2	44,000
31.3.2017	25,000	0	0
			3,10,000

Interest on Drawings $= \text{Total of Product} \times \dfrac{\text{Rate of Interest}}{100} \times \dfrac{1}{12} = 3{,}10{,}000 \times 10/100 \times 1/12$

$= ₹\ \mathbf{2{,}583.33}$

(4) When withdrawals are made during the year and the dates are not given

When dates of withdrawal are not given and lumpsum amount of withdrawal made during the year is given, the interest on total drawings is **ascertained for six months** on average basis.

$$\text{Interest on Drawings} = \text{Total Drawings} \times \frac{\text{Rate}}{100} \times \frac{6}{12}$$

ILLUSTRATION 27. **(Date of withdrawal not mentioned)** Raghav and Raj are partners in 3:2 ratio. They made drawings of ₹ 60,000 in their profit ratio during the accounting year. Calculate interest on drawing @ 10% p.a.

Solution

Total drawings = ₹ 60,000

Raghav's Drawings $= 60{,}000 \times \frac{3}{5} =$ ₹ 36,000

Raj's Drawings $= 60{,}000 \times \frac{2}{5} =$ ₹ 24,000

Interest on drawings (on average basic)

Raghav $= 36{,}000 \times \frac{10}{100} \times \frac{6}{12} =$ ₹ 1,800

Raj $= 24{,}000 \times \frac{10}{100} \times \frac{6}{12} =$ ₹ 1,200

(5 & 6) When withdrawals of fixed amount are made on the beginning of each quarter and on the last date of each quarter

(5) Withdrawals on first day of each quarter.

$$\text{Interest on Drawings} = \text{Total Drawings} \times \frac{\text{Rate}}{100} \times \frac{7\frac{1}{2}\text{ months}}{12\text{ months}}$$

(6) Withdrawals on last day of each quarter

$$\text{Interest on Drawings} = \text{Total Drawings} \times \frac{\text{Rate}}{100} \times \frac{4\frac{1}{2}\text{ months}}{12\text{ months}}$$

ILLUSTRATION 28. **(Amount withdrawn on beginning/at end of each quarter)** X and Y are sharing profits equally. X withdrew ₹ 8,000 on 1st April, 1st July, 1st Oct. and 1st Jan. during the year 2016-17, where as Y withdrew ₹ 10,000 on 30th June, 30th Sep., 31st Dec. and 31st March during the same period. Calculate interest on drawings @ 12% p.a.

Solution

Interest on Drawings :

Partner X (Drawings at beginning of each quarter)

Total Drawings = ₹ 8,000 × 4 = ₹ 32,000

$$\text{Interest on Drawings} = ₹\ 32{,}000 \times \frac{12}{100} \times \frac{7\frac{1}{2}\text{ months}}{12} = ₹\ 2{,}400$$

Partner Y (Drawings at end of each quarter)

Total Drawings = ₹ 10,000 × 4 = ₹ 40,000

$$\text{Interest on Drawings} = 40{,}000 \times \frac{12}{100} \times \frac{4\frac{1}{2}\text{ months}}{12} = ₹\ 1{,}800$$

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(7) When fixed amount is withdrawn in the middle of each month. Interest on drawings in this case is calculatd on total drawings for six months.

(8) When fixed amount is withdrawn for six months on the first day of each month and interest is calculated for six months. Interest on drawings in this case is calculated on total drawings for a period of 3½ months.

(9) When fixed amount is withdrawn for six months on the last day of each month and interest is calculated for six months.

In this case, Interest on drawings is calculated for 2½ months on total drawings.

ILLUSTRATION 29. **(Different cases of Interest on Drawings)** W, X, Y and Z are partners. During the year 2018, W withdrew ₹ 1,000 at the beginning of each month, X withdrew ₹ 1,000 at the end of each month, Y withdrew ₹ 12,000 during the year and Z withdrew ₹ 3,000 on 31st January, ₹ 2,000 on 31st March, ₹ 4,000 on 1st July, ₹ 1,500 on 30th September and ₹ 2,500 on 1st November. Calculate the interest on drawings @ 10% p.a. for the year ended 31st December 2018.

Solution

$$\text{Interest on W's Drawings} = ₹\ 12{,}000 \times \frac{10}{100} \times \frac{6\frac{1}{2}}{12} = ₹\ 650 \text{ (Drawings at beginning of each month)}$$

$$\text{Interest on X's Drawings} = ₹\ 12{,}000 \times \frac{10}{100} \times \frac{5\frac{1}{2}}{12} = ₹\ 550 \text{ (Drawings at end of each month)}$$

$$\text{Interest on Y's Drawings} = 12{,}000 \times \frac{10}{100} \times \frac{6}{12} = ₹\ 600 \text{ (Date of Drawings not mentioned)}$$

Interest on Z's Drawings :

A Date	B Amount of Drawings	C Months for which amount has been withdrawn	Product D = B × C
January 31	3,000	11	3,000 × 11 = 33,000
March 31	2,000	9	2,000 × 9 = 18,000
July 1	4,000	6	4,000 × 6 = 24,000
September 30	1,500	3	1,500 × 3 = 4,500
November 1	2,500	2	2,500 × 2 = 5,000
			84,500

$$\text{Interest on Drawings} = ₹\ 84{,}500 \times \frac{10}{100} \times \frac{1}{12} = ₹\ 704.17$$

INTEREST ON DRAWINGS AT A GLANCE

	Situation	*Period of Interest*
Case 1	When Fixed amount is withdrawn on the first day of every month.	$6\frac{1}{2}$ months on total drawings.
Case 2	When fixed amount is withdrawn on the last day of every month.	$5\frac{1}{2}$ months on total drawings.
Case 3	When fixed amount is withdrawn in the middle of each month.	Six months interest on total drawings.
Case 4	Fixed amount is withdrawn in the beginning of each quarter.	$7\frac{1}{2}$ months on total drawings.
Case 5	Fixed amount is withdrawn at the end of each quarter.	$4\frac{1}{2}$ months on total drawings.
Case 6	When fixed amount is withdrawn for six months on the first day of every month and interest is calculated for six months.	$3\frac{1}{2}$ months on total drawings.
Case 7	When fixed amount is withdrawn for six months on the last day of every month and interest is calculated for six months	$2\frac{1}{2}$ months on total drawings.
Case 8	When different amount is withdrawn on different dates.	One month interest on total of product.
Case 9	When dates of withdrawls are not given.	Six months interest on total drawings.

ILLUSTRATION 30. **(Different cases of Interest on Drawings)** Partner 'P' has withdrawn the following amount during the year ended 2016-17. You are required to find *out interest on drawings @ 6% p.a.*

(1) ₹ 6,000 withdrawn on the last day each month during the first four months.

(2) During next six months, he withdrew ₹ 2,000 pm in the middle of every month.

(3) On 28-2-17, he withdrew ₹ 10,000.

Solution

Date of Drawings	*Amount*	*Period (Upto Mar. 31)*	*Product*
30-4-16	6,000	11 months	66,000
31-5-16	6,000	10 months	60,000
30-6-16	6,000	9 months	54,000
31-7-16	6,000	8 months	48,000
15-8-16	2,000	7.5 months	15,000
15-9-16	2,000	6.5 months	13,000
15-10-16	2,000	5.5 months	11,000
15-11-16	2,000	4.5 months	9,000
15-12-16	2,000	3.5 months	7,000
15-01-17	2,000	2.5 months	5,000
28-02-17	10,000	1 month	10,000
			2,98,000

$$\text{Interest on Drawings} = \text{Total of Product} \times \frac{\text{Rate of Interest}}{100} \times \frac{1}{12}$$

$$= 2,98,000 \times \frac{6}{100} \times \frac{1}{12}$$

$$= ₹\ 1,490$$

ILLUSTRATION 31. **(Interest on Drawings/Product Method)** Kanika and Gautam are partners doing a dry cleaning business in Lucknow, sharing profits in the ratio of 2 : 1 with capitals of ₹ 5,00,000 and ₹ 4,00,000 respectively. Kanika withdrew the following amounts during the year 2013-14 to pay the hostel expenses of her son.

	₹
1st April	10,000
1st June	9,000
1st Nov.	14,000
1st Dec.	5,000

Gautam withdrew ₹ 15,000 on the first day of April, July, October and January to pay rent for the accommodation of his family. He also paid ₹ 20,000 per month as rent for the office of partnership which was in a nearby shopping complex.

Calculate interest on Drawings @ 6% p.a. **(CBSE Sample Paper 2015)**

Solution

Calculation of Interest on Kanika's Drawings :

Date	Amount (₹)	Months (Upto March 31)	Product
1-4-2013	10,000	12	1,20,000
1-6-2013	9,000	10	90,000
1-11-2013	14,000	5	70,000
1-12-2013	5,000	4	20,000
			3,00,000

Interest on Kanika's Drawings = ₹3,00,000 × 6% × 1/12 = ₹ 1,500

Calculation of Interest on Gautam's Drawings :

Date	Amount (₹)	Months	Product
1-4-2013	15,000	12	1,80,000
1-7-2013	15,000	9	1,35,000
1-10-2013	15,000	6	90,000
1-1-2014	15,000	3	45,000
			4,50,000

Interest on Gautam's Drawings

$$= \text{Total of Product} \times \frac{\text{Rate of Interest}}{100} \times \frac{1}{12}$$

$$= 4,50,000 \times \frac{6}{100} \times \frac{1}{12} = ₹\ 2,250$$

Alternatively,

Interest on Gautam's drawings can be calculated by using direct method as follows :

$$\text{Interest on Gautam's Drawings} = \text{Total Drawings} \times \text{Rate of Interest} \times \frac{7.5}{12}$$

$$= 60{,}000 \times 6\% \times \frac{7.5}{12}$$

$$= ₹\ 2{,}250$$

Note. 1. $7\frac{1}{2}$ month is used as drawings are made on 1st day of every quarter.

2. Amount paid by Gautam ₹ 20,000 p.m. for the rent of office of partnership are not drawings because it is a business expenditure. Hence question of interest does not arise on this amount.

ILLUSTRATION 32. **(Interest on Capital as a Charge/Interest on Drawings)** Lalan and Balan were partners in a firm sharing profits in the ratio of 3:2. Their fixed capital on 1.4.2010 were Lalan ₹ 1,00,000 and Balan ₹ 1,50,000. They agreed to allow interest on capital @ 12% per annum and to charge on drawings @ 15% per annum. The firm earned a profit, before all above adjustments of ₹ 30,000 for the year ended 31.3.2011. The drawings of Lalan and Balan during the year were ₹ 3,000 and ₹ 5,000 respectively. Prepare Profit and Loss Appropriation Account of Lalan and Balan. The Interest on capital will be allowed even if the firm incurs a Loss.

Solution

PROFIT AND LOSS APPROPRIATION ACCOUNT

Particulars		₹	*Particulars*		₹
To Interest on Capital A/c :			By Profit and Loss A/c		30,000
Lalan's Current A/c (1,00,000 × 12/100)	12,000		(Profit for the year before Interest on		
Balan's Current A/c (1,15,000 × 12/100)	18,000	30,000	Capital & Drawings)		
To Net Profit		Nil	Profit & Loss Appropriation A/c		
			By Profit & Loss A/c (Profit for the year)		Nil
To Profit tfd to :			By Interest on Drawings A/c :		
Lalan's Current A/c (3/5)	360		Lalan's Current A/c (3,000×15/100×6/12)	225	
Balan's Current A/c (2/5)	240	600	Balan's Current A/c (5,000×15/100×6/12)	375	600
		600			600

Working Note :

4. In the absence of date of drawings, Interest on drawings has been charged for 6 months.
5. Capitals are fixed, hence amounts are transferred to Partner's Current A/c.

ILLUSTRATION 33. **(Interest on Capital/Interest on Drawings/Transfer to Reserve)** Vandana and Pinky are partners in a firm sharing profits and losses equally. On 1st

April, 2016, the capitals of the partners were : Vandana ₹ 2,00,000 and Pinky ₹ 1,00,000. The Profit and Loss Appropriation Account of the firm showed a net profit of ₹ 5,00,000 for the year ended 31st March 2017.

The term of partnership Deed provided the following:

(i) Interest on capitals @5% per annum.

(ii) Interest on drawings @ 5% per annum. Drawing being Vandana ₹ 40,000 and Pinky ₹ 20,000.

(iii) Transfer 10% of distributable profits to reserve fund.

Prepare Profit and Loss Appropriation Account for the year ended 31st March 2017.

Solution

PROFIT AND LOSS APPROPRIATION ACCOUNT
FOR THE YEAR ENDING 31ST MARCH 2017

Particulars		₹	*Particulars*	₹
To Interest on Capital A/c :			By Profit and Loss A/c (Profit for the year)	5,00,000
Vandana's (2,00,000×5/100)	10,000		By Interest on Drawing A/c : **(W.N1)**	
Pinky's (1,00,000 × 5/100)	5,000	15,000	–Vandana's 40,000 × 5/100 × 6/12	1,000
To Reserve fund A/c **(WN2)**		48,650	–Pinky's 20,000 × 5/100 × 6/12	500
To Profit transferred to partners capital A/c				
Vandana (1/2)	2,18,925			
Pinky (1/2)	2,18,925	4,37,850		
		5,01,500		5,01,500

Working Notes :

1. In the absence of date of drawings, Interest on drawings has been calculated on an average basis for 6 months.

2. **Calculation of Amount transferred to Reserve fund**

Distributable Profits = Profit + Interest on Drawing – Interest on Capital

= ₹5,00,000 + ₹ 1,000 + ₹ 500 – ₹ 10,000 – ₹ 5,000 = ₹ 4,86,500

Amount Transferred to Reserve fund = ₹ 4,86,500 × 10/100 = **₹48,650**

ILLUSTRATION 34. **(Interest on Capital & Interest on drawings)** A and B are partners in a firm in 3:2 ratio. A has capital of ₹ 40,000 and B ₹ 90,000 on 1-4-16. A contributed additional capital ₹ 10,000 on 30-6-16. It was further decided that with effect from 1-1-17 both the partners will have capital ₹ 80,000 each. Apart from the above adjustments, A withdrew ₹ 2,000 at the end of each quarter for personal use where as B withdrew ₹ 1,500 at the beginning of each quarter commencing from 1-4-16.

Interest on capital is to be allowed at 9% pa while on drawings, interest is to be charged at 6% pa. Profits for the year before above adjustments were ₹ 30,000. Prepare Profit & Loss Appropriation Account and Capital Account of partners for the year 2016-17.

Solution

DR. **PROFIT & LOSS APPROPRIATION ACCOUNT** **CR.**

Particulars		₹	Particulars		₹
To Interest on Capital : (*WN1*)			By Profit b/d		30,000
A	4,950		By Interest on drawings : (*WN2*)		
B	7,875	12,825	A	180	
To Profit Transferred to :			B	225	405
A's Capital (3/5 × 17,580)	10,548				
B's Capital (2/5 × 17,580)	7,032	17,580			
		30,405			30,405

DR. **CAPITAL ACCOUNT** **CR.**

Particulars	A	B	Particulars	A	B
To Cash A/c (Withdrawn Permanently)	–	10,000	By Balance b/d	40,000	90,000
			By Cash A/c (Additional capital)	10,000	
To Drawings (Normal Drawings)	8,000	6,000	By Cash A/c (Additional capital)	30,000	–
To Interest on Drawings **(WN2)**	180	225	By Interest on Capital **(WN1)**	4,950	7,875
To Balance c/d	87,318	88,682	By Profit & loss App. A/c	10,548	7,032
	95,498	1,04,907		95,498	1,04,907

Working Notes :

(1) Interest on capital :

A : On ₹ 40,000 for 3 months (from 1-4-2016 to 30-6-2016)

40,000 × 3/12 × 9/100 = 900

On ₹ 50,000 (i.e. 40,000 + 10,000 for 6 months (from 1-7-2016 to 31-12-2016)

50,000 × 6/12 × 9/100 =2,250

On ₹ 80,000 for 3 months (from 1-1-2017 to 31-3-2017)

80,000 × 3/12 × 9/100 = 1,800

4,950

B : On ₹ 90,000 for 9 months (from 1-4-2016 to 31-12-2016)

90,000 × 9/12 × 9/100 = 6,075

On ₹ 80,000 for 3 months (from 1-1-2017 to 31-3-2017)

80,000 × 3/12 × 9/100 = 1,800

7,875

(2) Interest on Drawings :

A : Total drawings : 2,000 × 4 = ₹ 8,000

(Interest is to be calculated for $4\frac{1}{2}$ months (as the drawings are made at end of each quarter)

$$8,000 \times \frac{6}{100} \times \frac{4.5}{12} = ₹\ 180$$

B : Total drawings 1,500 × 4 = ₹ 6,000

(Interest is to be calculated for $7\frac{1}{2}$ months i. e. $\frac{12\text{ months} + 3\text{ months}}{2}$)

(as the drawings are made at beginning of each quarter)

$$6,000 \times \frac{6}{100} \times \frac{7.5}{12} = ₹\ 225$$