CHAPTER 1

Accounting for Partnership Firms—Fundamentals

Learning Objectives

- Partnership: Meaning, Features; Rights and Duties of Partners.
- Partnership Deed: Meaning, Contents, Rules in the Absence of Partnership Deed.
- Distribution of Profits among Partners—Profit and Loss Appropriation Account.
- Treatment of Interest on Partners' Loan.
- Partners' Capital Accounts—Fixed and Fluctuating—Its difference.
- Interest on Partners' Capital—General Rules
- Interest on Drawing of Partners—Drawing against Profit and Drawing against Capital.
- Partners' Salary/Commission.
- Questions Based on Profit and Loss Appropriation Accounts.
- Past Adjustments/Adjustments in Closed Accounts.
- Guarantee of Minimum Profit to a Partner.

We all know that sole proprietorship form of business is the oldest and the simplest form of business. In these businesses, only one man invests capital, manages the business and is responsible for the whole affairs of the business. This form of business has limited capital, skill, risk taking capacity and managerial ability. To resolve these limitations, two or more persons enter into an agreement to form a partnership so as to enhance capital, skill, risk taking capacity and managerial ability.

Meaning of Partnership

As per Section 4 of the Indian Partnership Act, 1932, partnership is defined as :

"Partnership is the relation between persons who have agreed to share the profits of a business carried on by all or any of them acting for all."

The persons who have agreed to form partnership business, are individually called as 'partners' and collectively as 'firm' and the name under which they are carrying on the business is called 'firm name'.

As per partnership Act, 1932, partnership firm has no separate legal entity.

Features or Characteristics or Elements of Partnership

The essential features of partnership are as under:

1. Association of two or more persons. The partnership is an association of two or more persons who have agreed to run the business and share its profit. The Indian Partnership Act is silent about the maximum number of partners, however, the Indian Companies Act, 2013 limits the number of partners to 50 [Sec. 464 read along with Rule No. 10 of Companies (Miscellaneous) Rule, 2014]. The partnership firm becomes illegal if the number of partners exceeds this limit.

2. Agreement. The partnership is the result of an agreement, either written or oral. The agreement is the basis of their rights and duties. This relationship may exist for a particular venture, for a specific period or at will. The agreement among partners if written is termed as 'Partnership Deed'.

3. Business. The agreement among partners must be for carrying on some lawful business and to earn profit. Mere joint ownership of some property is not a business. They are co-owners and not partners as their motive is not to earn profit on recurring basis.

4. Sharing of Profit. The partnership is the relation between partners who have agreed to share the profit of the business. Usually, partners also share losses as well but it is not essential that all the partners must share the losses also. They may have provision in the partnership deed that a particular partner/partners shall not bear the loss of the firm.

5. Business Carried on by all or any of them acting for all. The business of partnership firm may be carried on by all the partners or by any one of them acting for all. It means that one partner is acting as an agent of the firm and all the partners are bound by the act of a partner who is acting as an agent of the partnership firm.

R Rights of Partners

Partners have the following rights:

1. Right to take part in the management of the business.
2. Right to inspect books of accounts.
3. Right to share profits or losses of the business in the agreed ratio. In the absence of an agreement, every partner will share profits or losses equally.
4. No new partner can be admitted without the consent of the existing partners.
5. Every partner has a right to retire from the firm after giving due notice.
6. If any partner incurs expenses for the business, he has a right to be indemnified by the firm.
7. If any partner has advanced loan to the firm besides his capital, he has a right to receive interest on loan at the agreed rate. He will get interest on loan @ 6% p.a. in the absence of any written agreement.
8. Right to be consulted about the affairs of the business.

R Duties of Partners

1. Every partner should devote due time in the business.
2. Every partner should carry on the business of the firm diligently.
3. No partner should engage himself in competitive business.
4. Every partner should act within the authority.
5. It is the duty of a partner to indemnify the firm for his willful negligence.
6. It is the duty of each partner to use the property of the firm for the partnership firm.

Partnership Deed

A partnership is based on agreement. It is, therefore, necessary that terms and conditions of the partnership be agreed upon among all the partners. These terms and conditions may either be oral or written. Both are eqully enforceable by law, however, the written agreements are always better to resolve the misunderstanding and disputes, if any at a later date. Such a written agreement signed by all the partners and duly stamped as per Stamp Act, 1889 is called **'Partnership Deed'** or **'Articles of Partnership'.**

Thus, partnership deed is a document prepared with the mutual consent of all partners, containing all the details of the partnership agreement. The deed must be signed by all the partners and should be duly stamped.

Contents of Partnership Deed

1. **Name and address of the firm.**
2. **Names and addresses of partners.**
3. **Nature of business.** Which the firm proposes to carry.
4. **Capital Contribution.** Amount of capital to be contributed by each partner.
5. **Interest on Capital.** Whether interest on capital be allowed or not, if yes, the rate of interest to be allowed.
6. **Interest on Drawings.** Whether interest to be charged on partners' drawings or not, if yes, the rate of interest to be charged.
7. **Profit Sharing Ratio.** Ratio in which profits or losses of the firm be shared by partners.
8. **Interest on Partner's Loan.** If a partner advances loan to firm, rate of interest to be given on loan.
9. **Salary/Commission.** Whether any salary or commission be allowed to partners or not. If yes, how much ?
10. **Accounting Period.** Date on which accounts shall be closed every year.
11. **Rights and Duties of Partners** be decided clearly.
12. **Auditing of Accounts.** Whether accounts of the firm shall be subject to audit or not. If yes, mode of appointment.
13. **Operation of Bank Account.** Whether bank account shall be operated by a single partner or jointly by partners.
14. **Goodwill.** Manner in which goodwill of the firm be valued in case of admission or retirement or death of a partner.
15. **Valuation of Assets.** Method of valuation of assets in case of admission or retirement or death of a partner.
16. **Duration of Partnership.** Period of partnership, if any. If the partnership is at will, duration of notice required by a retiring partner.
17. **Settlement of Dispute.** In case of dispute among partners, how will it be resolved?
18. **Settlement in case of dissolution of firm.** The manner in which accounts will be settled in case of dissolution of firm. Whether the decision of Garner *Vs.* Murray will apply in case of insolvency of a partner or not?

19. **Settlement of Accounts in case of retirement or death of a partner.** Manner in which amount due on retirement or death of a partner will be computed and paid.
20. **Rules to be followed while admitting a partner.**

R Rules Applicable in the Absence of Partnership Deed

In the absence of partnership deed or if it is silent in respect of the following matters, the provisions of Indian Partnership Act, 1932 shall apply which are as under:

1. Profit Sharing Ratio	Profits/losses are to be shared equally.
2. Interest on Capital	No interest on capital is paid. Even if there is a provision to pay interest on capital, it is paid only when there is a profit.
3. Interest on Drawing	No interest is charged on drawing of partners.
4. Interest on Partners' Loan	Interest is paid @ 6% p.a. even if there is a loss.
5. Salary/Commission to a Partner	No Salary/commission is paid for the conduct of business to any partner.
6. Admission of a Partner	No new partner can be admitted without the consent of the existing partners.

R Some other Provisions of Partnership Act, 1932

1. Registration of Firm. The registration of partnership firm is optional. It is not compulsory as per Partnership Act, 1932

2. Minor as a Partner. A minor can be admitted as a partner with the consent of all the existing partnes. [Sec. 30]

3. Liabiliy of Partners. In case of partnership, the liability of each partner is unlimited. It means that loss of partnership firm will be met first of all by the partners out of their capital and thereafter out of their personal property. Thus, liability of partners is always unlimited.

4. Sleeping Partner. In a partnership firm, it is not necessary that all the partners remain active. One or more partners may be admitted as sleeping partners. They will contribute their capital for agreed share of profit. However, the profit sharing ratio of all the partners will remain equal in the absence of partnership deed.

5. Interest on Capital of Partners. Interest on capital is paid to partners provided it is stated in the partnership deed and firm is earning profit. Interest on capital is never paid if the firm is incurring loss even though it is permissible in partnership deed. If the profit is inadequate to pay interest on capital, it will be paid to the extent of profit in the ratio of interest due to partners.

6. Following persons cannot be admitted as a partner:

(i) Persons of unsound mind/lunatic.

(ii) Insolvent persons.

(iii) Any individual disqualified by law.

(iv) Minor in normal course.

Example. Durga and Naresh were partners in a firm. They wanted to admit five more members in the firm. List any two categories of individuals other than minors who cannot be admitted by them. **(*C.B.S.E., 2017-AI*)**

Solution. Any two of the following:

- Persons of unsound mind/Lunatic.
- Insolvent persons.
- Any other individual who has been disqualified by law.

Following illustrations will help in understanding the treatment of above concepts *i.e.*, application of rules in the absence of partnership deed.

R **Illustration 1.** Alka, Barkha and Charu are partners in a firm having no partnership agreement. Alka, Barkha and Charu contributed ₹ 2,00,000 ₹ 3,00,000 and ₹ 1,00,000 respectively. Alka and Barkha desire that profit should be divided in the ratio of capital contribution. Charu does not agree to this. How will you settle the dispute? **(*C.B.S.E., Sample Paper 2012-13 and 2013-14*)**

Solution. *(i)* Charu is correct.

(ii) Profits will be divided equally among partners in the absence of partnership deed.

R **Illustration 2(A).** The partnership deed is silent on payment of salary to partners. Anita, a partner claimed that since she managed the business, she should get a monthly salary of ₹ 10,000. Is she entitled for the salary? Give reasons.

(C.B.S.E. 2014-C)

Solution. Anita is not entitled for salary.

Reason. A partner is not entitled to claim any remuneration in the absence of provision in partnership deed.

R **Illustration 2(B).** A, B and C are partners in a firm. They do not have partnership deed. How will they resolve their dispute in the following cases?

(a) A contributed ₹ 20,000, B ₹ 30,000 and C ₹ 40,000 as capital. A wants that he should be given a salary of ₹ 1,000 p.m. while B wants to get commission of 5% on sales made by him.

(b) C advanced a loan of ₹ 50,000 to the firm and wants that he should be given interest on loan @ 12% p.a. which is the market rate.

(c) They want to get interest on their capital @ 6% p.a. and desire to divide the profit of the firm in the ratio of their capital

Solution. *(a)* In the absence of partnership deed, neither A is entitled to get any salary nor B is entitled to get any commission on sales made by him.

(b) C is entitled to get interest on loan advanced by him to the firm at 6% p.a.

(c) Partners are not entitled to get interest on capital. The profit will be divided equally among the partners and not in their capital ratio.

R **Illustration 3.** Amit and Sumit are partners with a capital of ₹ 1,00,000 and ₹ 1,50,000 respectively. On 1st January, 2016, Amit gave a loan amounting to ₹ 60,000 and Sumit introduced ₹ 50,000 as further capital. Profit of the year was ₹ 53,600. Both expect interest at 10% p.a. on loan and additional capital introduced. There is no partnership deed. How the profit should be divided? Give reasons.

Solution. *(i)* Amit is entitled to get interest on loan @ 6% p.a. but no interest will be paid on additional capital of Sumit.

(ii) Profit of the firm will be divided equally among the partners.

	(₹)
Total Profit of the firm	53,600
Less: Interest on loan to Amit ₹ 60,000 @ 6% p.a.	3,600
Balance Profit of the firm	50,000

Both Amit and Sumit will get ₹ 25,000 each as profit. (Profit will be divided equally among partners in the absence of partnership deed.)

R Distribution of profits among Partners: Profit and Loss Appropriation Account.

In case of sole proprietorship firm, net profit or net loss depicted by Profit and Loss Account is transferred to his capital Account. But in case of partnership firm, it is the usual practice to transfer the net profit as per Profit and Loss Account to a newly opened account, namely **Profit and Loss Appropriation Account.** The profit is distributed among partners as per provisions of the partnership deed *i.e.,* interest on capital, interest on drawing, salary to partner, commission to partner are shown in it and thereafter, profit is distributed among partners in the agreed ratio. **In the absence of partnership deed, profits are distributed equally among partners according to provisions of Indian Partnership Act, 1932.**

R Features of Profit and Loss Appropriation Account

Following are the features of Profit and Loss Appropriation Account:

(*i*) It is a nominal account.

(*ii*) It is an extension of Profit and Loss Account to depict the appropriation of profit among the partners.

(*iii*) It is prepared by partnership firms.

(*iv*) It discloses the appropriation of accounting profit among partners of the firm.

(*v*) The entries shown in Profit and Loss Appropriation Account are either based on partnership deed or based on Indian Partnership Act, 1932.

R Profit and Loss Appropriation Account

Profit and Loss Appropriation Account is, thus, an extension of the Profit and Loss Account. In case of partnership firm, it is an account showing distribution of profit among partners as per partnership deed or as per provisions of Indian Partnership Act, 1932.

Dr. **Specimen of Profit & Loss Appropriation Account** *Cr.*

Particulars	*(₹)*	*Particulars*	*(₹)*
To Interest on Partners' Capital		By Profit & Loss A/c	
To Partners' Salaries		(Profit transferred)	
To Partners' Commission		By Interest on Partners' Drawing	

To Reserves A/c To Profit transferred to Partners' Capital or Current A/c			

The journal entries passed for above transactions are as under:

1. Interest on Capital:

(i) **On allowing interest on capital.**

Interest on Capital A/c Dr.
  To Partners' Capital A/c

(ii) **On closure of interest on capital account.**

Profit & Loss Appropriation A/c Dr.
  To Interest on Capital A/c
(Interest on Capital A/cs are closed)

2. Interest on Drawings

(i) **On charging interest on drawings.**

Partners' Capital A/c Dr.
  To Interest on Drawings A/c

(ii) **On Closure of interest on drawings account.**

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

3. Salary/Commission Payable to Partners

(i) **On Allowing Salary/Commission.**

Partners' Salary/Commission A/c Dr.
  To Partners' Capital A/c

(ii) **On Closure of Salary/Commission A/c**

Profit & Loss Appropriation A/c Dr.
  To Partners' Salary/Commission A/c

4. Transferring Part of Profit to General Reserve.

Profit & Loss Appropriation A/c Dr.
  To General Reserve A/c

5. Distribution of Profit among Partners

Profit & Loss Appropriation A/c Dr.
  To Partners' Capital/Current A/c

Note: It should be noted that payment to partners such as interest on capital, salaries, commission, etc. are appropriation of profit and not the charge against profit so these items will never come in Profit and Loss A/c. But interest paid on partner's loan or rent paid to a partner is a charge against profit so these items will come in Profit and Loss A/c.

Illustration 4. (No Partnership Deed)

X presents following Profit & Loss Appropriation Account to other partner, Y.

Profit & Loss Appropriation A/c

Dr. *for the year ending 31-3-2020* *Cr.*

Particulars		(₹)	*Particulars*	(₹)
To X's Salary		7,000	By Profit & Loss A/c (Net Profit)	33,600
To Y's Commission		4,000	**By Interest on Drawings**	
To Interest on Capital:			X @ 6%	1,000
X—on 40,000 @ 6%		2,400	Y @ 6%	600
Y—on 30,000 @ 6%		1,800		
To Interest on X's Loan @ 6%		6,000		
To Profit trans. to Capital A/cs:				
X—4/7	8,000			
Y—3/7	6,000	14,000		
		35,200		35,200

There is no partnership deed. Y feels that he is not treated properly. Point out the violations of law if any and redraw the Profit & Loss Appropriation A/c in case it has not been drawn properly.

Solution. The account presented by X is not as per Indian Partnership Act, 1932 in the absence of partnership deed. Mistakes are as under:

(i) No Salary/Commission is allowed to any partner.

(ii) Interest on Capital is not allowed.

(iii) Interest on Drawing should not be charged.

(iv) Profits be shared equally.

(v) Though Interest on partner's loan @ 6% has been charged correctly, yet it should have been charged to Profit & Loss A/c. as it is a charge against profit.

Thus, the correct Profit & Loss Appropriation A/c will be:

Profit & Loss A/c

Dr. *for the year ending 31-3-2020* *Cr.*

Particulars	(₹)	*Particulars*	(₹)
To Interest on X's Loan @ 6%	6,000	By Profit before Interest	33,600
To Net Profit	27,600		
	33,600		33,600

Profit & Loss Appropriation A/c

Dr. *for the year ending 31-3-2020* *Cr.*

Particulars		(₹)	*Particulars*	(₹)
To Profit trans. to Capital A/cs:			By Profit & Loss A/c (Net Profit)	27,600
X—½	13,800			
Y—½	13,800	27,600		
		27,600		27,600

Net Profit and Divisible Profit. The Profit and Loss Account of the firm reveals Net Profit as it has been arrived after charging all expenses which are in the nature of charge against profit.

Thereafter, Profit and Loss Appropriation Account is prepared. Partners' salaries, commission, interest on capital etc. are charged to it as an appropriation of profit. At last, the balance amount of profit is ultimately distributed among partners. It is called divisible profit.

Illustration 5. A and B are partners. The net divisible profit as per Profit and Loss Appropriation A/c is ₹ 2,50,000. The total interest on partners' drawing is ₹ 4,000. A's salary is ₹ 4,000 per quarter and B's salary is ₹ 40,000 per annum. Calculate the net profit/loss earned during the year.

(C.B.S.E. Sample Paper 2016 & 2017)

Solution. **Profit & Loss Appropriation A/c**

Dr. *for the year ending ....* *Cr.*

Particulars	*(₹)*	*Particulars*	*(₹)*
To A's Salary (₹ 4,000 × 4)	16,000	By Profit & Loss A/c (Profit)	
To B's Salary	40,000	**(Balancing Figure)**	**3,02,000**
To Profit transferred to Partners	2,50,000	By Interest on Drawings	4,000
	3,06,000		3,06,000

Ans. Net Profit earned during year is ₹ 3,02,000.

R **Interest on Partners' Loan to the Firm.** Every partner is entitled to interest on loan provided by him at an agreed rate. In the absence of partnership deed, interest on loan given by any partner be allowed @ 6% p.a. whether there is profit or loss in the partnership firm. **[Section 13*(d)*]**

Interest on partner's loan is a **Charge against profit and not an appropriation out of profits.** Thus, interest on partner's loan has to be paid whether firm is earning profit or not.

Accounting Treatment. Interest on partner's loan is an expense for the firm so it should be debited to Profit and Loss A/c.

Partner has given loan to the firm so interest on loan is a income of the concerned partner as a lender of the money. Hence, interest on loan is credited to Partner's Loan A/c and not to his Capital Account. **Thus, interest on partner's loan is a charge against profit so it is debited to Profit and Loss A/c and never to Profit and Loss Appropriation A/c.**

> **Note:** At the time of dissolution of partnership firm, repayment of Partner's Loan and interest thereon has a priority over the repayment of partner's capital so interest on partner's loan is credited to Partner's Loan A/c and never to his Capital A/c. **[Section 48], Indian Partnership Act, 1932.**

The entries passed are:

(i) **For Interest on Partners' Loan**

Interest on Partners' Loan A/c Dr.

To Partners' Loan A/c

(ii) **For Closure of Interest on Loan A/c**

Profit & Loss A/c Dr.

To Interest on Partners' Loan A/c

Distinction between Profit & Loss Account and Profit & Loss Appropriation Account

Profit and Loss Account	*Profit and Loss Appropriation A/c*
1. It is prepared after the preparation of Trading A/c.	1. It is prepared after the preparation of Profit and Loss A/c.
2. Profit & Loss Account is prepared to compute net profit or net loss of the business for an accounting year.	2. In case of partnership firm, profit is transferred to Profit & Loss Appropriation Account to distribute the profit of the accounting year among the partners.
3. Items debited to this account are expenses/losses and these are charge against profit.	3. Items debited to this account are appropriations of profit.
4. This account is prepared as per principle of matching concept.	4. Principle of matching concept is not followed while preparing this account.
5. This account does not have opening or closing balance of profit.	5. This account may have both opening as well as closing balance.
6. It is prepared by all the business concerns.	6. It is prepared by partnership firms.

Difference between Partner's Loan A/c and Partner's Capital Accounts

1. In case of dissolution of partnership firm, partner's loan along with interest thereon is payable in priority to capital account of partners.

2. In the absence of partnership deed, no interest is payable on capital of partners, however, interest @ 6% p.a. is payable on partner's loan.

3. Interest payable on partner's loan is a charge against profit so it is debited to Profit and Loss Account while interest on partner's capital (if payable as per terms of agreement) is an appropriation of profit so it is debited to Profit and Loss Appropriation Account.

Distinction between Charge Against Profit and Appropriation of Profit

Basis	*Charge Against Profit*	*Appropriation of Profit*
1. Nature	Deduction of expenses/losses are made from revenue to ascertain profit/loss of the firm.	It refers to transfer of profits to various heads.
2. Recording	Debited to Profit & Loss A/c.	Debited to P&L Appropriation A/c.
3. Examples	Interest on partner's loan, rent paid to partner, etc.	Interest on Capital paid to partners, salary/commission paid to partners, etc.
4. When prepared	Prepared even if there is a loss.	Prepared only when there is a profit.

Illustration 6(A). A and B entered into partnership on 1st April 2019 without any partnership deed. They introduced capitals of ₹ 5,00,000 and ₹ 3,00,000 respectively. On 31st October 2019, A advanced ₹ 2,00,000 by way of loan to the firm without any agreement as to interest.

The Profit and Loss Account for the year ended 31-3-2020 showed a profit of ₹ 4,30,000, but the partners could not agree upon the amount of interest on loan to be charged and the basis of division of profits.

Pass a journal entry for the distribution of the profit between the partners and prepare the Capital A/cs of both the partners and Loan A/c of 'A'.

(C.B.S.E., 2011-AI – modified)

Solution. In the absence of partnership deed, profit sharing ratio will remain equal and interest on loan of partner will remain @ 6% p.a.

Profit & Loss A/c

Dr. *for the year ending 31st March, 2020* *Cr.*

Particulars	(₹)	*Particulars*	(₹)
To Interest on A's Loan $\left(2,00,000 \times \frac{6}{100} \times \frac{5}{12}\right)$	5,000	By Profit before Interest on Partner's Loan	4,30,000
To Profit transferred to P&L Approp. A/c	4,25,000		
	4,30,000		4,30,000

Profit & Loss Appropriation A/c

Dr. *for the year ending 31st March, 2020* *Cr.*

Particulars	(₹)	*Particulars*	(₹)
To Profit trans. to Capital A/cs:		By Profit & Loss A/c (Profit)	4,25,000
A's Capital A/c	2,12,500		
B's Capital A/c	2,12,500		
	4,25,000		4,25,000

Dr. **Partners' Capital A/c** *Cr.*

Date	*Particulars*	*A*	*B*	*Date*	*Particulars*	*A*	*B*
2020		(₹)	(₹)	2019		(₹)	(₹)
March 31	To Balance c/d	7,12,500	5,12,500	April 1	By Bank A/c	5,00,000	3,00,000
				2020 March 31	By Profit & Loss Approp. A/c	2,12,500	2,12,500
		7,12,500	5,12,500			7,12,500	5,12,500

Dr. **A's Loan A/c** *Cr.*

Date	*Particulars*	(₹)	*Date*	*Particulars*	(₹)
31-3-20	To Balance c/d	2,05,000	31-10-19	By Bank A/c	2,00,000
			31-3-20	By Interest on Loan A/c	5,000
		2,05,000			2,05,000

Journal

Date	Particulars		L.F.	Dr. (₹)	Cr. (₹)
2020					
March 31	Profit and Loss Appropriation A/c	Dr.		4,25,000	
	To A's Capital A/c				2,12,500
	To B's Capital A/c				2,12,500
	(For profit distributed equally between A & B)				

Illustration 6(B). (Partnership deed)

A, B and C are partners in a business with capitals of ₹ 1,00,000, ₹ 80,000 and ₹ 60,000 respectively. The partnership deed provides the followings:

(i) B gets a salary of ₹ 1,000 p.m.

(ii) Interest on capital be provided @ 10% p.a.

(iii) C gets commission ₹ 4,000.

(iv) Interest on drawings—A ₹ 500, B ₹ 400 and C ₹ 300.

(v) Transfer to General Reserve ₹ 3,000.

(vi) Profits be divided in the ratio of their capital contributions.

The profit for the year ending 31st March, 2020 before taking above facts is ₹ 56,200.

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

Solution. **Journal**

Date	Particulars		L.F.	Dr. (₹)	Cr. (₹)
2020					
Mar. 31	Profit & Loss A/c	Dr.		56,200	
	To Profit & Loss Appropriation A/c				56,200
	(Profit transferred to P & L Appropriation A/c)				
I *(a)*	B's Salary A/c	Dr.		12,000	
	To B's Capital A/c				12,000
	(Salary due to partner B)				
I *(b)*	Profit & Loss Appropriation A/c	Dr.		12,000	
	To B's Salary A/c				12,000
	(Salary of B transferred to P & L Appropriation A/c)				
II *(a)*	Interest on Capital A/c	Dr.		24,000	
	To A's Capital A/c				10,000
	To B's Capital A/c				8,000
	To C's Capital A/c				6,000
	(For interest on capital due)				
II *(b)*	Profit & Loss Appropriation A/c	Dr.		24,000	
	To Interest on Capital A/c				24,000
	(Interest on Capital transferred to P & L Appro. A/c)				
III *(a)*	C's Commission A/c	Dr.		4,000	
	To C's Capital A/c				4,000
	(For commission due to C)				

III *(b)*	Profit & Loss Appropriation A/c	Dr.		4,000	
	To C's Commission A/c				4,000
	(For C's commission transferred to P & L Appro. A/c)				
IV *(a)*	A's Capital A/c	Dr.		500	
	B's Capital A/c	Dr.		400	
	C's Capital A/c	Dr.		300	
	To Interest on Drawings A/c				1,200
	(Interest on drawing charged to partners)				
IV *(b)*	Interest on Drawings A/c	Dr.		1,200	
	To Profit & Loss Appropriation A/c				1,200
	(Interest on drawing transferred to P & L Appro. A/c)				
V	Profit & Loss Appropriation A/c	Dr.		3,000	
	To General Reserve A/c				3,000
	(Transfer of profit to General Reserve)				
VI	Profit & Loss Appropriation A/c	Dr.		14,400	
	To A's Capital A/c				6,000
	To B's Capital A/c				4,800
	To C's Capital A/c				3,600
	(For profit transferred to Capital Account of partners in capital ratio *i.e.,* 5 : 4 : 3)				

Profit & Loss Appropriation A/c

Dr. *for the year ending 31st March, 2020* *Cr.*

Particulars		*(₹)*	*Particulars*		*(₹)*
To B's Salary A/c		12,000	By Profit & Loss A/c (Net Profit)		56,200
To Interest on Capital A/c:			By Interest on Drawings A/c:		
A	10,000		A	500	
B	8,000		B	400	
C	6,000	24,000	C	300	1,200
To C's Commission A/c		4,000			
To General Reserve A/c		3,000			
To Profit Trans. to Capital A/cs:					
A 5/12	6,000				
B 4/12	4,800				
C 3/12	3,600	14,400			
		57,400			57,400

R **Illustration 6(C).** D, E and F were partners in a firm sharing profits in the ratio of 5 : 7 : 8. **Their fixed capitals were D ₹ 5,00,000. E ₹ 7,00,000 and F ₹ 8,00,000.** Their partnership deed provided for the following:

(i) Interest on capital @ 10% p.a.
(ii) Salary of ₹ 10,000 per month to F.
(iii) Interest on drawings @ 12% p.a.

D withdrew ₹ 40,000 on 31-1-2019; E withdrew ₹ 50,000 on 31-3-2019 and F withdrew ₹ 30,000 on 31-12-2019.

During the year ended 31-12-2019, the firm earned a profit of ₹ 3,50,000.

Prepare Profit and Loss Appropriation Account for the year ended 31-12-2019. ***(C.B.S.E., 2010-C – modified)***

Solution. **Profit & Loss Appropriation A/c**

Dr. *for the year ending 31st December, 2019* *Cr.*

Particulars		*(₹)*	*Particulars*	*(₹)*
To Interest on Capital A/c:			By Profit & Loss A/c (Net Profit)	3,50,000
D's Current A/c	50,000		By Interest on Drawings A/c:	
E's Current A/c	70,000		D's Current A/c	
F's Current A/c	80,000	2,00,000	(40,000 × 12/100 × 11/12)	4,400
To F's Current A/c (Salary)		1,20,000	E's Current A/c	
To Profit Transferred to:			(50,000 × 12/100 × 9/12)	4,500
D's Current A/c				
(₹ 38,900 × 5/20)	9,725			
E's Current A/c				
(₹ 38,900 × 7/20)	13,615			
F's Current A/c				
(₹ 38,900 × 8/20)	15,560	38,900		
		3,58,900		3,58,900

Note: In case of fixed capital of partners, appropriation of profit will be made in the current account of partners.

R **Illustration 7.** X and Y are partners sharing profits in the ratio of 3 : 2. Their partnership deed provided for allowing interest on capital @ 10% p.a. and charging interest on drawings @ 12% p.a. The incomplete Profit and Loss Appropriation Account for the year ended 31st March, 2019, partners capital and current accounts are given below:

Profit and Loss Appropriation A/c

Dr. *for the year ended 31st March, 2019* *Cr.*

Particulars		*(₹)*	*Particulars*		*(₹)*
To Interest on Capital:			By Profit and Loss A/c		
X's Current A/c	…………		Net Profit b/d		…………
Y's Current A/c	…………	…………	By Interest on Drawings:		
To Salary			X's Current A/c	…………	
Y's Current A/c		…………	Y's Current A/c	…………	…………
To Profit transferred to:					
X's Current A/c	1,20,000				
Y's Current A/c	…………	…………			
		2,84,000			2,84,000

Dr. **Partners' Capital A/cs** *Cr.*

Particulars	*X (₹)*	*Y (₹)*	*Particulars*	*X (₹)*	*Y (₹)*
To Balance c/d	…………	…………	By Balance b/d	…………	…………
	…………	…………		…………	…………

Dr. **Partners' Current A/cs** *Cr.*

Particulars	*X (₹)*	*Y (₹)*	*Particulars*	*X (₹)*	*Y (₹)*
To Bank (Drawing)	10,000	9,000	By Balance b/d	78,000	69,000
To	....	....	By Interest on Capital	18,000	24,000
To	....	....	By	....	....
			By	....	....
	....	....		....	....

Complete the Profit and Loss Appropriation A/c for the year ended 31st March, 2019, Partners Capital A/cs and Current A/cs. ***(C.B.S.E., 2019–C)***

Solution. **Profit and Loss Appropriation A/c**
Dr. *for the year ended 31st March, 2019* *Cr.*

Particulars		*(₹)*	*Particulars*		*(₹)*
To Interest on Capital:			By Profit and Loss A/c (Bal. Fig.)		**2,82,860**
X's Current A/c	**18,000**		By Interest on Drawings:		
Y's Current A/c	**24,000**	**42,000**	X's Current A/c	**600**	
To Salary A/c			Y's Current A/c	**540**	**1,140**
Y's Current A/c (Bal. Figure)		**42,000**			
To Profit transferred to:					
X's Current A/c	1,20,000				
Y's Current A/c	**80,000**	**2,00,000**			
		2,84,000			2,84,000

Dr. **Partners' Capital A/cs** *Cr.*

Particulars	*X (₹)*	*Y (₹)*	*Particulars*	*X (₹)*	*Y (₹)*
To Balance c/d	**1,80,000**	**2,40,000**	By Balance b/d	**1,80,000**	**2,40,000**

Dr. **Partners' Current A/cs** *Cr.*

Particulars	*X (₹)*	*Y (₹)*	*Particulars*	*X (₹)*	*Y (₹)*
To Bank (Drawing)	10,000	9,000	By Balance b/d	78,000	69,000
To **Interest on Drawings**	**600**	**540**	By Interest on Capital	18,000	24,000
To **Balance c/d**	**2,05,400**	**2,05,460**	By **Salaries A/c**	—	**42,000**
			By **P and L Appropriate A/c (Profit)**	**1,20,000**	**80,000**
	2,16,000	**2,15,000**		**2,16,000**	**2,15,000**

R **Illustration 8(A). (Appropriations are more than Available Profit/Inadequate Profit)**

On 1-4-2019, Jay and Vijay entered into partnership for supplying laboratory equipments to government schools situated in remote and backwards areas. They contributed capital ₹ 80,000 and ₹ 50,000 respectively and agreed to share the profits in the ratio of 3 : 2. The partnership deed provided that the interest on capital shall be allowed at 9% per annum. During the year, the firm earned a profit of ₹ 7,800. Showing your calculations clearly, prepare the Profit and Loss Appropriation Account of Jay and Vijay for the year ended 31-3-2019.

(C.B.S.E., 2015 – modified)

Solution. **Profit and Loss Appropriation A/c**

Dr. *for the year ended 31-3-2019* *Cr.*

Particulars		*(₹)*	*Particulars*	*(₹)*
To Interest on Capital:			By Net Profit	7,800
Jay	4,800			
Vijay	3,000	7,800		
		7,800		7,800

Working Notes:

(i) **Calculation of Interest on Capital**

On Jay's Capital = ₹ 80,000 × 9/100 = ₹ 7,200

On Vijay's Capital = ₹ 50,000 × 9/100 = ₹ 4,500

Total Appropriation of Profit ₹ 11,700

(ii) But available net profit is ₹ 7,800 which is less than the amount of appropriation for the year *i.e.,* ₹ 11,700 so it should be divided between Jay and Vijay in the ratio of their appropriation of profit *i.e.,* ₹ 7,200: 4,500 (8 : 5) and not in their profit sharing ratio of 3 : 2.

(iii) This is so as profits after complete appropriation shall only be distributed in their profit sharing ratio (3 : 2) and not before as it is not distributable profit.

Thus, Interest on Jay's Capital $= 7{,}800 \times \frac{8}{13} =$ ₹ 4,800[1]

Interest on Vijay's Capital $= 7{,}800 \times \frac{5}{13} =$ ₹ 3,000[2]

R **Illustration 8(B). (Inadequate Profit)**

A and B were partners in a firm sharing profits in the ratio of 5 : 3. Their fixed capitals on 31st March, 2017 were: A ₹ 60,000 and B ₹ 80,000, They agreed to allow interest on capital @ 12% p.a. The profit of the firm for the year ended 31st March, 2018 before allowing interest on capitals was ₹ 12,600.

Pass necessary journal entries for the above transactions in the books of A and B. Also show your working notes clearly. ***(C.B.S.E., 2019)***

Solution.

Working Note: Interest on Capital:

A = ₹ 60,000 @ 12% p.a. = ₹ 7,200

B = ₹ 80,000 @ 12% p.a. = ₹ 9,600

Total Interest = ₹ 16,800

Since Profit during the year is ₹ 12,600 which is less than the total interest payment so Interest on Capital will be distributed in the ratio of ₹ 7,200 : ₹ 9,600 *i.e.,* 3 : 4.

Thus, A's Interest will be = ₹ 12,600 × 3/7 = ₹ 5,400

and B's Interest will be = ₹ 12,600 × 4/7 = ₹ 7,200

Journal

Date	Particulars		L.F.	Dr. (₹)	Cr. (₹)
2018	Interest on Capital A/c	Dr.		12,600	
Mar. 31	To A's Current A/c				5,400
	To B's Current A/c				7,200
	(Interest on Capital credited to Partners' Current A/c)				
	Profit and Loss Appropriation A/c	Dr.		12,600	
	To Interest on Capital A/c				12,600
	(Interest on Capital transferred to Profit and Loss Appropriation A/c)				

Illustration 8(C). (Appropriations are more than available profit)

A and B are partners sharing profits in the ratio of 4 : 3. A contributed ₹ 3,00,000 and B ₹ 1,00,000 as their capital. The deed provided that interest on capital be allowed at 10% p.a. and salary be allowed to B as ₹ 2,500 p.m. The net profit before providing interest on capital and salary amounts to ₹ 42,000 for the year ended 31st March, 2020.

Show the distribution of profit for the year.

Solution. **Profit and Loss Appropriation A/c**

Dr. *for the year ending 31st March, 2020* Cr.

Particulars		(₹)	Particulars	(₹)
To Interest on Capital:			By Net Profit	42,000
A	18,000[1]			
B	6,000[2]	24,000		
To B's Salary		18,000[3]		
		42,000		42,000

Working Notes:

(i) **Actual Appropriation:**

	A (₹)	B (₹)
Interest on Capital	30,000	10,000
Salary	—	30,000
Total	30,000	40,000

(ii) Total appropriation of profit is ₹ 70,000 which is more than the actual Net Profit ₹ 42,000 so it should be divided between A and B in the ratio of their appropriation 3 : 4 and not in their profit sharing ratio of 4 : 3.

∴ A's share is = ₹ 42,000 × $\frac{3}{7}$ = ₹ 18,000[1]

B's share is = ₹ 42,000 × $\frac{4}{7}$ = ₹ 24,000

(iii) Total appropriation of B ₹ 24,000 be divided between:

	B's Interest		B's Salary
Actual	₹ 10,000		₹ 30,000
ratio	1	:	3

∴ ₹ 24,000 be divided in ratio 1 : 3 *i.e.,* Interest = ₹ 24,000 × $\frac{1}{4}$ = ₹ 6,000[2] and salary = ₹ 24,000 × $\frac{3}{4}$ = ₹ 18,000[3]

R Special Aspects of Partnership Accounts

The final accounts of a partnership firm are similar to the final accounts of a sole trader but there are certain issues which require considerations while preparing final accounts of a partnership firm. These issues are:

1. Partners' Capital Accounts
2. Partners' Drawing Accounts
3. Interest on Partners' Capital
4. Interest on Partners' Drawings
5. Interest on Partners' Loan
6. Partners' Salary or Commission
7. Capital Ratio of Partners
8. Past Adjustments or Adjustments in Closed Accounts
9. Guarantee of Profit to a Partner

R I. Partners' Capital Accounts

Separate Capital Accounts are maintained for each partner. The capital contributed by each partner is credited to their capital accounts. Capital can be brought in cash or in the forms of other assets like, building, machinery, stock, furniture, etc. Often, partners' capital accounts are opened and maintained in columnar form. These capital accounts are maintained in two ways :

(1) Fixed Capital Accounts

(2) Fluctuating Capital Accounts.

(1) Fixed Capital Accounts. Under this system, two accounts, namely—Capital Account and Current Account for each partner are maintained. The transactions pertaining to introduction of capital, additional capital and withdrawl of capital are recorded in their 'Capital Accounts'. All other transactions like interest on capital, interest on drawing, salary or commission to partner, drawing and share of profits or losses are recorded in their 'Current Accounts'. Thus, **'Capital Accounts'** of partners will depict the same capital year after year unless further capital is introduced or withdrawn by the partners. The partners **'Current Accounts'** will, however, go on fluctuating year after year. Usually, it has a credit balance but it may have even debit balance if either drawings of partner is more than his share of credit balance or his share of loss exceeds credit items. The Current Accounts of partners are shown on the liabilities side of balance sheet if they have credit balance and are shown on the assets side of the Balance Sheet if they have debit balance.

The format of Capital Accounts' and Current Accounts' of partners are as under :

When Capital Accounts are Fixed:

Dr. **Partners' Capital Accounts** *Cr.*

Particulars	*X* (₹)	*Y* (₹)	*Particulars*	*X* (₹)	*Y* (₹)
To Cash/Bank A/c	—	—	By Balance b/d	—	—
(Withdrawl of Capital)			By Cash/Bank A/c	—	—
To Balance c/d	—	—	(Additional Capital)		

Dr. **Partners' Current Accounts** *Cr.*

Particulars	*X* (₹)	*Y* (₹)	*Particulars*	*X* (₹)	*Y* (₹)
To Balance b/d			By Balance b/d		
(if debit balance)	—	—	(if credit balance)	—	—
To Drawing A/c	—	—	By Interest on Capital A/c	—	—
To Interest on Drawing A/c	—	—	By Salary A/c	—	—
To Profit & Loss A/c (Loss)	—	—	By Commission A/c	—	—
To Balance c/d	—	—	By Profit & Loss	—	—
			Approp. A/c (Profit)	—	—

(2) Fluctuating Capital Accounts. Partners Capital Accounts are said to be fluctuating when their capitals do not remain fix but varies with each debit/credit entry. Since current accounts are not kept under this system, so all entries pertaining to capital, addition of capital or withdrawl of capital, drawings, interest on capital, interest on drawing, salary or commission of partners, profit or loss shares are recorded in the capital account itself so the closing balance will differ with the opening balance of capital account. That is why it is called as fluctuating capital. The format of partners' capital account is as under when their capital is fluctuating.

When Capital Accounts are Fluctuating

Dr. **Partners' Capital Accounts** *Cr.*

Particulars	*X* (₹)	*Y* (₹)	*Particulars*	*X* (₹)	*Y* (₹)
To Drawing A/c	—	—	By Balance b/d		
To Interest on drawing A/c	—	—	(opening balance)	—	—
To P & L A/c(loss share)	—	—	By Cash/Bank A/c	—	—
To Balance c/d	—	—	(additional capital)		
			By Interest on Capital A/c	—	—
			By Salary A/c	—	—
			By Commission A/c	—	—
			By P&L Approp. A/c	—	—
			(Profit Share)		

Note: Only Capital Accounts are prepared and Current Accounts are not prepared when Capital Accounts of partners are fluctuating.

Distinction between Fixed Capital Accounts and Fluctuating Capital Accounts

Basis	*Fixed Capital Accounts*	*Fluctuating Capital Accounts*
1. Number of Accounts	Two accounts are maintained for each partner *i.e.,* Fixed Capital Account and Current Account.	Only one account (*i.e.,* Capital A/c) for each partner is maintained.
2. Change in Capital	Under fixed capital, partners' capital accounts usually remain fix and do not change from year to year basis.	Under fluctuating capital, partners' capital accounts go on changing from one year to another year.

3. Recording of Transactions	Entries relating to drawing, interest on capital, interest on drawing, salary, commission, profit or loss share of partner are recorded in the current account of partner and not in the fixed capital account.	Entries pertaining to drawing, interest on capital, interest on drawing, salary, commission, profit or loss share are recorded in the capital account itself.
4. Balance	Fixed capital account always shows credit balance while current accounts may show debit or credit balance.	Fluctuating capital accounts may show credit or debit balance of partners.

Distinction between Partners' Fixed Capital Accounts and Current Accounts

Basis	*Fixed Capital Accounts*	*Current Accounts*
1. Objective	Only partners' capital is shown in this account. However, addition or with-drawl of capital is shown in this account.	All the entries pertaining to partners' except their capital are shown in this account so that partners may not withdraw more amount than what is due to them.
2. Nature of Account	The capital of partners usually remain fixed over period of years.	The current account balance of part-ners go on changing year after year.
3. Balance	Fixed capital accounts show credit balance of partners.	Current account of partners may show credit or debit balance.
4. Interest on Capital	Interest on Capital is calculated on fixed capital of partners but shown in partners' current account.	Interest on fixed capital is shown in the partners current account.

R **Illustration 9. (When Capitals are Fixed and Fluctuating)**

X and Y are partners with capitals of ₹ 50,000 and ₹ 30,000 respectively on 1st April, 2019. The trading profit of the firm for the accounting year before appropriation as per partnership deed was ₹ 22,000.

As per partnership deed, interest on capitals is allowed @ 8% p.a. Y is entitled to a salary of ₹ 500 p.m. Drawings of partners were ₹ 6,000 and ₹ 5,000 and interest thereon amounts to ₹ 300 and ₹ 200 for X and Y respectively.

Show how the profit will be divided between X and Y and also show partners' Capital Accounts under :

(i) Fixed Capital and

(ii) Fluctuating Capital

Solution. **Profit & Loss Appropriation A/c**

Dr. *for the year ending 31-3-2020* *Cr.*

Particulars		*(₹)*	*Particulars*		*(₹)*
To Interest on Capital A/c			By Net Profit (as per P & L A/c)		22,000
X	4,000		By Interest on Drawings:		
Y	2,400	6,400	X	300	
To Y's Salary		6,000	Y	200	500

To Profit trans. to Capital A/cs :				
X—½	5,050			
Y—½	5,050	10,100		
		22,500		22,500

Note: Profit sharing ratio is not given so it will be treated as 1 : 1.

(i) Fixed Capitals

Dr. **Partners' Capital Accounts** *Cr.*

Date	Particulars	X	Y	Date	Particulars	X	Y
2020		(₹)	(₹)	2019		(₹)	(₹)
Mar. 31	To Balance c/d	50,000	30,000	April 1	By Balance b/d	50,000	30,000
				2020			
				April 1	By Balance b/d	50,000	30,000

Dr. **Partners' Current Accounts** *Cr.*

Date	Particulars	X	Y	Date	Particulars	X	Y
2020		(₹)	(₹)	2020		(₹)	(₹)
Mar. 31	To Drawing A/c	6,000	5,000	Mar. 31	By Interest on		
Mar. 31	To Interest on				Capital A/c	4,000	2,400
	Drawings A/c	300	200	Mar. 31	By Salary A/c	—	6,000
Mar. 31	To Balance c/d	2,750	8,250	Mar. 31	By P & L Approp. A/c	5,050	5,050
		9,050	13,450			9,050	13,450
				2020			
				April 1	By Balance b/d	2,750	8,250

(ii) Fluctuating Capitals

Dr. **Partners' Capital Accounts** *Cr.*

Date	Particulars	X	Y	Date	Particulars	X	Y
2020		(₹)	(₹)	2019		(₹)	(₹)
Mar. 31	To Drawing A/c	6,000	5,000	April 1	By Balance b/d	50,000	30,000
Mar. 31	To Interest on			2020	By Interest on		
	Drawing A/c	300	200	Mar. 31	Capital A/c	4,000	2,400
Mar. 31	To Balance c/d	52,750	38,250	Mar. 31	By Salary A/c	—	6,000
				Mar. 31	By P & L Approp. A/c (Profit)	5,050	5,050
		59,050	43,450			59,050	43,450
				2020			
				April 1	By Balance b/d	52,750	38,250

R **Illustration 10. (Fluctuating and Fixed Capital)** Prepare the Capital Accounts of partners from the following particulars, using *(i)* Fluctuating Capital *(ii)* Fixed Capital:

Transactions for the year 2019 are:

Particulars	*Amit (₹)*	*Sumit (₹)*
Commenced business (1-1-2019)	60,000	40,000
Drawings	9,000	5,000
Interest on Capital	4,800	3,200
Interest on Drawing	900	500
Salary	5,000	—
Commission	—	4,000
Interest on Partners' Loan	—	3,000
Profit share during 2019	6,000	6,000

Solution. *(i)* According to Fluctuating Capital Method

Dr. **Partners' Capital Accounts** *Cr.*

Date	*Particulars*	*Amit*	*Sumit*	*Date*	*Particulars*	*Amit*	*Sumit*
2019		(₹)	(₹)	2019		(₹)	(₹)
Dec. 31	To Drawings A/c	9,000	5,000	Jan. 1	By Bank A/c	60,000	40,000
Dec. 31	To Interest on Drawing A/c	900	500	Dec. 31	By Interest on Capital A/c	4,800	3,200
Dec. 31	To Balance c/d	65,900	47,700	Dec. 31	By Salary A/c	5,000	—
				Dec. 31	By Commission A/c	—	4,000
				Dec. 31	By P & L Approp. A/c (Profit)	6,000	6,000
		75,800	53,200			75,800	53,200
				2020 Jan. 1	By Balance b/d	65,900	47,700

***(ii)* According to Fixed Capital Method**

Dr. **Partners' Capital Account** *Cr.*

Date	*Particulars*	*X*	*Y*	*Date*	*Particulars*	*X*	*Y*
2019		(₹)	(₹)	2019		(₹)	(₹)
Dec. 31	To Balance c/d	60,000	40,000	Jan. 1	By Bank A/c	60,000	40,000
				2020 Jan. 1	By Balance b/d	60,000	40,000

Dr. **Partners' Current Accounts** *Cr.*

Date	*Particulars*	*X*	*Y*	*Date*	*Particulars*	*X*	*Y*
2019		(₹)	(₹)	2019		(₹)	(₹)
Dec. 31	To Drawing A/c	9,000	5,000	Dec. 31	By Interest on Capital A/c	4,800	3,200
Dec. 31	To Interest on Drawings A/c	900	500	Dec. 31	By Salary A/c	5,000	—
Dec. 31	To Balance c/d	5,900	7,700	Dec. 31	By Commission A/c	—	4,000
				Dec. 31	By P & L Approp. A/c (Profit)	6,000	6,000
		15,800	13,200			15,800	13,200
				2020 Jan. 1	By Balance b/d	5,900	7,700

> **Note:** Interest on partners' loan is never recorded in partners' capital account or in partners' current account rather it is added in partners' loan account.

R II. Partners' Drawing Account

The amount withdrawn by partners from the firm in anticipation of their profit share to meet their domestic expense is called drawing. The amount of drawing of each partner is usually settled by partners and it is written in the partnership deed. Drawing may be made by partners either in cash or in the form of goods. At the end of the accounting period, drawing account is transferred to debit side of partners' capital account (in case of fluctuating capital) or to partners' current account (if capital is fixed). The entry passed is:

(i) Partners' Drawing A/c   Dr.
  To Cash/Bank/Purchases A/c

(ii) Partners' Capital/Current A/c   Dr.
  To Partners' Drawing A/c

> **Note:** If a partner has withdrawn his capital for meeting his personal needs (*i.e.,* other than domestic needs), it is called partners' drawing against capital. It is recorded as :
> Partners' Capital A/c   Dr.
>   To Cash/Bank A/c
> (For drawing against Capital of Partner)

Thus, we have:

(i) Withdrawl of Capital—Drawing against capital

(ii) Withdrawl in anticipation of profit—Drawing against profit.

R Distinction between Drawing against Capital and Drawing against Profit

Basis	*Drawing against Capital*	*Drawing against Profit*
1. Debit	Partners' Capital Account is debited.	Drawing of Partners' account is debited.
2. Part	It constitutes part of partners' capital.	It is part of expected profit of the firm.
3. Effect on Capital	Partners' capital is reduced.	It is recorded in partners' current a/c so capital of partners is not reduced.
4. Interest on Capital	Interest on capital is affected.	Interest on drawing is affected but there is no effect on interest on capital.

R III. Interest on Partners' Capital

Interest on capital is allowed to a partner to compensate for contributing capital to the firm in excess of the profit sharing ratio.

Interest on partners' capital is computed at the rate of interest mentioned in 'Partnership Deed' with reference to time period and it is treated as appropriation of profits. No interest on capital is allowed in the absence of partnership deed or if it is silent with regard to interest on partners' Capital. If further capital is introduced by a partner or is withdrawn by a partner, interest is calculated with reference to time period of use of capital in the business.

Formula

$$\text{Interest on Capital} = \text{Amount of Capital} \times \frac{\text{Rate}}{100} \times \text{Time}$$

Accounting Treatment

(i)	Interest on Capital A/c	Dr.
	To A's Capital/Current A/c	
	To B's Capital/Current A/c	
(ii)	Profit & Loss Appropriation A/c	Dr.
	To Interest on Capital A/c	

R Rules for Providing Interest on Capital to Partners

Interest on Partners' Capital

Case if	*Provisions*
1. **Partnership Deed is silent in respect of interest on Capital.**	Interest on capital is not allowed.
2. **Partnership Deed provides for interest on capital but silent with regards to its treatments as charge or appropriation.**	Interest on capital is allowed if there is a profit. **(a) In case of loss** — Interest on capital is not allowed. **(b) Profit is more than interest amount** — Interest on capital is allowed at the agreed rate. **(c) Profit is less than the amount of interest.** — Interest is given to the extent of profit in the ratio of interest on capital of partners.
3. **Partnership Deed provides interest on Capital as a charge against profit.**	Interest on capital is allowed even if there is a loss. Profit and Loss A/c is prepared in such cases instead of Profit & Loss Appropriation A/c.

R Illustration 11. (Interest on Capital)

Anil and Sunil are partners in a firm. Their capitals as on 1-4-2019 were ₹ 2,00,000 and ₹ 1,00,000 respectively sharing profits equally. On 1st October, 2019, they decided that their capital should be ₹ 1,50,000 each. Necessary adjustments in capitals were made by withdrawing or by introducing cash. Interest on Capital is allowed at 10% p.a. Compute interest on capital for both the partners for the year 2019-20.

Solution. **Calculation of Interest on Capital**

Anil (₹)

On ₹ 2,00,000 for 6 months = $2,00,000 \times \frac{10}{100} \times \frac{6}{12}$	10,000
On ₹ 1,50,000 for 6 months = $1,50,000 \times \frac{10}{100} \times \frac{6}{12}$	7,500
	17,500

Sunil (₹)

On ₹ 1,00,000 for 6 months = $1,00,000 \times \frac{10}{100} \times \frac{6}{12}$	5,000

On ₹ 1,50,000 for 6 months = $1,50,000 \times \frac{10}{100} \times \frac{6}{12}$ 7,500

12,500

R **Illustration 12.** P, Q and R started a partnership business on 1-7-2019. They contributed ₹ 5,00,000, ₹ 6,00,000 and ₹ 7,00,000 respectively as their capital. Interest on capital is to be provided @ 12% per annum. The firm earned a profit of ₹ 1,75,000 for the year ended 31-3-2020. The Profit sharing ratio of P, Q and R is 1 : 2 : 2.

Prepare Profit and Loss Appropriation Account for the year ended 31-3-2020.

(C.B.S.E., 2004-AI-C – modified)

Solution. Calculation of Interest on Capital for 9 Months

(₹)

$P = 5,00,000 \times \frac{12}{100} \times \frac{9}{12}$ 45,000

$Q = 6,00,000 \times \frac{12}{100} \times \frac{9}{12}$ 54,000

$R = 7,00,000 \times \frac{12}{100} \times \frac{9}{12}$ 63,000

Profit & Loss Appropriation A/c

Dr. *for the year ending 31-3-2020* *Cr.*

Particulars		*(₹)*	*Particulars*	*(₹)*
To Interest on Capital A/c			By Profit & Loss A/c	
P	45,000		(Net Profit)	1,75,000
Q	54,000			
R	63,000	1,62,000		
To Profit trans. to Capital A/cs:				
P	2,600			
Q	5,200			
R	5,200	13,000		
		1,75,000		1,75,000

R&U **Illustration 13(A). (Interest on capital when profit is inadequate)**

X and Y are partners having capitals ₹ 1,00,000 and ₹ 80,000 respectively. Interest on capital is allowed @ 6% p.a. Their profit sharing ratio is 2 : 3. The profit for the business before providing interest on capital for the year ending 31st March, 2020 is ₹ 9,000. Show the relevant account to represent interest on capital of partners when:

(i) partnership deed is silent about treatment of interest on capital

(ii) interest on capital is charge as per partnership deed.

Solution. *(i)* When Partnership Deed is silent about treating interest on capital as charge or appropriation.

Profit & Loss Appropriation A/c

Dr. *for the year ending 31-3-2020* *Cr.*

Particulars		(₹)	Particulars	(₹)
To Interest on Capital A/c			By Profit & Loss A/c (Profit)	9,000
X	5,000[1]			
Y	4,000[2]	9,000		
		9,000		9,000

Working Note: Interest on Capital is

$$X = ₹\ 1{,}00{,}000 \times \frac{6}{100} = ₹\ 6{,}000$$

$$Y = ₹\ 80{,}000 \times \frac{6}{100} = ₹\ 4{,}800$$

Total 10,800

Since total interest on capital is more than the profit for the year so interest on capital can be paid only upto ₹ 9,000 to X : Y in the ratio of 6,000 : 4,800 or 5 : 4 and not in profit sharing ratio 2 : 3. Profit sharing ratio applies only after complete appropriation and if profit remains. Thus, interest on capital charged will be:

$$X = ₹\ 9{,}000 \times \frac{5}{9} = ₹\ 5{,}000^{1}$$

$$Y = ₹\ 9{,}000 \times \frac{4}{9} = ₹\ 4{,}000^{2}$$

***(ii)* When interest on capital is a charge as per partnership deed.**

Profit & Loss A/c

Dr. *for the year ended 31-3-2020* *Cr.*

Particulars		(₹)	Particulars		(₹)
To Interest on Capital A/c			By Profit and Loss A/c (Profit)		9,000
X	6,000		By Loss trans. to capital a/cs:		
Y	4,800	10,800	X—2/5	720	
			Y—3/5	1,080	1,800
		10,800			10,800

Note: Profit & Loss Appropriation Account has not been prepared as interest on capital has been treated as charge against profit and thus, loss has been shared in profit sharing ratio.

R **Illustration 13(B). (Interest on capital is a charge against profit)**

Arun and Arora were partners in a firm sharing profits in the ratio of 5 : 3. Their fixed capitals on 1-4-2019 were: Arun ₹ 60,000 and Arora ₹ 80,000. They agreed to allow interest on capital @ 12% p.a. and to charge interest on drawings @ 15% p.a. The profit of the firm for the year ended 31-3-2020 before all above adjustments were ₹ 12,600. The drawings made by Arun were ₹ 2,000 and by Arora ₹ 4,000 during the year. Prepare Profit and Loss Appropriation Account of Arun and Arora.

Show your calculations clearly. The interest on capital will be allowed even if the firm incurs loss. ***(C.B.S.E., 2012 – modified)***

Solution. **Profit and Loss Appropriation A/c**

Dr. *for the year ended 31-3-2020* *Cr.*

Particulars	(₹)	*Particulars*		(₹)
To Interest on Capital:		By Profit & Loss A/c (Profit)		12,600
Arun's Current A/c	7,200	By Interest on Drawings:		
Arora's Current A/c	9,600	Arun's Current A/c	150	
		Arora's Current A/c	300	450
		By Net Loss Transferred (5 : 3):		
		Arun's Current A/c	2,344	
		Arora's Current A/c	1,406	3,750
	16,800			16,800

Notes. *(i)* Interest on drawing will be calculated for 6 months on an average basis.
(ii) **As per question, interest on capital is a charge against profit so it should be debited to Profit & Loss A/c and not to Profit & Loss Appropriation A/c. It is, however, done only as per requirement of the question.**

R **Illustration 14. (Interest on Capital)**

A and B started a partnership firm on 1st April, 2019 with capital of ₹ 2,00,000 and ₹ 1,50,000 respectively. On 1st July, they further introduced capital of ₹ 50,000 and ₹ 30,000 respectively. B, however, withdrew ₹ 20,000 out of his capital on 1st February, 2020.

Compute interest on capital of partners for the year ending 31st March, 2020 assuming rate of interest on capital as 8% p.a.

Solution. **Calculation of Interest on Capital**

For A	(₹)
On ₹ 2,00,000 for 3 months (1st April to 30th June) $2,00,000 \times \frac{8}{100} \times \frac{3}{12}$	4,000
On ₹ 2,50,000 for 9 months (1st July to 31st March) $2,50,000 \times \frac{8}{100} \times \frac{9}{12}$	15,000
	19,000
For B	(₹)
On ₹ 1,50,000 for 3 months (1st April to 30th June) $1,50,000 \times \frac{8}{100} \times \frac{3}{12}$	3,000
On ₹ 1,80,000 for 7 months (1st July to 31st January) $1,80,000 \times \frac{8}{100} \times \frac{7}{12}$	8,400
On ₹ 1,60,000 for 2 months (1st Feb. to 31st March) $1,60,000 \times \frac{8}{100} \times \frac{2}{12}$	2,133
	13,533

R **Illustration 15. (Interest on capital when closing capital is given)**

P and Q are partners sharing profits and losses in the ratio of 3 : 2. Their capitals as on 31st March, 2020 were ₹ 4,00,000 and ₹ 2,00,000 respectively. During the year, drawings of P and Q were ₹ 50,000 and ₹ 40,000. On 1st January, 2020, Q introduced additional capital of ₹ 80,000. They earned profit amounting to ₹ 70,000 for the year ending 31st March, 2020.

Later on, they decided to charge interest on their capital @ 12% p.a. Compute interest on capital.

Solution. Interest on capital is always calculated on the opening capital but we are given the closing capital here.

We know that:

Capital (end) = Capital (Opening) + Additional Capital – Drawing + Profit Share

Thus,

Opening Capital = Closing Capital – Additional Capital + Drawings – Profit Share

Calculation of Opening Capitals

Particulars	*P* (₹)	*Q* (₹)
Capital (at end *i.e.,* 31-3-2020)	4,00,000	2,00,000
Less: Additional Capital (1st January, 2020)	—	80,000
	4,00,000	1,20,000
Add: Drawing	50,000	40,000
	4,50,000	1,60,000
Less: Profit (₹ 70,000 in ratio 3 : 2)	42,000	28,000
Capital (beginning *i.e.,* 1-4-2019)	4,08,000	1,32,000

Calculation of Interest on Capital

		(₹)
P —	On ₹ 4,08,000 @ 12% for 1 year	48,960
Q —	On 1,32,000 @ 12% for 9 months	11,880
	On 2,12,000 @ 12% for 3 months	6,360
		18,240

Illustration 16. (Interest on Capital)

P and Q are partners sharing profits equally. On 1-4-2019, their capitals were ₹ 80,000 and ₹ 60,000 respectively.

P introduced ₹ 20,000 as additional Capital on 1st July and Q introduced ₹ 40,000 on 1st January. They withdrew ₹ 500 p.m. for their household expenses in anticipation of their profit share. Interest on capital is allowed @ 9% p.a. Compute interest on capital of partners for the year ending 31st March, 2020.

Solution. **Calculation of Interest on Capital**

	(₹)
(i) **For P**	
On ₹ 80,000 @ 9% for 3 months $\left(80{,}000 \times \frac{9}{100} \times \frac{3}{12}\right)$	1,800
On ₹ 1,00,000 @ 9% for 9 months $\left(1{,}00{,}000 \times \frac{9}{100} \times \frac{9}{12}\right)$	6,750
	8,550

(ii) **For Q**	
On ₹ 60,000 @ 9% for 9 months $\left(60{,}000 \times \frac{9}{100} \times \frac{9}{12}\right)$	4,050
On ₹ 1,00,000 @ 9% for 3 months $\left(1{,}00{,}000 \times \frac{9}{100} \times \frac{3}{12}\right)$	2,250
	6,300

Note. Since drawing of both the partners of ₹ 500 p.m. is for domestic purpose so it will not lead to reduction of capital employed of partners, hence, ignored.

Illustration 17. Ram and Mohan started business on 1-4-2019 with a capital of ₹ 4,00,000 and ₹ 2,50,000 respectively sharing profits in the ratio of 3 : 2. On 1st October, 2019, they decided that capital of the firm should be ₹ 6,50,000 and it should be shared by the partners in their profit sharing ratio. Accordingly, they decided to introduce or withdraw their capital. Interest on capital is allowed at 10% p.a. Calculate interest on capital for the year ending 31st March, 2020.

Solution.

	Ram	*Mohan*
(i) **Calculation of Partners' Capital**	(₹)	(₹)
Capital on 1-4-2019	4,00,000	2,50,000
Capital on 1-10-2019 (₹ 6,50,000 in ratio 3 : 2)	3,90,000	2,60,000

(ii) **Interest on Capital**	
For Ram	(₹)
On ₹ 4,00,000 @ 10% for 6 months	20,000
On ₹ 3,90,000 @ 10% for 6 months	19,500
	39,500
For Mohan	(₹)
On ₹ 2,50,000 @ 10% for 6 months	12,500
On ₹ 2,60,000 @ 10% for 6 months	13,000
	25,500

IV. Interest on Partners' Drawings

The amount withdrawn by partners in cash or kind for domestic use in anticipation of profit share is referred to as drawing of partners. If the partnership deed so provides, interest on drawing is charged. The entry passed is:

(i) **For interest on drawing charged**	
Partners' Capital/Current A/c	Dr.
To Interest on Drawing A/c	
(ii) **For closure of interest on drawing account**	
Interest on Drawings A/c	Dr.
To Profit and Loss Appropriation A/c	

Interest on drawing is always calculated with reference to time period for which money is withdrawn. Interest on drawing is calculated depending upon the availability of information. It is computed as:

Interest on Monthly Drawings. When drawing by partners' is made on monthly basis, interest is computed in the following manner provided—**amount of drawing of each month is uniform**.

(i) **When drawings of a fixed amount are made at the beginning of each month.** Interest will be charged on the whole amount for 6·5 months.

$$\text{Interest on Drawing} = \frac{\text{Total Drawings} \times \text{Rate of Interest}}{100} \times \frac{6{\cdot}5^{*}}{12}$$

* It is average of 12, 11, 10 ..... 1 = 78 ÷ 12 = 6·5 months

Alternatively,

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

$$= \frac{\text{12 months + 1 month}}{2}$$

$$= \frac{13}{2} = 6{\cdot}5 \text{ months}$$

(ii) **When drawings of a fixed amount are made at the end of each month.** Interest will be charged for 5·5 months.

$$\text{Interest on Drawing} = \frac{\text{Total Drawings} \times \text{Rate of Interest}}{100} \times \frac{5{\cdot}5^{*}}{12}$$

* It is average of 11, 10, 9 ..... 0 = 66 ÷ 12 = 5·5 months

Alternatively,

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

$$= \frac{11 + 0}{2} = 5{\cdot}5 \text{ months}$$

(iii) **When drawings of a fixed amount are made in the middle of each month.** Interest will be charged for 6 months.

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

* It is average of $11\frac{1}{2}, 10\frac{1}{2}, 9\frac{1}{2} .... \frac{1}{2}$ = 72 ÷ 12 = 6 months

Alternatively,

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

$$= \frac{11{\cdot}5 + 0{\cdot}5}{2} = \frac{12}{2} = 6 \text{ months}$$

Illustration 18. A, B and C are partners in a firm sharing profits equally. 'A' withdrew ₹ 500 p.m. at the beginning of each month while 'B' withdrew ₹ 700 p.m. at the end of each month. C, however, preferred to draw ₹ 800 p.m. at the middle of each month. Interest is to be charged at 12% p.a. as per partnership deed. Calculate the interest on drawing of each partner.

Solution.

(i) **Interest on drawings of 'A' — drawn at the beginning of each month**

Total drawings = ₹ 500 × 12 = ₹ 6,000

Interest will be charged for 6·5 months as drawings are made at the beginning of each month.

$$\text{Interest} = ₹\ 6{,}000 \times \frac{12}{100} \times \frac{6{\cdot}5}{12} = ₹\ 390$$

(ii) **Interest on drawings of 'B' — drawn at the end of each month**

Total drawings = ₹ 700 × 12 = ₹ 8,400

Interest will be charged for 5·5 months as drawings are made at the end of each month.

$$\text{Interest} = ₹\ 8{,}400 \times \frac{12}{100} \times \frac{5{\cdot}5}{12} = ₹\ 462$$

(iii) **Interest on drawings of 'C' — drawn at the middle of each month**

Total drawings = ₹ 800 × 12 = ₹ 9,600

Interest will be charged for 6 months as drawings are made at the middle of each month.

$$\text{Interest} = ₹\ 9{,}600 \times \frac{12}{100} \times \frac{6}{12} = ₹\ 576$$

Interest on Quarterly Drawings. When fixed amount is drawn by partners on quarterly basis, interest is computed in the following manner.

(i) **When drawings of a fixed amount are made at the beginning of each quarter.** Interest will be charged for 7·5 months.

$$\text{Interest on Drawings} = \frac{\text{Total Drawings} \times \text{Rate of Interest}}{100} \times \frac{7{\cdot}5^{*}}{12}$$

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

$$= \frac{12+3}{2} = \frac{15}{2} = 7{\cdot}5 \text{ months}$$

(ii) **When drawings of a fixed amount are made at the end of each quarter.** Interest on drawing will be charged for 4·5 months.

$$\text{Interest on Drawings} = \frac{\text{Total Drawings} \times \text{Rate of Interest}}{100} \times \frac{4{\cdot}5^{*}}{12}$$

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

$$= \frac{9+0}{2} = 4{\cdot}5 \text{ months}$$

(iii) **When drawings of a fixed amount are made at the middle of each quarter.** Interest will be charged for 6 months.

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

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

$$= \frac{10 \cdot 5 + 1 \cdot 5}{2} = \frac{12}{2} = 6 \text{ months}$$

R **Illustration 19.** X, Y and Z are three partners sharing profits in the ratio of 3 : 2 : 1. They withdrew ₹ 5,000 each on quarterly basis. Compute interest on drawing for the year ending 31st March, 2020 @ 9% p.a. for partners in the followings cases:

(i) X withdrew at the beginning of each quarter
(ii) Y withdrew at the end of each quarter
(iii) Z withdrew at the middle of each quarter.

Solution.

Total drawings of X, Y and Z are = ₹ 5,000 × 4 = ₹ 20,000 for each partner

Case I. Interest on Drawings of X — drawn at the beginning of each quarter

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

$$= \frac{12 + 3}{2} = 7 \cdot 5 \text{ months}$$

Interest on Drawings of X = ₹ 20,000 × $\frac{9}{100} \times \frac{7 \cdot 5}{12}$ = ₹ 1,125

Case II. Interest on Drawings of Y — drawn at the end of each quarter

$$\text{Average Period} = \frac{9 + 0}{2} = 4 \cdot 5 \text{ months}$$

Interest on Drawings of Y = ₹ 20,000 × $\frac{9}{100} \times \frac{4 \cdot 5}{12}$ = ₹ 675

Case III. Interest on Drawings of Z — drawn at the middle of each quarter

$$\text{Average Period} = \frac{10 \cdot 5 + 1 \cdot 5}{2} = 6 \text{ months}$$

Interest on Drawings of Z = ₹ 20,000 × $\frac{9}{100} \times \frac{6}{12}$ = ₹ 900

If Fixed amount is withdrawn for 6 months on monthly basis for half year ending 30th June:

(1) **When drawings of a fixed amount are made at the beginning of each month.** Interest will be charged for 3·5 months.

$$\text{Interest on Drawings} = \text{Total Drawings} \times \frac{\text{Rate}}{100} \times \frac{3 \cdot 5}{12}$$

(2) When drawings of a fixed amount are made at the end of each month. Interest will be charged for 2·5 months for half year ending 30th June:

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

(3) When drawings of a fixed amount are made at the middle of each month. Interest will be charged for 3 months for half year ending 30th June:

$$\text{Interest on Drawings} = \text{Total Drawings} \times \frac{\text{Rate}}{100} \times \frac{3}{12}$$

R **Illustration 20.** A, B and C are partners sharing profits in the ratio of 2 : 2 : 1. A drew ₹ 5,000 at the beginning of each month, B drew ₹ 5,000 at the end of each month and C drew ₹ 5,000 at the middle of each month. Interest on drawings is charged at 6% p.a. Determine the amount of interest on drawing if this process is continued for a period of 6 months ending 30th September, 2020.

Solution.

Total drawings of 6 months = ₹ 5,000 × 6 = ₹ 30,000

	A (Beginning)	*B (End)*	*C (Middle)*
Average Period	$\frac{6+1}{2} = 3{\cdot}5$ months	$\frac{5+0}{2} = 2{\cdot}5$ months	$\frac{5{\cdot}5+0{\cdot}5}{2} = 3$ months
Interest on Drawings	₹ $30{,}000 \times \frac{6}{100} \times \frac{3{\cdot}5}{12}$ = ₹ 525	₹ $30{,}000 \times \frac{6}{100} \times \frac{2{\cdot}5}{12}$ = ₹ 375	₹ $30{,}000 \times \frac{6}{100} \times \frac{3}{12}$ = ₹ 450

If Fixed amount is withdrawn for first 6 months of the year on monthly basis but interest is computed for the year ending 31st December.

R **Illustration 21.** P, Q and R are partners in a firm. P drew ₹ 2,000 at the beginning of each month, Q drew ₹ 2,000 at the end of each month and R drew ₹ 2,000 at the middle of each month. This process of drawing continued for the first six months of the year 2019 starting from January. Compute interest on drawing @ 10% p.a. for the year ending 31st December, 2019.

Solution.

Total drawings of 6 months = ₹ 2,000 × 6 = ₹ 12,000 each

Interest on Drawing	*P (Beginning)*	*Q (End)*	*R (Middle)*
Average Period till Dec., 2019	$\frac{12+7}{2} = 9{\cdot}5$ months	$\frac{11+6}{2} = 8{\cdot}5$ months	$\frac{11{\cdot}5+6{\cdot}5}{2} = 9$ months
Interest on Drawings till Dec., 2019	₹ $12{,}000 \times \frac{10}{100} \times \frac{9{\cdot}5}{12}$ = ₹ 950	₹ $12{,}000 \times \frac{10}{100} \times \frac{8{\cdot}5}{12}$ = ₹ 850	₹ $12{,}000 \times \frac{10}{100} \times \frac{9}{12}$ = ₹ 900

Notes: Alternatively,

(i) Compute interest on drawings of P, Q and R for first 6 months *i.e.,* for 3·5, 2·5 and 3 months respectively.

(ii) Since interest on drawing is to be computed for the year 2019 from January to December so add interest on total drawings of first 6 months (*i.e.,* on ₹ 12,000) for last 6 months (1st July to December, 31) as well.

(iii) *(a)* Thus, P's interest on drawings will be for 3·5 + 6 = 9·5 months.

(b) Q's interest on drawings will be for 2·5 + 6 = 8·5 months.

(c) R's interest on drawings will be for 3 + 6 = 9 months.

Calculation of Interest on Drawings when unequal amount is drawn on different dates. Under such circumstances, interest on drawing can be computed by either of the two ways:

(i) Simple Method

(ii) Product Method

(i) **Simple Method.** Interest on drawing under this method is computed on each single drawing with reference to period of utilization of money.

(ii) **Product Method.** The amount of each drawing is multiplied with the number of months/number of days. The sum of products so obtained is determined and interest is computed for 1 month if the period is taken in months or for 1 day if the period is considered in days of a year.

U **Illustration 22(A).** Compute interest on drawing @ 12% p.a. for the year 2020 if Amit withdrew followings amounts during 2020:

	(₹)
February 1	3,000
April 30	4,000
June 1	3,000
September 30	5,000
November 1	7,000
December 31	2,000

Solution. The interest can be computed either by using *(i)* Simple Method or by using *(ii)* Product Method.

***(i)* Simple Method**

Date of Drawing	*Amount*	*Months (upto Dec. 31)*	*Interest @ 12% p.a.*
2020	(₹)		(₹)
February 1	3,000	11	330
April 30	4,000	8	320
June 1	3,000	7	210
September 30	5,000	3	150
November 1	7,000	2	140
December 31	2,000	0	0
Total Interest			1,150

* Interest = ₹ 3,000 × $\frac{12}{100} \times \frac{11}{12} =$ ₹ 330

***(ii)* Product Method**

Date of Drawing	*Amount*	*Months upto December 31*	*Product for 1 Month (Amount × No. of Months)*
2020	(₹)		(₹)
February 1	3,000	11	33,000
April 30	4,000	8	32,000
June 1	3,000	7	21,000
September 30	5,000	3	15,000
November 1	7,000	2	14,000
December 31	2,000	0	0
		Total	1,15,000

Interest on ₹ 1,15,000 @ 12% p.a. for 1 month

Interest on Drawing = ₹ 1,15,000 × $\frac{12}{100} \times \frac{1}{12}$ = ₹ 1,150

U **Illustration 22(B).** Kanika and Gautam are partners doing a dry cleaning business in Lucknow, sharing profits in the ratio 2 : 1 with capitals ₹ 5,00,000 and ₹ 4,00,000 respectively. Kanika withdrew the following amounts during the year 2019-20 to pay the hostel expesnes of her son.

2019-20	(₹)
1st April	10,000
1st June	9,000
1st November	14,000
1st December	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.

(C.B.S.E., Sample Paper 2014-15 – modified)

Solution.

(A) Computation of Interest on Drawing of Kanika

Date of Drawing (2019-20)	*Amount (₹)*	*Months upto March 31*	*Product for 1 month (₹)*
April 1	10,000	12	1,20,000
June 1	9,000	10	90,000
November 1	14,000	5	70,000
December 1	5,000	4	20,000
			3,00,000

Interest on ₹ 3,00,000 for 1 month @ 6% p.a.

Interest on Drawings = ₹ 3,00,000 × $\frac{6}{100} \times \frac{1}{12}$ = ₹ 1,500

(B) Interest on Drawings of Gautam

He withdrew ₹ 15,000 on first day of April, July, October and January (*i.e.,* fixed amount at the beginning of each quarter). Thus, interest will be charged for 7·5 months.)

Total Drawings = ₹ 15,000 × 4 Qtr. = ₹ 60,000

Interest on Drawings = ₹ 60,000 × $\frac{6}{100} \times \frac{7 \cdot 5}{12}$ = ₹ 2,250

Notes: *(i)* Average Period = $\frac{12+3}{2}$ = 7·5 months.

(ii) Payment of office rent is not a drawing.

Calculation of Interest on Drawings when date of drawing is not given: If we are given total drawings of a partner say ₹ 60,000 during the year without reference to exact timings of the drawings, in such cases interest on drawings be computed for 6 months period.

R **Illustration 23(A).** Gopi withdrew ₹ 48,000 for his household expenses during the ending 31st March, 2020. Compute interest on drawing for the year 2019-20 if rate of interest on drawing is @ 10% p.a. Will the interest on drawing differ if Gopi withdraws ₹ 4,000 per month?

Solution.

(i) It is assumed that drawings had been made evenly throughout the period of the year so interest on drawing will be computed for 6 months

∴ Interest on drawings = ₹ 48,000 × $\frac{10}{100} \times \frac{6}{12}$ = ₹ 2,400

(ii) Total drawings of the year = ₹ 4,000 × 12 = ₹ 48,000

Since time of drawing of each month is not given so it is assumed that it has been made in the middle of each month.

Interest on drawings = ₹ 48,000 × $\frac{10}{100} \times \frac{6}{12}$ = ₹ 2,400

Interest on drawing if rate of interest is given without reference to p.a. (per annum): In such cases, interest on drawing is computed on percent basis without reference to time factor. This can be seen from the following illustration.

R **Illustration 23(B).** X and Y are partners sharing profits equally. X withdrew ₹ 20,000 and Y withdrew ₹ 25,000 during the year ending 31st March, 2020. As per partnership deed, interest on drawing is computed at 6%. Find the interest on drawings.

Solution. Since the interest on drawing is given at 6% without reference to per annum so it will be computed without reference to time factor.

Interest on Drawing = Drawing × $\frac{\text{Rate}}{100}$

X = ₹ 20,000 × $\frac{6}{100}$ = ₹ 1,200; Y = ₹ 25,000 × $\frac{6}{100}$ = ₹ 1,500

R **Illustration 24. (Interest on Drawings)**

Compute interest on drawings of Rajesh @ 10% p.a. in the following alternate cases for the year ended 31st March 2020.

Case I. If his drawings during the year was ₹ 40,000

Case II. If he withdrew ₹ 2,500 p.m. during the year.

★ **Case III.** If he withdrew ₹ 3,000 p.m. for first six months in the beginning of each months and he withdrew ₹ 3,000 p.m. for the later 6 months at the end of each months.

Solution.

Case I. Interest on drawing will be computed for an average period of 6 months assuming that drawings were made evenly throughout the year.

$$\text{Interest} = ₹\ 40{,}000 \times \frac{10}{100} \times \frac{6}{12} = ₹\ 2{,}000$$

Case II. Total drawings for the year = ₹ 2,500 × 12 = ₹ 30,000

Interest on drawing will be computed for 6 months assuming that drawings were made in the middle of each months as nothing is stated.

$$\text{Interest} = ₹\ 30{,}000 \times \frac{10}{100} \times \frac{6^*}{12} = ₹\ 1{,}500$$

$$\text{* Average Period} = \frac{11{\cdot}5 + 0{\cdot}5}{2} = 6 \text{ months}$$

Case III. Total drawing for 6 months = ₹ 3,000 × 6 = ₹ 18,000

(a) Interest on drawing for first 6 months (at the beginning of each month) will be interest for 3·5 months (*i.e.,* 1 April to 30 September.)

$$\text{Interest} = ₹\ 18{,}000 \times \frac{10}{100} \times \frac{3{\cdot}5^*}{12} = ₹\ 525$$

$$\text{* Average Period} = \frac{6+1}{2} = 3{\cdot}5 \text{ months}$$

But interest on drawing on ₹ 18,000 will continue till 31st March (*i.e.,* from October 1st to 31st March for 6 months also.)

$$\therefore \text{Interest} = ₹\ 18{,}000 \times \frac{10}{100} \times \frac{6}{12} = ₹\ 900$$

So total interest will be = ₹ 525 + 900 = ₹ 1,425

Alternatively, Interest on drawings at the beginning of each month for first 6 months till 31st March will be interest for 9·5 months.

$$\therefore \text{Interest} = ₹\ 18{,}000 \times \frac{10}{100} \times \frac{9{\cdot}5}{12} = ₹\ 1{,}425$$

$$\text{*}\textbf{Average Period} = \frac{12+7}{2} = 9{\cdot}5 \text{ months}$$

*[12 months from 1st April to 31st March and 7 months from 1st September to 31st March (Since interest on drawing is computed till 31st March)]

(b) Interest on drawing for last 6 months (at the end of each month) will be interest for 2·5 months (*i.e.,* from October 1 to March 31.)

$$\text{Interest} = ₹\ 18{,}000 \times \frac{10}{100} \times \frac{2{\cdot}5^{*}}{12} = ₹\ 375$$

$$^{*}\ \text{Average Period} = \frac{5+0}{2} = 2{\cdot}5 \text{ months}$$

(c) Thus, total interest on drawing for whole year is ₹ 1,425 + 375 = ₹ 1,800

R V. Interest on Partners' Loan

It has already been discussed after **Illustration-6** in detail.

R VI. Partners' Salary or Commission

(A) Salary to Partner. If a partner is more active or is devoting more time in the business, he may be allowed salary as per terms and conditions of Partnership Deed. The entries passed are:

(i)	Partners' Salary A/c	Dr.
	To Partners' Capital/Current A/c	
(ii)	Profit and Loss Appropriation A/c	Dr.
	To Partners' Salary A/c	

(B) Partners' Commission. The partner of a firm is often allowed commission as % on net profit so that he may discharge his duty with dedication. Commission payable to a partner is computed in two ways, namely:

(i) **As percentage of net profit before charging such commission.** It is computed as—if net profit before charging commission is ₹ 15,000 and rate of commission is 10%.

$$\text{Commission} = \text{Net Profit} \times \frac{\text{Rate}}{100} = ₹\ 15{,}000 \times \frac{10}{100} = ₹\ 1{,}500$$

(ii) **As percentage of net profit after charging such commission**

$$\text{Commission} = \text{Net Profit before commission} \times \frac{\text{Rate of Commission}}{100 + \text{Rate of Commission}}$$

Suppose net profit before partners' commission is ₹ 22,000. Ram is entitled to commission @ 10% on net profit after charging his commission as per Partnership Deed. Compute his commission.

$$\text{Commission} = ₹\ 22{,}000 \times \frac{10}{(100+10)} = ₹\ 22{,}000 \times \frac{10}{110} = ₹\ 2{,}000$$

Accounting Treatment

(i)	Partners' Commission A/c	Dr.
	To Partners' Capital/Current A/c	
(ii)	Profit and Loss Appropriation A/c	Dr.
	To Partners' Commission A/c	

QUESTIONS BASED ON PROFIT AND LOSS APPROPRIATION A/C

Following illustrations are based on preparation of Profit and Loss Appropriation Account incorporating problems of partners' interest on capital, interest on drawing, interest on partners' loan, partners' salary and partners' commission.

R **Illustration 25(A).** A and B started business on July 1, 2019, each partner contributed ₹ 1,50,000 as his share of capital. Three months later, on October 1, 2019, B makes an additional contribution of ₹ 1,00,000 which is treated as a loan. The profit for the period ending March, 2020 was ₹ 85,000 before charging any interest. The partners had drawn ₹ 24,000 each on 1st January, 2020.

Prepare the Profit and Loss Appropriation Account for the period ended March 31, 2020. ***(C.B.S.E., 2006-F Set-I, modified)***

Solution. **Profit & Loss Appropriation Account**

Dr. *for the year ending 31st March, 2020* *Cr.*

Particulars		(₹)	*Particulars*		(₹)
To Profit transferred to:			By P&L A/c (Net Profit)	85,000	
A's Capital A/c	41,000		*Less:* Interest on B's Loan		
B's Capital A/c	41,000	82,000	$\left(₹\ 1{,}00{,}000 \times \frac{6}{100} \times \frac{6}{12}\right)$	3,000	82,000
		82,000			82,000

Notes:
1. Interest on partners' loan is charged @ 6% p.a. in the absence of partnership deed. It is a charge aganist profit so it should either be charged to Profit and Loss A/c or it should be deducted from the credit side of Profit and Loss Appropriation A/c in the inner column.
2. No interest on capital is payable and no interest on drawing is receivable in the absence of partnership deed.
3. Profit sharing ratio will be 1 : 1 in the absence of partnership deed.

Illustration 25(B). L, M and N are partners in a firm sharing profits and losses in the ratio of 2 : 3 : 5.

On April 1, 2016, their fixed capitals were ₹ 2,00,000, ₹ 3,00,000 and ₹ 4,00,000 respectively. Their partnership deed provided for the following:

(i) Interest on capital @ 9% per annum.

(ii) Interest on Drawings @ 12% per annum.

(iii) Interest on partners' loan @ 12% per annum.

On July 1, 2016, L brought ₹ 1,00,000 as additional capital and N withdrew ₹ 1,00,000 from his capital. During the year, L, M and N withdrew ₹ 12,000, ₹ 18,000 and ₹ 24,000 respectively for their personal use. On January 1, 2017, the firm obtained a loan of ₹ 1,50,000 from M. The Net profit of the firm for the year ended March 31, 2017 after charging interest on M's loan was ₹ 85,000.

Prepare Profit and Loss Appropriation Account and Partners Capital Account. ***(C.B.S.E., Sample Paper 2017-18) [6 Marks]***

Solution. **Profit and Loss Appropriation Account**

for the year ended on March 31, 2017

Dr. *Cr.*

Particulars		(₹)	*Particulars*		(₹)
To Interest on Capital:			By Profit and Loss A/c –		
L's Current A/c	24,750		Net Profit b/d		85,000
M's Current A/c	27,000		By Interest on Partners' Drawings:		
N's Current A/c	29,250	81,000	L's Current A/c	720	
To Profit trans. to			M's Current A/c	1,080	
Partners' Current A/cs:			N's Current A/c	1,440	3,240
L	1,448				
M	2,172				
N	3,620	7,240			
		88,240			88,240

Partners' Capital A/c

Dr. *Cr.*

Date	*Particulars*	*L* (₹)	*M* (₹)	*N* (₹)	*Date*	*Particulars*	*L* (₹)	*M* (₹)	*N* (₹)
2016					2016				
Jul. 1	To Bank A/c	—	—	1,00,000	Apr. 1	By Balance b/d	2,00,000	3,00,000	4,00,000
					Jul. 1	By Bank A/c	1,00,000	—	—
2017									
Mar. 31	To Balance c/d	3,00,000	3,00,000	3,00,000					
		3,00,000	3,00,000	4,00,000			3,00,000	3,00,000	4,00,000

Working Notes:

1. Interest on Capital of L

		(₹)
On ₹ 2,00,000 @ 9% p.a. for 1 year	=	18,000
On ₹ 1,00,000 @ 9% p.a. for 9 months	=	6,750
		24,750

2. Interest on Capital of M

On ₹ 3,00,000 for 1 year = ₹ 27,000

3. Interest on Capital of N

		(₹)
On ₹ 4,00,000 @ 9% p.a. for 3 months	=	9,000
On ₹ 3,00,000 @ 9% p.a. for 9 months	=	20,250
		29,250

4. Interest on drawings be calculated for 6 months as it is given without reference to time period

R **Illustration 26.** A, B and C were partners in a firm having capital of ₹ 60,000, ₹ 60,000 and ₹ 80,000 respectively. Their current account balances were A—₹ 10,000, B—₹ 5,000 and C—₹ 2,000 (Dr.). According to partnership deed, the partners were entitled to interest on capital @ 5% p.a. C being the working partner was also entitled to a salary of ₹ 6,000 p.a. The profits were to be divided as follows :

(*i*) The first ₹ 20,000 in proportion of their Capitals.