Accounting for Partnership : Basic Concept

Nature of Partnership & Partnership Deed

Objective of this Lesson

After going through this lesson, you shall be able to understand the following concepts related to Partnership.

- Nature of Partnership
- Characteristics of Partnership
- Partnership Deed and its Content
- Importance of Partnership Deed
- Provisions in Absence of Partnership Deed

Introduction to Partnership

The word 'Partnership' in the lay-man sense implies an agreement between two people to work together or jointly. In accountancy, the meaning of partnership is the similar to that of in the general sense but with a greater depth. In our context, partnership implies the agreement between two or more people who have decided to carry-out a business jointly. The main motive to form a partnership is to earn profit arising out of the business activities.

Formal Definition of Partnership

According to the Section 4 of the Partnership Act, 1932, partnership is an agreement between two or more persons who have agreed to share profits or losses of a business that will be carried by all or any one of them acting for all. The persons who joined their hands to set up the partnership business individually are known as 'Partners' and all the partners in the partnership business collectively known as 'Firm'. The name under which the partners decided to carry out their business is known as 'Firm Name'. Partnership is a separate business entity. It implies that a partnership firm is different from its partners. Any action taken by the partnership firm does not bind its partners. Also any action taken by the partners does not bind the partnership firm. But from the legal point of view, partnership firm is not treated as a separate business entity from its partners. It is same in the eyes of law.

Characteristics of Partnership

The following are the important characteristics of a partnership.

1. **Two or More Persons-** Partnership is an agreement between two or more persons coming together for a common goal. There should be at least two persons to form a partnership. Although as per the Partnership Act of 1932, there is ***no maximum limit*** on the number of partners in a partnership firm, but as per ***Rule (10) of Companies (Miscellaneous) Rules Act 2014, the maximum number of partners permissible is 50***.

   Therefore, in case the number of partners exceeds the aforesaid limit, then the concerned partnership is considered to be illegal. In this regards it must be noted that Section 464 of the Companies Act, 2013 provides that number of persons in any association/partnership shall not exceed one hundred subject to the limit prescribed in rules.

   In this regard, it must be noted that the maximum number of partners is not limited in case an association or partnership is formed by professionals such as chartered accountants, lawyers, company secretaries, etc. These professionals are governed by the special laws as formed by their respective professional institutions.

   Prior to the enforcement of Companies Act of 2013, the earlier act of 1956, imposed restrictions on the maximum number of partners to 10 in case of banking business and 20 in case of any other kind of business. However, with effect from April 01, 2014, Companies Act of 1956 has been replaced by Companies Act of 2013.

2. **Partnership Deed-** An agreement between the partners of a partnership firm to carry out the business activities under a common banner of a partnership firm is termed as Partnership Deed. To form a partnership business, a partnership agreement is required. In other words, partnership is created by a partnership agreement. The partnership agreement can either be written or oral. The partnership deed in both the forms is equally valid in the eyes of law. However, it is always preferred to have a written agreement to avoid the future conflicts and disputes among the partners. The partnership agreement helps in governing the partners for carrying out the proposed business activities. It also forms the basis for defining the relationship among the partners.

3. **Business-** A partnership is formed to carry out a legal business. Any partnership formed for carrying out an illegal business is treated as an illegal partnership. For example, partnership for smuggling is treated as illegal. In other words, the business activities should be lawful to form a partnership.

4. **Sharing of Profits or Losses-** The profits earned or losses incurred by a partnership firm must be distributed among the partners as per the partnership deed. It is one of the important features of a partnership. In short, the partners must share all the profits or losses of the business in the agreed ratio.
   However; it is not always necessary that all the partners in a partnership firm will bear the loss. It is as per the terms and conditions of the partnership deed.

5. **Liability-** In a partnership business, the liability of the partners is unlimited. They are liable for all the debts of the partnership firm. Each partner is liable jointly with all the other partners and also individually to the third party for all the acts of the firm. If the assets of the firm are not sufficient to meet its obligations, then the partners may be compelled to bring their personal assets to pay the firm's debt.

6. **Mutual Agency-** The partnership may be carried on by all the partners or by any one of them on behalf of all. All the partners have equal right to participate in the activities of the business. There exists a principal and agent relationship among the partners of a firm. As an agent, a partner may bind the other partners by his/her acts and as a principal, a partner is himself/herself bound by the acts done by the other partners. Thus, it can be concluded that mutual agency is very important feature of partnership firm without which it cannot be considered as partnership.

<u>Note</u>: *In case of any question regarding the permissible limit on the maximum number of partners in a partnership firm, the students shall take the limit as 50.*

Liabilities Of A Partner

When a partnership is formed certain terms governing his relationship with the firm are also decided a priori that makes him liable in the following cases:
1) Competitive Business by a Partner: In case a partner carries a business that is quite similar to that of the firm and earns profits from it, then he shall be liable to pay such profits to the firm. The reason being

that his business being a competition for the firm violates the very basic nature of trust bestowed on him by the firm.

2) Profit for self from a firm's transaction: If a partner earns any profit for self through the use of business's property or connection or through any business transaction then the profit so earned shall be handed over to the firm as it is. The reason being that a partner must not take undue advantage of the firm for his own personal gains. For example, rent from a business property belonging to the firm must not be taken by the partner, etc.

Some other important Provisions of the Indian Partnership Act, 1932

1) Sec. 30: A minor may be admitted for the benefit of partnership if agreed upon by all the partners.
2) Sec. 31: If all partners agree or the express agreement among the partners permit, a person can be admitted as a partner to the firm.
3) Sec. 32: If all partners agree or the express agreement among the partners permit, a person may retire from the firm.
4) Sec. 69: It is optional to register the firm
5) Sec. 35: A firm is dissolved on the death of the firm unless otherwise agreed by the partners in the Partnership Deed.

Note: *The above provisions will apply when Partnership Deed does not exist or where it exists it does not have a clause to this effect.*

PARTNERSHIP DEED

Partnership requires mutual trust, confidence and understanding among all the partners. An agreement that contains every aspects and terms that the partners agreed upon before commencing the partnership firm is termed as partnership deed. A partnership deed can either be oral or written. Both the forms of the partnership deed are equally valid in the eyes of law. However, it is always advisable and preferable to have a written agreement in order to avoid any future conflicts and disputes among the partners. The partnership agreement in the written form is termed as Partnership Deed.

Thus, a partnership deed can be defined as a document containing the details about the partners and agreement among all the partners of a partnership firm. It includes agreement on profit sharing ratio, salaries, commission of partners, interest on partner's capital and drawings, interest on loan given or taken by the partners, etc. The deed also defines the rights and responsibilities of all the partners of a firm. Generally, the following details are included in a Partnership Deed.

1. Name and addresses of the firm and its principal place of business
2. Name and addresses of all the partners
3. Nature and type of the business
4. The date of commencement of partnership
5. Duration of Partnership
6. Contribution to capital by each partner
7. Profit and sharing ratio
8. Rate of interest on capital, drawings and loans
9. Rights, duties and responsibilities of each partner
10. Salaries, commission, if payable to the partners
11. Method of valuation of goodwill
12. Rules regarding admission, retirement, death and dissolution of the firm, etc.
13. Method of revaluation of assets & liabilities etc.

Importance of Partnership Deed

A partnership deed is a written partnership agreement among the partners of a partnership firm. Although, the law does not make it compulsory to have a written partnership agreement but it is always preferred to have a agreement in writing due to the following reasons.

1. It provides information regarding rights, duties and obligations of each of the partners
2. It helps in avoiding the misunderstanding and disagreements among the partners on any issue. This is because a deed contains all the terms and conditions accepted by the partnership at the inception of the partnership, which can be referred to as and when needed.
3. It acts as an evidence in the court of law.
4. It serves as basis for the formation of a partnership.

Provision in Absence of Partnership Deed/When Partnership Deed is Silent

In absence of partnership deed or when a partnership deed is silent on any fronts, then the following rules should be applied.

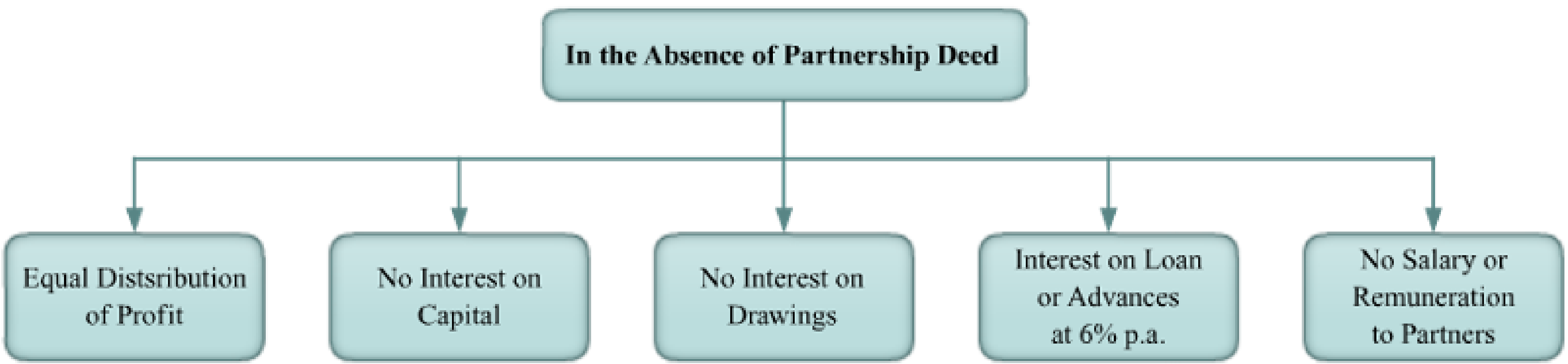
1. ***Profit Sharing Ratio***- In absence of a partnership deed or when the partnership deed does not provide any provisions relating to profit sharing ratio, then profits and losses are shared equally among all the partners irrespective of their capital contributions.

2. ***Interest on Capital***- In absence of a partnership deed, no interest shall be allowed to any partners on the capital invested by them.

3. ***Interest on Drawings***- In the absence of a partnership deed, no interest is charged from the partners on the amount of drawings made by them individually.

4. ***Interest on Loans or Advances***- Sometimes, partners advance loan to their partnership firm. In such a case, the partners (who advanced the loan) are entitled to receive interest on the loan @ 6% per annum. The interest on loan to the partners has to be provided even in the absence of a partnership deed. As interest on loan is an obligation for a partnership firm, so it is liable to pay such interest under every circumstances,irrespective of profits earned or losses incurred by the firm.

5. ***Salary or Remunerations to Partners***- In absence of a partnership deed, the partners are not entitled to receive any salary or remuneration for participating in the business of the firm.



Rights of Partners of a Partnership Firm

The given below are the rights of partners in a Partnership Firm.

1. Every partner has a right to share profits or losses of the firm equally or in the ratio as agreed among them.

2. Every partner has a right to receive interest on loan and advances provided to the firm at the rate of 6% p.a. if the rate is not agreed among the partners.
3. Every partner has a right to participate in the conduct or management of the business.
4. Every partner has a right to access, inspect and copy the books of accounts and records of the firm.
5. Every partner has a right to voice his/her opinion on the matters relating to the business.
6. Every partner has a right to be indemnified for all the expenses and liabilities incurred by him/her on behalf of the business.
7. Every partner has a right to use the property of the firm exclusively for the partnership business and not for personal use.
8. A partner has a right to restrict the admission of a new partner or prevent the expulsion of existing partner from the firm.
9. A partner has a right to retire from the firm after giving a proper notice or with the consent of all other co-partners.
10. In case of emergency, a partner has a right to act on behalf of the firm in order to prevent it from the losses and posses a right to claim indemnity for the payments made by him/her for such act.

Some Important Facts

- It should be noted that usually all the partners are entitled to share firm's profit or bear the losses. However, there may be a few situations where not all the partners need to bear losses so incurred. The following are the circumstances in which a partner need not to bear loss when:

    1. a partner is admitted to share profit only (and not to bear any losses).
    2. the losses are incurred due to willful negligence of the other partners.

- We all know the importance of the partnership deed. However, it should be noted that though it is advisable but not mandatory to have a partnership deed. Similarly, as per the Indian Partnership Act of 1932, it is also not compulsory to register a partnership firm. The partners find it beneficial to register their partnership firm (in order to procure license and other permissions) and to have a written partnership deed (in order to avoid any future disputes among them).

Limited Liability Partnership

LLP is a relatively new form of business entity that was formed to overcome the limitations of the existing forms of business entity mainly, Partnership and Company. The need for LLP grew as small business owners who usually started off with the Partnership form of business had to bear unlimited liability despite their meager means. Thus, LLP provided the much needed respite by combining the best of both worlds. By drawing its characteristics from both the partnership and the company form, it is slowly catching up to be a popular way of organising the business. As a hybrid, it makes the liability of the partners limited to the extent of their contribution to the firm and frees them from being held liable for the negligence or misconduct of their partners. This has therefore made it an attractive form of business entity.

LLP as constituted in India

The Limited Liability Partnership Act, 2008 came into effect from 31st March, 2009 for the reasons as stated above. Being a part of the Indian corporate structure it is organised as follows:

1) Like any other Partnership firm, LLP is subject to income tax.
2) It protects individual partners from the joint liability created by another partner's misconduct or wrongful business decisions.
3) LLP has a separate legal entity which is distinct and separate from its owners unlike a partnership. Partners may come and go but the firm continues to exists due to its perpetual succession like a limited liability company. There is no limit on the maximum number of members as it is not governed by the Indian Partnership Act, 1932. As per the LLP Act, 2008 at least one partner in the LLP should be an Indian Citizen and an Indian National.
4) The authority to control and register LLPs is the Registrar of Companies.

Features Of A LLP

1) Independent Entity: Like any living person, LLP has its own individual identity which is separate and distinct from its owners. This makes it similar to a company and ensures that partners may come or go but the business continues to exist.

2) Minimum amount of Capital: Capital acts as the food for an enterprise and a good amount of capital makes the survival of the firm long-term. Therefore, the minimum amount of capital of LLP is decided before hand by the partners rather than any Act and is contributed by them.

3) Optional Audit: Audit ensures that the books of accounts of the firm are presented in a true and fair manner. It also safeguards the interests of the stakeholders involved which in the case of a company are huge in numbers. That is why, it is mandatory for a company to have regular audits. However, Unlike a company, audit of LLP's books of accounts is not mandatory, except:

(a) If the contributions of the LLP exceeds 25 lakhs; or
(b) If the annual turnover exceeds 40 lakhs.

3) Minimum Number of Members: Having shared some of its features with the Partnership, LLP can also be constituted with a minimum of two members having a Directors Identification Number (DIN) and also acting as designated partners. However, there is no limit on the maximum number of partners all of whom are required to have their Directors Identification Number(DIN).
Registration process is same as that of a company.

Advantages Of A LLP

1) The reason LLP is called a hybrid of partnership and company form is the feature of limited liability of the members to the extent of their contribution in the firm. It thereby overcomes the disadvantage of a Partnership firm. However, it draws some similarity with it by preparing an agreement that is similar to a Partnership Deed.

2) LLP allows more flexibility to the members to organise their internal structure. This is owing to the fact that in a company the Articles of Associations are drawn up by the management and others have to follow them blindly but this is not the case with the LLP. Here, the members mutually decide and arrive at the internal structure of the firm.

3) Companies are bound by the Act and henceforth do not have the autonomy to raise and utilise funds as per their will. LLP thus overcomes this limitation by allowing the partners to raise and use the funds at their own discretion.

4) LLP can have any number of partners without having to worry about any prescribed limit which is not the case with a company.

Limitations Of LLP

1. LLP is not immune from the acts of its partners who might act to the disadvantage of the firm. Thereby making the firm liable for their acts.
2. LLP's sources of funds are limited to the extent that it does not raise money from the public in general.
3. LLP is not considered a very lucrative investment by venture capital firms who prefer private limited over LLP. This is because LLP is a relatively new concept in India which they do not wish to test. LLPs having their own agreements that might state a duration for which the firm will exist. Also, some of the advantages of LLP like that of optional audit does not go well with the objectives of a venture capitalist.

Difference Between LLP and Partnership Firm

Basis	LLPs	Partnerships
1. Independent Entity	It has an entity separate from its owners.	It does not have a separate entity.
2. Number of Partners	No maximum limit but minimum shall be two.	Maximum: 50 Minimum: 2
3. Governing Law	The Limited Liability Partnership Act, 2008	Indian Partnership Act, 1932
4. Registration of the Firm	Registration mandatory with the Registrar of Companies(Roc)	Not mandatory
5. Liability of the partners	Limited to the extent of their contribution to the firm.	Unlimited meaning their personal property can be used for paying off the firm's liability.
6. Perpetual Existence	It has a perpetual existence and is not affected by the death, admission, exit or retirement of partners.	It does not have a perpetual existence.
7. Body Corporate As a Partner	Can be admitted as a partner.	Cannot be admitted as a partner
8. Who owns the assets?	Assets of the firm are owned by the LLP and not the partners.	Assets of the firm are owned by the partners and not the firm.

Profit and Loss Appropriation Account

Objective

After going through this lesson, you shall be able to understand the following concepts.

- Profit and Loss Appropriation Account and its Features
- Difference between Profit and Loss Account and Profit and Loss Appropriation Account
- Steps to prepare Profit and Loss Appropriation Account
- Format of Profit and Loss Appropriation Account
- Need to Profit and Loss Adjustment Account

Profit and Loss Appropriation Account

In the previous class, we understood Profit and Loss Account in the chapter of Financial Statements of a sole proprietor. In case of the partnership firms, we need to prepare a similar account known as *Profit and Loss Appropriation Account*. Similar to the Profit and Loss Account, Profit and Loss Appropriation Account is also a nominal account. This implies that the appropriation account is prepared by following the rule of nominal account,"***Debit all expenses and losses and Credit all incomes and profits***".

This account is prepared after Profit and Loss Account. The Profit and Loss Appropriation Account is prepared primarily to show the appropriation (distribution) of profits among the partners. That is, in different words, this account shows how the net profit is distributed (appropriated) among all the partners of a partnership firm. The appropriation of net profit is done after considering all the relevant adjustments such as interest on partners' capitals, interest on drawings, partners' salary and commissions, etc.

Features of Profit and Loss Appropriation Account

a. It is an extension of Profit and Loss Account.
b. It is prepared to show how the profit available for appropriation has been appropriated among different items such as interest on capitals, partners' remunerations in the form of salary, commissions, etc. It is nominal account in nature.
c. In case of partnership firms, the items of profit due to the partners such as interest on capitals, partners' remunerations in the form of salary, commissions, are debited and the items due from partners such as interest on partners' drawings, net profit are credited to the Profit and Loss Appropriation Account.

Relationship between Profit and Loss Account and Profit and Loss Appropriation Account

The following points highlight the relationship between the two accounts.

1. Profit and Loss Account is prepared to ascertain the amount of net profit after considering all the expenses and incomes of a firm. On the other hand, Profit and Loss Appropriation Account is prepared to show how the net profit so ascertained is distributed among all the partners of the firm.

2. Profit and Loss Appropriation Account is prepared after Profit and Loss Account. The appropriation account is prepared using the net profit (or net loss) revealed by the Profit and Loss Account. Thus, in this sense Profit and Loss Appropriation Account is regarded as an extension of Profit and Loss Account.

Difference Between Profit and Loss and Profit and Loss Appropriation Account

Points of Difference	Profit and Loss Account	Profit and Loss Appropriation

		Account
Objective	It is prepared to ascertain profit earned and loss incurred from the main course of business.	It is prepared to show the appropriation of profit.
Partnership Agreement	Items in this account may or may not be related to the partnership agreement.	Items in this account are shown as per the partnership agreement.
Concept or Basis	It prepared by following the matching concept	It is prepared by following partnership agreement.
Starts with	It begins with Gross Profit or Gross Loss.	It begins with Net Profit/ Loss or the opening balance that is available for appropriation.

Difference Between Appropriation Out Of Profit And Charge Against Profit

Basis of Difference	Appropriation Out Of Profit	Charge Against Profit
1. Recording	Recorded on the debit side of Profit And Loss Appropriation A/c.	Recorded on the debit side of Profit And Loss A/c.
2. Essential or not	Appropriations made only when profit exists.	Charges Against profits are to be made even when there is a loss.
3. Nature	It constitutes distribution of profits under different heads.	While computing net profit or loss, they comprise of expenses to be deducted from profits.

4. Example	Partner's Salary, Interest on Capital, etc.	Rent paid to a partner and Interest on partner's loan.

Steps to Prepare Profit and Loss Appropriation Account

The following are the steps to prepare the Profit and Loss Appropriation Account.

Step 1: Show Net Profit on the credit side of the Profit and Loss Appropriation Account. If Net Loss is given, then it is shown on the debit side of the account.

Step 2: The items such as Interest on Partners' Capitals, Partners' Salary, Partners' Commissions, Bonus to the Partners, profit transferred to reserves, etc. are shown on the debit side of the Profit and Loss Appropriation Account.

Step 3: If Interest on Partners' Drawings is given, then it is shown on the credit side of the account.

Step 4: Finally, both the sides are totaled. If the total of the ***debit side exceeds that of the credit side***, then the difference amount is shown on the credit side of the account as '***Loss transferred to Partners' Capital Accounts***'. On the contrary, if the total of the ***credit side exceeds that of the debit side***, then the difference amount is shown on the debit side of the account as '***Profit transferred to Partners' Capital Accounts***'.

Format of Profit and Loss Appropriation Account

Profit and Loss Appropriation Account
for the year ended ....

Dr. **Cr.**

Particulars	**Amount Rs**	**Particulars**	**Amount Rs**
Profit and Loss A/c (*Net Loss*- transferred from Profit and Loss A/c) Interest on Partners' Capital Salary to Partner/s Commission to Partner/s Bonus to Partner/s Reserve (Amount transferred to reserve)		Profit and Loss A/c (*Net Profit*- transferred from Profit and Loss A/c) Interest on Partners's Drawings	

#Profit transferred to Partners' Capital A/c (or Current A/c)*		#Loss transferred to Partners' Capital A/c (or Current A/c)*	

#Either Profit or Loss will occur at a time.

*Divisible profits (or losses) are transferred to Partners' Capital Account in case of 'Fluctuating Capital Method' and in case of 'Fixed Capital Method' divisible profits (or losses) are transferred to Partners' Current Account.

Journal Entries relating to Profit and Loss Appropriation Account

Transferring the balance of Profit and Loss Account to Profit and Loss Appropriation Account

In case of Credit Balance ***(Net Profit)***	**In case of Debit Balance** ***(Net Loss)***
Profit and Loss A/c Dr. To Profit and Loss Appropriation A/c	Profit and Loss Appropriation A/c Dr. To Profit and Loss A/c

Interest on Capital

For Crediting Interest on Capital
Interest on Capital A/c Dr. To Partners' Capital/ Current A/c (individually)
For transferring Interest on Capital
Profit and Loss Appropriation A/c Dr. To Interest on Capital A/c
Alternatively, *for above two entries, only one single entry can be passed as*
Profit and Loss Appropriation A/c Dr. To Partners' Capital/ Current A/c *(individually)*

Salary or Commission or Bonus to Partners

For Crediting Partners' Salary, Commission, Bonus
Partners' Salary A/c Dr. Partners' Commission A/c Dr. Bonus to Partners A/c Dr. To Partner's Capital/Current A/c (individually)
For transferring Partners' Salary, Commission, Bonus to Profit and Loss Appropriation Account
Profit and Loss Appropriation A/c Dr. To Partners' Salary A/c To Partners' Commission A/c To Bonus to Partners A/c
Alternatively, for the above two entries, one single entry can be passed as:
Profit and Loss Appropriation A/c Dr. To Partner's Capital/Current A/c (individually)

Interest on Drawings

For Charging Interest on Drawings to Partners' Capital Account
Partners' Capital/Current A/c (individually) Dr. To Interest on Drawings A/c
For transferring Interest on Drawings to Profit and Loss Appropriation Account
Interest on Drawings A/c Dr. To Profit and Loss Appropriation A/c
Alternatively, for the above two entries, one single entry can be

passed as:
Partner's Capital/Current A/c (individually) Dr. To Profit and Loss Appropriation A/c

Reserve

For transferring Reserve to Profit and Loss Appropriation A/c
Profit and Loss Appropriation A/c Dr. To Reserve A/c

Share of Profit or Loss on Appropriation

In case of ***Profit***
Profit and Loss Appropriation A/c Dr. To Partner's Capital/Current A/c (individually)
In case of ***Loss***
Partner's Capital/Current A/c (individually) Dr. To Profit and Loss Appropriation A/c

Example: P and Q are partners in a partnership firm sharing profits and losses in the ratio of 3 : 1. Their partnership deed provides for the following provisions:

i. Interest on capital at 8% p.a.
ii. Salary to P Rs 800 per month and to Q Rs 1,200 per month.
iii. 10% of the net profit required to be transferred to reserve.
iv. Bonus to Q Rs 5,000.
v. Interest on partners drawings amounts to Rs 300 for P and Rs 200 for Q.

The capital balances of P and Q were Rs 60,000 and Rs 80,000 respectively. The net profit of the firm for the year ended was Rs 80,000. Prepare Profit and Loss Appropriation Account.

Solution

Profit and Loss Appropriation Account

Dr. **Cr.**

Particulars	**Amount Rs**	**Particulars**	**Amount Rs**

Interest on Capital: (***WN 1***)		Profit and Loss A/c (Net Profit)	80,000
P 4,800		Interest on Drawings:	
Q 6,400	11,200	P 300	
Salary to:		Q 200	500
P (Rs 800 × 12) 9,600			
Q (Rs 1,200 × 12) 14,400	24,000		
Bonus to Q	5,000		
Transfer to Reserve (***WN 2***)	8,000		
Profit transferred to: (***WN 3***)			
P's Capital A/c 24,225			
Q's Capital A/c 8,075	32,300		
	80,500		80,500

Working Notes:

WN 1 *Calculation of Interest on Capital*

$$\text{Interest on P's Capital} = 60{,}000 \times \frac{8}{100} = \text{Rs } 4{,}800$$

$$\text{Interest on Q's Capital} = 80{,}000 \times \frac{8}{100} = \text{Rs } 6{,}400$$

WN 2 *Calculation of Transfer to Reserve*

Transfer to reserve = 10% of Net Profit

$$= \frac{10}{100} \times 80{,}000 = \text{Rs } 8{,}000$$

WN 3 *Calculation of Profit Share of each Partner*

Profit available for distribution = 32,300
Profit sharing ratio = 3 : 1

$\therefore$ P's profit $= 32{,}300 \times \frac{3}{4} =$ Rs 24,225

and Q's profit $= 32{,}300 \times \frac{1}{4} =$ Rs 8,075

Example: S and M are partners in a partnership firm sharing profits and losses in the ratio of 3 : 2 with capital of Rs 1,50,000 and Rs 2,40,000 respectively. Interest on capital is agreed at 7% p.a. Salary to active partners is Rs 16,800. S worked as active partner for 4 months and M for the remaining period. Deed provides for commission to M at 8% of net profit after allowing interest on partners' capital. The net profit of the firm for the year ended was Rs 1,17,300. Prepare Profit and Loss Appropriation Account.

Solution

Profit and Loss Appropriation Account

Dr. **Cr.**

Particulars		Amount Rs	Particulars	Amount Rs
Interest on Capital: (***WN 1***)			Profit and Loss A/c (Net Profit)	1,17,300
S	10,500			
M	16,800	27,300		
Salary to:				
S (16,800/12 × 4)	5,600			
M (16,800/12 × 8)	11,200	16,800		
Commission to M (***WN 2***)		7,200		
Profit transferred to: (***WN 3***)				
P's Capital A/c	39,600			
Q's Capital A/c	26,400	66,000		
		1,17,300		1,17,300

Working Notes:

WN 1 *Calculation of Interest on Capital*

$$\text{Interest on S's Capital} = 1{,}50{,}000 \times \frac{7}{100} = \text{Rs } 10{,}500$$

$$\text{Interest on M's Capital} = 2{,}40{,}000 \times \frac{7}{100} = \text{Rs } 16{,}800$$

WN 2 *Calculation of Commission to Partners*

Commission to M = 8% of Net Profit after allowing Interest on Partners' Capital
Net Profit after allowing Interest on Partners Capital = 1,17,300 – 27,300 = Rs 90,000

$$\therefore \text{Commission to M} = 90{,}000 \times \frac{8}{100} = \text{Rs } 7{,}200$$

WN 3 *Calculation of Profit Share of each Partner*

Profit available for distribution = 66,000
Profit sharing ratio = 3 : 2

$$\therefore \text{ S's profit} = 66{,}000 \times \frac{3}{5} = \text{Rs } 39{,}600$$

$$\text{and M's profit} = 66{,}000 \times \frac{2}{5} = \text{Rs } 26{,}400$$

Treatment of Peculiar Items (Manager's Commission, Interest on Partner's Loan, Rent Paid, etc.)

Sometimes, it may happen that few items such as manager's commission, interest on loan (loan advanced by partner to the firm), rent paid, etc. are given in the question. Such items reduce the net profit of a firm, as these are to be paid before ascertaining the true net profit, which is distributed among the partners in firm of profits. In more technical terms, it implies that such items are charge out of profits and not appropriation of profits. This implies that a firm has to bear/pay these expenses irrespective of profits or losses. The following are the two different methods to ascertain the true profit/loss net of (above) expenses (namely, manager's commission, rent paid, interest on loan) that is available for distribution among the partners.

1. ***By preparing Profit and Loss Adjustment Account***- By this approach, the omitted items are shown in an account known as Profit and Loss Adjustment Account. This account is prepared after Profit and Loss Account and just before the Profit and Loss Appropriation Account. This helps to fetch the amount of net profit that is actually available for the appropriation among the partners. The net profit (loss) so ascertained is shown on the credit (debit) side of the Profit and Loss Appropriation Account.

2. ***By showing the Net Profit after adjusting such items***- As per this approach, there is no need to prepare Profit and Loss Adjustment Account. In fact, the amount of net profit or net loss as per the Profit and Loss Account is shown on the credit or debit side of the Profit and Loss Appropriation Account, but after adjusting (deducting) the amount of Manager's Commission, Interest on Partner's Loan, etc.

These methods can be better understood with the help of the following examples.

Example**:** Anik and Manik started a partnership business on April 01, 2011. Their capital contribution were Rs 1,40,000 and Rs 1,05,000 respectively. Their partnership deed provides for the following.

a. Interest on capital @ 10%.
b. Salary to Anik Rs 1,400 per month and to Manik Rs 2,100 per month.
c. Amount of loan advanced by Anik to the firm Rs 1,00,000.
d. Rent paid to Manik amounts to Rs 12,590.
e. Profit sharing ratio is 3 : 2.

The profit for the year ended March 31, 2012 before considering above appropriations were Rs 1,51,200. Interest on drawings made by the partners amounted to Rs 1,340 for Anik and Rs 1,750 for Manik. Show the distribution of profits between the partners.

Solution

Method-1: By Preparing Profit and Loss Adjustment Account

Profit and Loss Adjustment Account

for the year ended March 31, 2012

Dr. **Cr.**

Particulars	Amount Rs	Particulars	Amount Rs
Interest on Loan (1,00,000 × 6%)	6,000	Net Profit	1,51,200

Rent to Manik	12,590		
Profit transferred to Profit and Loss Appropriation A/c	1,32,610		
	1,51,200		1,51,200

Profit and Loss Appropriation Account

for the year ended March 31, 2012

Dr. **Cr.**

Particulars		Amount Rs	Particulars		Amount Rs
Interest on Capital:			Profit transferred from Profit and Loss Adjustment A/c		1,32,610
Anik (Rs 1,40,000 × 10%)	14,000		Interest on Drawings:		
Manik (Rs 1,05,000 × 10%)	10,500	24,500	Anik	1,340	
			Manik	1,750	3,090
Salary to:					
Anil (Rs 1,400 × 12)	16,800				
Manik (Rs 2,100 × 12)	25,200	42,000			
Profit transferred to:					
Anik's Capital A / c (Rs69, 200 × $\frac{3}{5}$)	41,520				
Manik's Capital A / c (Rs 69, 200 × $\frac{2}{5}$)	27,680	69,200			
		1,35,700			1,35,700

Method-2: When Profit and Loss Adjustment Account is not Prepared

Profit and Loss Appropriation Account

for the year ended March 31, 2012

Dr.					Cr.
Particulars		**Amount Rs**	**Particulars**		**Amount Rs**
Interest on Capital to:			Profit transferred from Profit and Loss		1,32,610
Anik (Rs 1,40,000 × 10%)	14,000		Adjustment A/c (1,51,200 – 6,000 – 12,590)		
Manik (Rs 1,05,000 × 10%)	10,500	24,500	Interest on Drawings:		
			Anik	1,340	
Salary to-			Manik	1,750	3,090
Anil (Rs 1,400 × 12)	16,800				
Manik (Rs 2,100 × 12)	25,200	42,000			
Profit transferred to-					
Anik's Capital A / c (Rs69, 200 × $\frac{3}{5}$)	41,520				
Manik's Capital A / c (Rs 69, 200 × $\frac{2}{5}$)	27,680	69,200			
		1,35,700			1,35,700

Partners' Capital Accounts- Fixed and Fluctuating

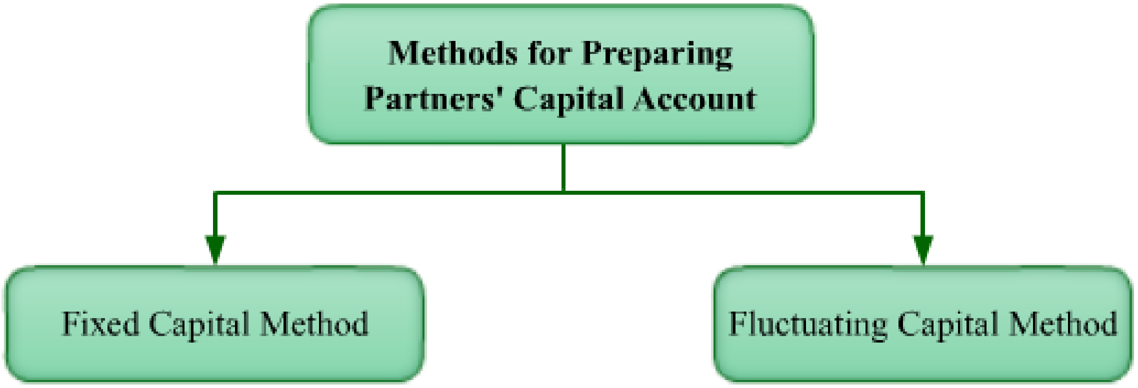
Objective

After going through this lesson, you shall be able to understand the following concepts.

- Partners' Capital Accounts
- Different Methods of Maintaining Partners' Capital Accounts- Fixed and Fluctuating Method
- Distinction between Fixed Capital Method and Fluctuating Capital Method
- Steps to prepare Partners' Capital Account

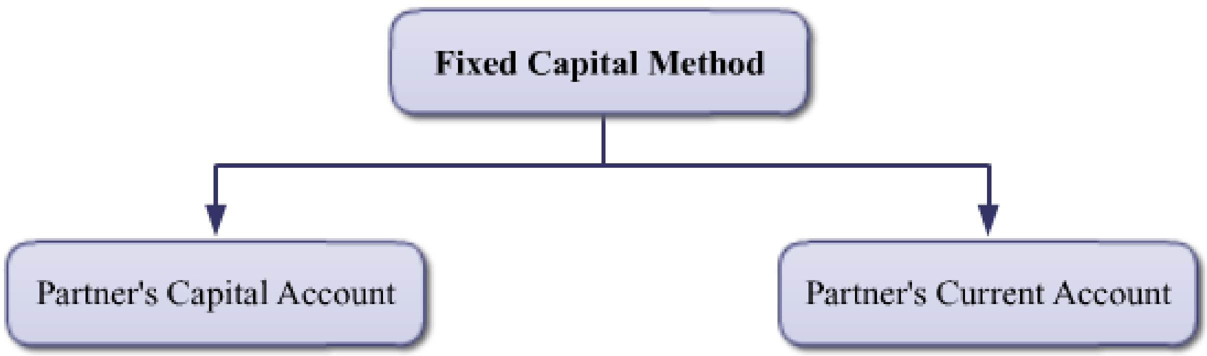
Partners' Capital Account

This account is prepared to record the amount contributed by each of the partners to their partnership firm. All types of the capital related adjustments such as bringing in fresh capital, drawings, salary, commission, profit or loss shares, etc. are shown in the Partners' Capital Accounts. This account is prepared after Profit and Loss Appropriation Account. There are two methods for maintaining the capital account of partners of a partnership firm. These are presented diagrammatically.



Fixed Capital Method

Under this method, the capital balances of the partners remains unchanged. It changes only when any amount of capital is withdrawn or additional capital is introduced during the accounting year by the partners. The fixed capital balances remain unaffected by the items of appropriation such as interest on capital, share of profit, commission, salary, etc. As per the Fixed Capital Method, two accounts are prepared.



(a) Partner's Capital Account- This account records only the opening capital balances and the closing capital balances of the partners. Besides this, it also records those transactions that are related to introduction and withdrawal of capital. The introduction takes place in form of bringing in of fresh capital by the partners, while withdrawal of capital happens in form of drawings out of capital.

If fresh capital is introduced during an accounting year, then it is credited to the Partners' Capital Account as 'Cash/Bank Account'. On the other hand, if any capital is withdrawn by the partners, then it is shown on the debit side of the capital account as 'Cash/Bank Account'. ***No other transactions*** such as, Partners' Salary, Interest on Partners' Capital, Commission, etc. is recorded in this account. This account always end-up showing credit balance as 'Balance c/d', which is shown on the Liabilities side of the Balance Sheet of the Partnership firm.

Partners' Capital Account

Dr. **Cr.**

Particulars	**Amount Rs**	**Particulars**	**Amount Rs**
Cash/Bank A/c (Withdrawal of Capital) Balance c/d (Closing balance)		Balance b/d (Opening Balance) Cash/Bank A/c (Additional Capital Introduced)	

(b) Partner's Current Account- The next account that is prepared after Partners' Capital Account under the Fixed Capital Account Method is Partners' Current Account. This account begins with the opening credit balance on the credit side of the current account (or with the opening debit balance on the debit side of the current account). This account does not record any transactions related to the capital account such as, opening and closing capital account balances, drawings and introduction of fresh capital.

This account majorly records transactions such as partners' salary, commission to partners, interest on drawings, bonus to partners, profit or loss of the Profit and Loss Appropriation Account, etc. Unlike Partners' Capital Account (under Fixed Capital Method), the Partners' Current Account can either show either debit closing balance or credit closing balance. The credit closing balance is shown on Liabilities side, while the debit closing balance is shown on the Assets side of the firm's balance sheet.

Partners' Current Account

Dr. **Cr.**

Particulars	**Amount Rs**	**Particulars**	**Amount Rs**
Balance b/d (in case of debit opening		Balance b/d (in case of credit	

balance) Drawings Interest on Drawing A/c Profit and Loss Appropriation A/c (Share of Loss) Balance c/d (*If credit side is* ***more*** *than debit side*)		opening balance) Interest on Capital Salary Commission Bonus Profit and Loss Appropriation A/c(Share of Profit) Balance c/d (If debit side is more than credit side)	

(II) Fluctuating Capital Method

Unlike Fixed Capital Method, under Fluctuating Capital Method, only one account namely, Partners' Capital Account is prepared. The basic difference between the two methods is that in the Fluctuating Capital Method, all the transactions either related to capital account or current account are recorded in the Partners' Capital Account. This means that along with the opening capital balances all the related transactions (which are shown in the Partners' Current Account above) such as drawings, interest on drawings, introduction of fresh capital, interest on capital, salary, share of profit or loss, commission, etc. are recorded in Partners' Capital Account. This method is known as Fluctuating Capital Method because the closing capital balances of the partners change (fluctuate) from one year to another year.

Partners' Capital Account

Dr. **Cr.**

Particulars	Amount Rs	Particulars	Amount Rs
Drawings Interest on Drawings Profit and Loss Appropriation A/c(Share of Loss)		Balance b/d (Opening Balance) Bank A/c (Additional Capital Introduced) Profit and Loss Appropriation A/c (Share of Profit) Interest on Capital Salary	

Balance c/d# (If credit side is more than debit side)		Commission Bonus Balance c/d# (If debit side is more than credit side)	

 # Either of them will happen

Distinction between Fixed Capital Method and Fluctuating Capital Method

The following are the points of differences between Fixed Capital Method and Fluctuating Capital Method.

Basis	Fixed Capital Method	Fluctuating Capital Method
No. of Accounts	Under this method, two different accounts are maintained for each partner of the firm. These are Partners' Capital Account and Partners' Current Account.	Under this method, only one account is maintained for each partner of the firm i.e. Partners' Capital Account.
Capital Balance	Generally, the capital balances of the partners remain unchanged except in case where capital is withdrawn or additional capital is introduced.	Under this method, capital balances of the partners keep on changing. In other words, the capital balances keep fluctuating.
Credit or Debit Balance	Under this method, Partners' Capital Account always reveals a credit balance.	Under this method, Partners' Capital Account may either show a credit balance or a debit balance.
Recording of Transactions	All the transactions related to the partners such as salary, drawings, interest on drawings, interest on capital, etc. are recorded in the Partners' Current Account and not in the Partner's Capital Account.	As under this only one account is maintained i.e. Partners' Capital Account, therefore, all the transactions related to the partners such as salary, drawings, interest on

		drawings, interest on capital, etc. are recorded in one single account.

***Note*:** In the absence of any instructions regarding the adoption of method for preparing the Capital Account of the partners, Fluctuating Method should be adopted.

Distinction Between Current A/c And Capital A/c

Basis Of Distinction	Current A/c	Capital A/c
1. Nature	When capital is introduced or withdrawn by the partner, the balance of this account does not changes.	Balance of capital changes when further capital is introduced or withdrawn by the partner except when there is a fixed capital.
2. When needed?	It is maintained when fixed capital account method is being followed.	It is maintained in all cases, whether following Fluctuation Capital Account Method or Fixed Capital Account Method.
3. Account's Balance	Can be a debit or a credit balance.	Will always have a credit balance when Fixed Capital Account Method is followed. In case of Fluctuating Capital Account Method, it may have either credit or a debit balance.
4. Kind of Transactions Recorded	It records transactions such as interest on capital, salary, commission, etc.	It records the amount invested by partners in the firm.

***Example*:** The following are data related to a partnership firm:

Particulars	A	B
Capital in the beginning	1,00,000	80,000
Interest on Capital	8%	8%
Drawings	20,000	12,000
Interest on Drawings	200	120
Salary	5,000	–
Commission	–	6,000
Interest on Loan	600	800
Profit and Loss Appropriation (Share of Profit)	8,000	6,000

Show the Partners' Capital Account in each of the following methods.

i. Fluctuating Capital Method
ii. Fixed Capital Method

Solution

(i) Fluctuating Capital Method

Partners' Capital Accounts

Dr. **Cr.**

Particulars	A	B	Particulars	A	B
Drawings	20,000	12,000	Balance b/d	1,00,000	80,000
Interest on Drawings	200	120	Interest on Capital	8,000	6,400
Balance c/d	1,00,800	86,280	Salary	5,000	
			Commission		6,000
			Profit and Loss Appropriation	8,000	6,000
	1,21,000	98,400		1,21,000	98,400

(ii) Fixed Capital Method

Partners' Capital Accounts

Dr. **Cr.**

Particulars	A	B	Particulars	A	B
			Balance b/d	1,00,000	80,000
Balance c/d	1,00,000	80,000			
	1,00,000	80,000		1,00,000	80,000

Partners' Current Accounts

Dr. **Cr.**

Particulars	A	B	Particulars	A	B
Drawings	20,000	12,000	Interest on Capital	8,000	6,400
Interest on Drawings	200	120	Salary	5,000	
Balance c/d	800	7,280	Commission		6,000
			Profit and Loss Appropriation	8,000	6,000

	21,000	18,400		21,000	18,400

Interest on Partners' Capitals

Objective

After going through this lesson, you shall be able to understand the following concepts.

- Interest on Capital and its Calculation
- Charge and Appropriation of Profits
- Calculation of Opening Capital Balance of Partners

Interest on Capital

Interest on capital is allowed to the partners to compensate them for their capital contribution to the firm. As we learnt in the previous lesson, interest on capital is provided only when it is specifically provided in the Partnership Deed. If the deed provides for the interest on capital, then it is provided at the specified rate on the capital balances for the period for which capital remained (invested) in the business. Interest on capital for the whole year is always calculated on the ***opening balance of partner's capital***.

But if any addition or withdrawal of capital is made during the year, then interest is computed for the period for which it remained in the business. Interest on capital is treated as an expense by the partnership firm (as it is paid by the firm to the partners) therefore, is debited to the Profit and Loss Appropriation Account. The formula for calculating interest on capital is given below.

$$\text{Interest on Capital} = \text{Capital Balance} \times \frac{\text{Rate}}{100} \times \text{Time Period}$$

The following Journal Entries are passed in the books of the partnership firm to record interest on capital.

For Crediting Interest on Capital
Interest on Capital A/c Dr. To Partners' Capital/ Current A/c (individually)
For transferring Interest on Capital

Profit and Loss Appropriation A/c Dr. To Interest on Capital A/c
Alternatively, *for above two entries, only one single entry can be passed as*
Profit and Loss Appropriation A/c Dr. To Partners' Capital/ Current A/c *(individually)*

Interest on Capital- *Charge* v/s *Appropriation of Profits*

Uptil now we know that interest on capital is to be allowed to the partners only when it is expressly provided in the partnership deed. Besides this, at times the partnership deed also specifies about the treatment of interest on capital. In such cases, partnership deed mentions whether the interest is to be treated as ***charge*** or ***appropriation of profits***. Before understanding the treatment of interest in both the cases, let us go through the literal meaning of the two words- charge and appropriation.

Charge out of profits- It implies that interest on capital has to be provided under any conditions. This means that the interest is provided on capital irrespective of sufficient profits or losses. For example, if the interest on capital is Rs 7,000 and if the firm has incurred a loss of Rs 8,000, then also interest has to be provided. On the other hand, if the firm has earned a profit of (say) Rs 5,000, then also the firm is bound to pay interest on capital, even though the profits are not sufficient to provide interest.

Appropriation (distribution) of profits- It implies that interest on capital is provided only in the cases where the firm has earned profits. This implies that no interest on capital is to be provided in case of loss. However, in case the firm has earned profits but the amount of profit is not sufficient to meet interest on capital, then the interest is provided to the extent of the profits available. For example, if the interest on capital is Rs 7,000 and the firm has earned a profit of Rs 5,000, then interest of Rs 5,000 (profits available) is provided.

In short, we can understand charge out of profits as a compulsory or mandatory obligations, whereas, appropriation of the profits as distribution of profits which could be possible only when there are sufficient profits.

Difference Between Divisible Profit And Net Profit

Divisible Profit	Net Profit
It is the profit that we arrive at after crediting Interest on drawings (if there)	It is the one which is transferred to Profit And Loss Appropriation Account and is

to Profit And Loss Appropriation Account and appropriation towards interest on capital and salary to partners.	subjected to appropriation as per the Partnership Deed.

Treatment of Interest on Capital- in case of Charge and Appropriation of Profits

As stated above that interest on capital can either be treated as charge or as appropriation of profits. Therefore, the accounting treatment of interest of capital depends on the condition specified in the partnership deed regarding charge or appropriation. Let us understand the accounting treatment of the interest on partners' capital in the following two situations.

Treatment of Interest of Capital in case of Charge out of Profits

When interest on capital is treated as charge out of profits, then irrespective of the fact that the firm has incurred losses or earned profits, the interest on capital has to be paid. That is, a firm cannot avoid to pay interest on capital under any circumstances- whether profits or losses.

Example: Guddu and Duggu are two partners sharing profits and losses in the ratio of 7 : 5. In the beginning of the year their capital balances were Rs 1,50,000 and Rs 1,90,000 respectively. As per their partnership deed, interest on capital is to be provided at the rate of 8% p.a. as a charge on profits. Calculate the interest on capital payable to the partners in each of the following situations.

i. The firm earned a profit of Rs 30,000
ii. The firm incurred a loss of Rs 10,000
iii. The firm earned a profit of Rs 20,200.

Solution: *Calculation of Interest on Capital*

$$\text{Interest on Guddu's Capital} = 1,50,000 \times \frac{8}{100} = \text{Rs } 12,000$$

$$\text{Interest on Duggu's Capital} = 1,90,000 \times \frac{8}{100} = \text{Rs } 15,200$$

$$\text{Total Amount of Interest} = 12,000 + 15,200 = \text{Rs } 27,200$$

i. Firm earned a profit of Rs 30,000

Interest on Capital is payable to the partners as per their Partnership Deed i.e. Rs 12,000 to Guddu and Rs 15,200 to Duggu.

ii. Firm incurred a loss of Rs 10,000

As the Partnership Deed provides for interest on capital as a charge on profits, therefore interest on capital is payable to the partners even if the firm had incurred a loss of Rs 10,000.

Profit and Loss Adjustment Account

Dr. **Cr.**

Particulars		Amount Rs	Particulars	Amount Rs
Loss		10,000	Net Loss	37,200
Interest on Capital:				
Guddu	15,000			
Duggu	17,200	27,200		
		37,200		37,200

iii Firm earned a profit of Rs 20,200

Profit and Loss Adjustment Account

Dr. **Cr.**

Particulars		Amount Rs	Particulars	Amount Rs
Interest on Capital:			Profit	20,200
Guddu	15,000		Net Loss	7,000
Duggu	17,200	27,200		
		27,200		27,200

NOTE*: *It should be noted that in case, the partnership deed mentions for providing interest on capital but does not specifies the treatment of interest as to be charge or appropriation, then it is assumed that interest must is treated as <u>appropriation of profits</u>.

Treatment of Interest of Capital in case of Appropriation of Profits

When interest on capital is treated as appropriation of profits, then firm has to pay interest on capital only if it earns profits. That is, to put in different words, in case of losses, the firm can avoid paying interest on capital. Accordingly, the treatment of interest on capital differs in the following two situations.

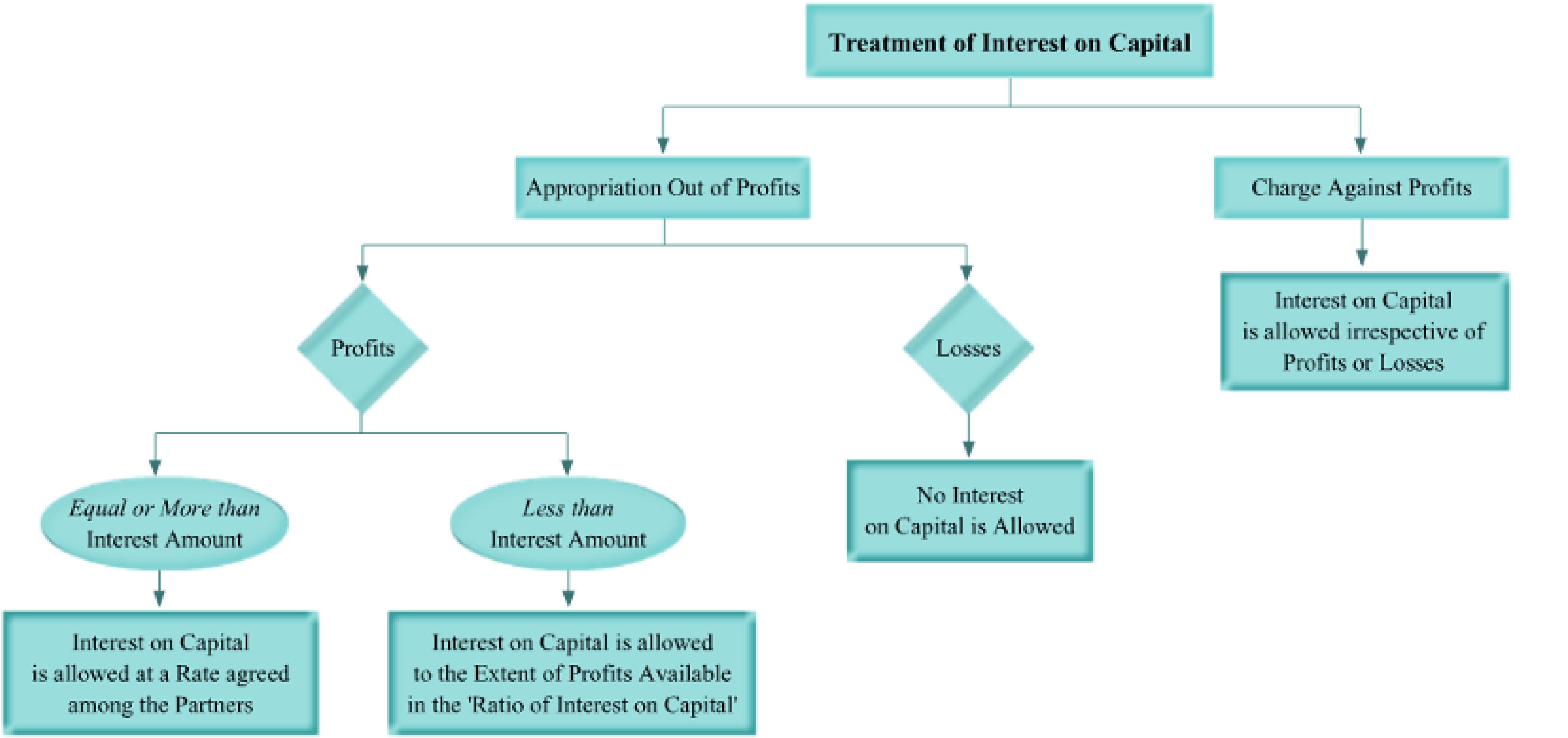
A. In case of Losses- If a partnership firm has incurred losses and interest on capital is treated as appropriation of profits, then the ***interest on capital is not payable***. This implies in case of losses no interest on capital is paid, even if the partnership deed specifies for it.

B. In case of Profits- If a partnership firm has earned profits and interest on capital is treated as appropriation of profits, then the interest is to be paid to the partners on their respective capital balances. In case the firm has earned profits, then it may happen that the profits earned may either exceed (or sufficient to pay) or may fall short of (or insufficient to pay) the interest on capital. Accordingly, the following two situations are probable.

   i. *When Sufficient Profits are Available*- If the profits available are sufficient to meet the obligation of interest on capital, then whole interest is payable to the partners.

   ii. *When Profits are Insufficient*- If the profits available are insufficient to pay the whole amount of interest on capital, then interest is payable to the extent of the profits available in the ratio of their interest on capital. For example, suppose there are two partners A and B sharing profits and losses equally. The firm earned profits of Rs 6,300 during the year and the interest on A's capital is Rs 5,000 and that of B is Rs 4,000. This means that total interest of Rs 9,000 (i.e. Rs 5,000 + Rs 4,000) exceeds the amount of profits available. In this case, the interest is payable to the extent of Rs 6,300 (profits available) in the ratio of their interest on capital i.e. 5 : 4. Thus, the interest on A' capital is Rs 3,500 (= 6,300 × 5/9) and that of B is Rs 2,800 (= 6,300 × 4/9). **[See below example case iv]**

Treatment of Interest on Capital can be better understood through the given below flow chart.



***Example*:** Sonu and Monu are the partners sharing profit and losses in the ratio of 3 : 2. They contributed Rs 2,40,000 and Rs 3,20,000 respectively as their capital. Show the treatment of interest on capital for the year in each of the following situation.

i. Interest on Capital is to be provided at 5% p.a. The Partnership Deed is silent as to the payment of interest on capital to the partners. Profits for the year is ended is Rs 80,000.
ii. Partnership deed provides for interest on capital @ 12% p.a. During the year firm incurred a loss of Rs 20,000.
iii. Partnership Deed provides for interest on capital @ 10% p.a. During the year firm earned a profit of Rs 96,000.
iv. Partnership Deed provides for interest on capital @ 10% p.a. The firm earned a profit of Rs 35,000 during the year.

Solution

i. Since, the partnership deed is silent as to the payment of the interest on capital, hence, ***no interest on capital*** shall be allowed to the partners. The whole amount of profit of Rs 80,000 will be distributed between Sonu and Monu in their profit sharing ratio i.e. 3 : 2.

ii. ***No interest on capital*** shall be provided to the partners. In case of Loss to the firm, interest on capital is not provided to the partners even if it is provided in partnership deed. The loss of Rs 20,000 will however be shared by Sonu and Monu in their profit sharing ratio (i.e. 3 : 2).

iii. *Calculation of Interest on Capital*

Interest on Capital to Sonu @ 10% p.a. $\left(2,40,000\times\frac{10}{100}\right)$	=	24,000
Interest on Capital to Monu @ 10% p.a. $\left(3,20,000\times\frac{10}{100}\right)$	=	32,000
		56,000

Profit and Loss Appropriation Account

Dr. **Cr.**

Particulars		Amount Rs	Particulars	Amount Rs
Interest on Capital to:			Profit and Loss A/c	96,000
Sonu's Capital A/c	32,000			
Monu's Capital A/c	24,000	56,000		
Profit transferred to:				
Sonu's Capital A/c	24,000			
Monu's Capital A/c	16,000	40,000		
		96,000		96,000

Since the firm has sufficient profit to pay the interest on capital to the partners, therefore, interest on capital shall be allowed to the partners at a rate agreed among them (i.e. 10% p.a.). The remaining profits (i.e. Rs 40,000) is to be distributed between Sonu and Monu in their profit sharing ratio (i.e. 3 : 2).

iv. *Calculation of Interest on Capital*

Interest on Capital to Sonu @ 10% p.a. $\left(2,40,000\times\frac{10}{100}\right)$	=	24,000
Interest on Capital to Monu @ 10% p.a. $\left(3,20,000\times\frac{10}{100}\right)$	=	32,000
		56,000

Profit for the year = Rs 35,000

Since the total profit available (i.e. Rs 35,000) is less than the total amount of interest on capital (i.e. Rs. 56,000), so interest on capital is provided to the extent of the available profits in the ratio of interest on capital of the partners. That is, available profit of Rs 35,000 is distributed between Sonu and Monu in the ratio of 3 : 4 (24,000 : 32,000 or 3 : 4 ⇒ Interest on capital ratios between Sonu and Monu)

Calculation of Interest on Capital Ratio

Sonu : Monu

Interest on Capital = 24,000 : 32,000 or,

3 : 4

Interest on Capital to Sonu	=	$35,000\times\frac{3}{7}$	=	Rs 15,000
Interest on Capital to Monu	=	$35,000\times\frac{4}{7}$	=	Rs 20,000

Profit and Loss Appropriation Account

Dr. **Cr.**

Particulars	**Amount Rs**	**Particulars**	**Amount Rs**
Interest on Capital:		Profit and Loss A/c	35,000

Sonu	20,000			
Monu	15,000	35,000		
		35,000		35,000

Computation of Opening balance of Capital

We know that interest on capital is always calculated on the opening capital balance. However, sometimes the question may specify closing capital balance instead of opening balance. In such cases, in order to calculate the interest on capital we first need to compute the opening capital balance. This is done with the help of the following formula.

<u>Calculation of Opening Capital Balance</u>

Particulars	Amount Rs
Capital at the end of the year (Closing Capital)	xxx
Add: Share in Loss	xxx
Add: Drawings made during the year	xxx
Add: Interest on Drawings	xxx
Less: Share of Profit	(xxx)
Less: Additional Capital	(xxx)
Capital in the Beginning of the Year (***Opening Capital***)	xxx

<u>Example</u>: Mahi and Mayank are two partners sharing profits and losses in the ratio of 2 : 1. Their capital balances at the end of the year were Rs 80,000 and 1,20,000 respectively. During the year Mahi and Mayank made the drawings of Rs 15,000 and Rs 18,000 respectively. Profit of the firm for the year ended March 31, 2012 was Rs 45,000. Calculate the interest on capital @ 8% p.a.

Solution: *<u>Calculation of Opening Capital</u>*

Particulars	Mahi	Mayank
Capital at the end of the year (Closing Capital)	80,000	1,20,000
Add: Drawings made during the year	15,000	18,000

	95,000	1,38,000
Less: Share of Profit (2 : 1)	(30,000)	(15,000)
Capital in the Beginning (Opening Capital)	65,000	1,23,000

Calculation of Interest on Capital

Interest on Mahi's Capital @ 8% p.a. $\left(65{,}000 \times \frac{8}{100}\right)$	=	Rs 5,200
Interest on Mayank's Capital @ 8% p.a. $\left(1{,}23{,}000 \times \frac{8}{100}\right)$	=	Rs 9,840
Total Interest Amount		Rs 15,040

Interest on Capital- When Capital Balance is *Not* same throughout an Accounting Period

When additional capital is introduced or any withdrawals are made during an accounting period, then interest on capital cannot be calculated on the opening capital balance. This is because the capital balance would not remained the same throughout the concerned period. In such a case, interest is calculated for the period for which the capital remained invested in the business. Let us understand this concept with the help of the following example.

Example: Happy and Sad are partners sharing profits and losses in the ratio of 1 : 2. The following is the information of capital balances of the partners is given. Calculate interest on capital, if it is charged @ 6% p.a.

Particulars	Happy	Sad
Opening Balances (January 01, 2012)	Rs 2,50,000	Rs 2,00,000
Drawings (July 01, 2012)	Rs 50,000	-
Additional Capital Introduced (July 01, 2012)	-	Rs 50,000
Additional Capital Introduced (October 01, 2012)	Rs 75,000	-

Solution: *Calculation of Interest on Happy's Capital*

During 2012	Capital Balances	Months remained in the business	Product = Column 2 × Column 3
From Jan. 01 to June 30	2,50,000	6	$2{,}50{,}000 \times \frac{6}{100} \times \frac{6}{12} = \text{Rs } 7{,}500$
From July 01 to Sep. 30	2,00,000	3	$2{,}00{,}000 \times \frac{6}{100} \times \frac{3}{12} = \text{Rs } 3{,}000$
From Oct. 01 to Dec. 31	2,75,000	3	$2{,}75{,}000 \times \frac{6}{100} \times \frac{3}{12} = \text{Rs } 4{,}125$
Total Interest on Happy's Capital			Rs 14,625

Calculation of Interest on Sad's Capital

During 2012	Capital Balances	Months remained in the business	Product = Column 2 × Column 3
From Jan. 01 to June 30	2,00,000	6	$2{,}00{,}000 \times \frac{6}{100} \times \frac{6}{12} = \text{Rs } 6{,}000$
From July 01 to Dec. 31	2,50,000	6	$2{,}50{,}000 \times \frac{6}{100} \times \frac{6}{12} = \text{Rs } 7{,}500$
Total Interest on Sad's Capital			Rs 13,500

Interest on Partners' Drawings

Objective

After going through this lesson, you shall be able to understand how to calculate Interest on Drawings in the following situations.

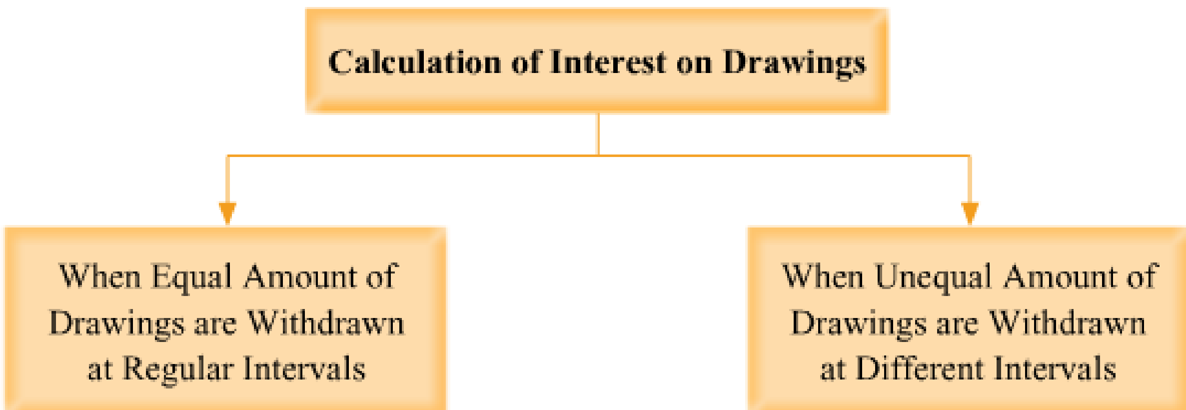
- When ***Equal*** amount is withdrawn at regular time intervals- Monthly, Quarterly and Half-Yearly
- When ***Unequal*** amount of drawings is withdrawn at different time intervals

Interest on Drawings

Any amount withdrawn by the partners from their partnership firm for their personal use is termed as drawings. The amount can either be withdrawn in cash or in kind by the partners. From the previous lessons, we know that interest on partners' drawings is chargeable only when it is specifically mentioned in the partnership deed, so if the deed is silent no interest shall be charged from the partners on their drawings. Interest is charged at a rate (specified in the deed) on the amount of drawings for the period for which the amount remained outstanding with the partners. The interest so charged on drawings is credited to the Profit and Loss Appropriation Account and debited to Partners' Capital/Current Account.

Calculation of Interest on Drawings

The calculation of interest on drawings depends on the nature of the withdrawals by the partners. That is, whether the drawings of ***equal*** amount have been made at ***regular intervals*** or drawings of ***unequal*** amount have been withdrawn at ***different intervals***. In this lesson, we will study how to calculate interest on drawings under two broad situations- Equal amount and Unequal amount of drawings.



I. *When Equal Amount of Drawings are Withdrawn at Regular Intervals*

In this case, partners withdraw equal amount from their partnership business at regular intervals say, monthly, quarterly or half-yearly. In all these situations, interest is computed on the basis of the average period. The ascertainment of average period is explained below.

1. When Fixed Amount is Withdrawn '*Every Month*'

a. When fixed amount of drawings is withdrawn at the '***beginning***' of each month

$$\text{Average Period} = \frac{\text{Total Period in Months} + 1}{2} = \frac{12+1}{2} = 6\frac{1}{2} \text{ months}$$

$$\text{Interest on Drawings} = \text{Annual Drawings} \times \frac{\text{Rate}}{100} \times \frac{6.5}{12}$$

b. When fixed amount of drawings is withdrawn at the '***end***' of each month

$$\text{Average Period} = \frac{\text{Total Period in Months} - 1}{2} = \frac{12-1}{2} = 5\frac{1}{2} \text{ months}$$

$$\text{Interest on Drawings} = \text{Annual Drawings} \times \frac{\text{Rate}}{100} \times \frac{5.5}{12}$$

c. When fixed amount of drawings is withdrawn in the '***middle***' of each month

$$\text{Average Period} = \frac{\text{Total Period in Months}}{2} = \frac{12}{2} = 6 \text{ months}$$

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

Example: Calculate the interest on drawings made by Mahima @ 12% p.a. for the year ended March 31, 2012 in each of the following case.

i. If she withdrew Rs 8,000 in the beginning of each month.

ii. If she withdrew Rs 6,000 in the middle of each month.

iii. If the she withdrew Rs 9,000 at the end of each month.

Solution

i. When drawings are made in the beginning of each month

Total Amount of Drawings = 8,000 × 12 = Rs 96,000

$$\text{Interest on Drawings} = 96{,}000 \times \frac{12}{100} \times \frac{6.5}{12} = \text{Rs } 6{,}240$$

ii. When drawings are made in the middle of each month

Total Amount of Drawings = 6,000 × 12 = 72,000

$$\text{Interest on Drawings} = 72{,}000 \times \frac{12}{100} \times \frac{6}{12} = \text{Rs } 4{,}320$$

iii. When drawings are made at the end of each month

Total Amount of Drawings = 9,000 × 12 = Rs 1,08,000

$$\text{Interest on Drawings} = 1{,}08{,}000 \times \frac{12}{100} \times \frac{5.5}{12} = \text{Rs } 5{,}940$$

2. When Fixed Amount is Withdrawn *'Quarterly'*

a. When fixed amount is withdrawn in the '***beginning***' of each quarter

$$\text{Average Period} = \frac{\text{Total Period in Months} + 3}{2} = \frac{12+3}{2} = 7\frac{1}{2} \text{ months}$$

$$\text{Interest on Drawings} = \text{Annual Drawings} \times \frac{\text{Rate}}{100} \times \frac{7.5}{12}$$

b. When fixed amount is withdrawn at the '***end***' of each quarter

$$\text{Average Period} = \frac{\text{Total Period in Months} - 3}{2} = \frac{12-3}{2} = 4\frac{1}{2} \text{ months}$$

$$\text{Interest on Drawings} = \text{Annual Drawings} \times \frac{\text{Rate}}{100} \times \frac{4.5}{12}$$

c. When fixed amount is withdrawn in the '***Middle***' of each quarter

$$\text{Average Period} = \frac{\text{Total Period in Months}}{2} = \frac{12}{2} = 6 \text{ months}$$

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

***Example*:** Calculate the interest on drawings made by Rahul @ 15% p.a. for the year ended March 31, 2012 in each of the following cases.

i. If he withdrew Rs 7,000 in the beginning of each quarter.

ii. If he withdrew Rs 8,000 at the end of each quarter.

iii. If he withdrew Rs 10,000 in the middle of each quarter.

Solution

i. When drawings are made in the Beginning of each quarter.

Total Amount of Drawings = 7,000 × 4 = 28,000

$$\text{Interest on Drawings} = 28{,}000 \times \frac{15}{100} \times \frac{7.5}{12} = \text{Rs } 2{,}625$$

ii. When drawings are made at the End of each quarter:

Total Amount of Drawings = 8,000 × 4 = Rs 32,000

$$\text{Interest on Drawings} = 32{,}000 \times \frac{15}{100} \times \frac{4.5}{12} = \text{Rs } 1{,}800$$

iii. When drawing are made in the middle of each quarter

Total Amount of Drawings = 10,000 × 4 = Rs 40,000

$$\text{Interest on Drawings} = 40{,}000 \times \frac{15}{100} \times \frac{6}{12} = \text{Rs } 3{,}000$$

3. When Fixed Amount is Withdrawn *'During a Period of 6 Months'*

a. When fixed amount is withdrawn in the '***beginning***' of every month for 6 months

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

$$\text{Interest on Drawings} = \text{Annual Drawings} \times \frac{\text{Rate}}{100} \times \frac{3.5}{12}$$

b. When fixed amount is withdrawn at the '***end***' of every month for 6 months

$$\text{Average Period} = \frac{5+0}{2} = 2\frac{1}{2} \text{ months}$$

$$\text{Interest on Drawings} = \text{Annual Drawings} \times \frac{\text{Rate}}{100} \times \frac{2.5}{12}$$

c. When fixed amount is withdrawn in the '***Middle***' of every month for 6 months

$$\text{Average Period} = \frac{5.5+0.5}{2} = 3 \text{ months}$$

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

***Example*:** Calculate the interest on drawings made by Vijay @ 9% p.a. for the year ended March 31, 2012 in each of the following cases.

i. If he withdrew Rs 5,000 in the beginning of each month for 6 months.

ii. If he withdrew Rs 3,000 at the end of each month for 6 months.

iii. If he withdrew Rs 7,000 in the middle of each month for 6 months.

Solution

$$\text{Interest on Drawings} = 30,000 \times \frac{9}{100} \times \frac{3.5}{12} = \text{Rs } 787.50$$

ii. When drawings are made at the end of each month for 6 months

Total Amount of Drawings = 3,000 × 6 = Rs 18,000

$$\text{Interest on Drawings} = 18,000 \times \frac{9}{100} \times \frac{2.5}{12} = \text{Rs } 337.50$$

iii. When drawings are made in the middle of each month for 6 months

Total Amount of Drawings = 7,000 × 6 = Rs 42,000

$$\text{Interest on Drawings} = 42,000 \times \frac{9}{100} \times \frac{3}{12} = \text{Rs } 945$$

II. *When Unequal Amount of Drawings are Withdrawn at Different Intervals*

It may be possible that partners of a partnership firm withdraw different amounts of drawings from the business at different time intervals. Consider a partner A, who withdrew Rs 2,000 on February 01, 2012, Rs 5,000 on June 30, 2012 and Rs 10,000 on November 30, 2012. We can observe that the partner has withdrawn different amount at irregular time intervals. That is, unlike the first case, we cannot find a general pattern of drawings in terms of monthly, quarterly, half-yearly and yearly. Therefore, interest on drawings cannot be computed using the average period. In this case, interest on drawings is calculated using Simple Method or Product Method.

Simple Method- Under this method, interest for each single drawing is ascertained with reference to the time.

Product Method- Under this method, the amount of drawings made by the partners is multiplied with the time period for which it remained outstanding from them during the year. The product so obtained are then summed up. The interest on drawings is calculated on the sum of the product so obtained for the period of 1 month (if period is given in months) or for 1 day (if period is given in days). The formula used for calculating interest under the product method is:

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

or,

$$\text{Interest on Drawings} = \text{Sum of Product} \times \frac{\text{Rate}}{100} \times \frac{1}{365}$$

***Example*:** A and B are partners in a partnership firm sharing profits and losses equally. During the year ending March 31, 2012, B withdrew the following amounts for his personal use. Calculate the interest on drawings to be charged at 8% p.a.

Date	Amount (Rs)
April 01, 2011	30,000
May 31, 2011	24,000
September 01, 2011	20,000
January 01, 2012	16,000
March 01, 2012	21,000

Solution

Simple Method

Date	Amount	No. of Months to March 31, 2012	Interest
April 01	30,000	12	$30{,}000 \times \frac{8}{100} \times 1 = \text{Rs } 2{,}400$
May 31	24,000	10	$24{,}000 \times \frac{8}{100} \times \frac{10}{12} = \text{Rs } 1{,}600$
September 01	20,000	7	$20{,}000 \times \frac{8}{100} \times \frac{7}{12} = \text{Rs } 933.33$
January 01	16,000	3	$16{,}000 \times \frac{8}{100} \times \frac{3}{12} = \text{Rs } 320$
March 01	21,000	1	$21{,}000 \times \frac{8}{100} \times \frac{1}{12} = \text{Rs } 140$
Total Interest			**Rs 5,393.33**

Product Method

Date	Amount (I)	No. of Months (II)	Product (Rs) (I × II)
April 01	30,000	12	3,60,000
May 31	24,000	10	2,40,000
September 01	20,000	7	1,40,000
January 01	16,000	3	48,000
March 01	21,000	1	21,000
Sum of Product			**8,09,000**

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

$$= 8{,}09{,}000 \times \frac{8}{100} \times \frac{1}{12} = \text{Rs } 5{,}393.33$$

Important Notes

***Note 1*:** In case the date of drawings made by the partners is not mentioned, then the interest on drawings is calculated for an average period of *six months*.

***Example*:** Calculate the interest on drawings of Raju @ 18% p.a. for the year ended March 31, 2012 if the drawings made during the year was Rs 50,000.

Solution: Since, no information regarding the date of drawings is mentioned, therefore, interest on drawings is to be calculated for a period of six months.

Total Amount of Drawings = Rs 50,000

Interest Rate = 18% p.a.

$$\text{Interest on Drawings} = 50{,}000 \times \frac{18}{100} \times \frac{6}{12} = \text{Rs } 4{,}500$$

Note 2: Sometimes, rate of interest on drawings in the question is mentioned without word '*per annum*' (p.a.). In such a situation, interest on drawings is charged for the whole year without taking into consideration the '*time factor*'. In other words, interest on drawings is calculated for a period of ***one year***.

Example: Calculate the interest on drawings of a partner @ 15% if he withdrew Rs 1,00,000 during the year.

Solution: Total Amount of Drawings = Rs 1,00,000

Interest Rate = 15%

$$\text{Interest on Drawings} = 1{,}00{,}000 \times \frac{15}{100} = \text{Rs } 15{,}000$$

Interest on Partners' Loan and Partners' Salary

Objective

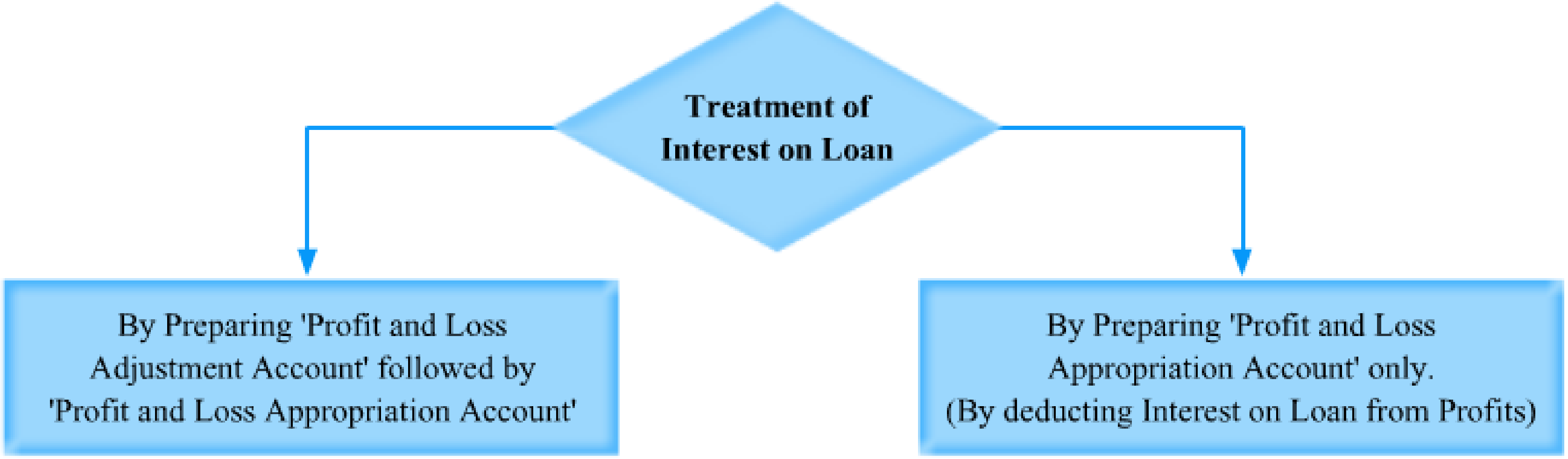
After going through this lesson, you shall be able to understand the following concepts.

- Interest on Partners' Loan and its Calculation
- Partners' Salary
- Partners' Commission

Interest on Loan to the Partner

Sometimes, partner/s may provide loan or advances to their partnership firm. Such partner/s is/are entitled to receive interest on his/their loan amount. As learnt in the previous lessons, interest on loan is payable @ 6% p.a.to the partners even if the partnership deed is silent regarding the same. If the deed mentions the rate, then the interest on partners' loan is paid at that rate only (and not @ 6% p.a.). The payment of interest on loan is regarded as an obligation for a firm, therefore, it is treated as a charge on profits. This can be put in different words as, a firm has to pay interest on the loan forwarded by a partner irrespective of profits or losses incurred during the year.

Treatment for Interest on Partners' Loan



The above figure presents the accounting treatment of interest on partners' loan. From the figure, we can understand the two ways of recording interest on loan.

1. ***By preparing Profit and Loss Adjustment Account and Profit and Loss Appropriation Account***- In this method, two accounts are prepared. The amount of interest on loan is shown on the debit side of the Profit and Loss Adjustment Account and the amount of net profit is shown on the debit side of the account as the balancing figure. This balancing figure represents the amount of profit available for appropriation and is shown on the credit side of the Profit and Loss Appropriation Account.

2. ***By preparing Profit and Loss Appropriation Account Only***- In this method, only one account- Profit and Loss Appropriation Account is prepared. The amount of profit available for appropriation is shown after deducting the amount of interest of loan on the credit side of the Profit and Loss Appropriation Account.

Note*: *It should be noted that in neither of the two methods, interest on loan is shown on the debit or credit side of the Profit and Loss Appropriation Account.

Example: P and Q are two partners sharing profits and losses in the ratio of 3 : 4. P and Q advanced loan of Rs 23,000 and Rs 27,000 respectively to the firm. The firm had a profit of Rs 47,000. Show the distribution of profits between P and Q if Interest on loan is payable at the 10% p.a. to the partners.

Solution

Method-1: By Preparing Profit and Loss Adjustment Account

Profit and Loss Adjustment Account

Dr. Cr.

Particulars		Amount Rs	Particulars	Amount Rs
Interest on Loan at 10%:			Profit for the year	47,000
P	2,300			
Q	2,700	5,000		
Net profit transferred to Profit and Loss Appropriation A/c		42,000		
		47,000		47,000

Profit and Loss Appropriation Account

Dr. Cr.

Particulars		Amount Rs	Particulars	Amount Rs
Profit transferred to-			Net Profit transferred from Profit and Loss A/c	42,000
P's Capital A/c	18,000			
Q's Capital A/c	24,000	42,000		
		42,000		42,000

Method-2: When Profit and Loss Adjustment Account is not prepared

Profit and Loss Appropriation Account

Dr. Cr.

Particulars		Amount Rs	Particulars	Amount Rs
Profit transferred to-			Profit after interest on Loan (Rs 47,000 – Rs 5,000)	42,000
P's Capital A/c	18,000			
Q's Capital A/c	24,000	42,000		
		42,000		42,000

Salary or Commission to Partners

Salary- Sometimes besides profits, partners are also entitled to receive salary. Similar to the interest on capital, salary is also payable to the partners only if it is specifically mentioned in the partnership deed. That is to say, if the deed is silent regarding partner's salary, then no salary is to be paid to any of the partners. Partner's salary is an expense for a firm, therefore, it is debited to the Profit and Loss Appropriation Account and is credited to the Partners' Capital or Current Account.

Journal Entries

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

Partners' Salary A/c	Dr.
To Partners' Capital or Current A/c	

Commission- Similar to the salary, partners are also entitled to receive commission if it is provided in the partnership deed. Similar to the partners' salary, commission being an expense is also debited to the Profit and Loss Appropriation Account and is credited to the Partners' Capital or Current Account.

Journal Entries

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

Partners' Commission A/c	Dr.
To Partners' Capital or Current A/c	

The commission to the partners can be provided on the following two basis.

i. On Net Profit or Divisible Profit '*Before*' Charging Such Commission.
ii. On Net or Divisible Profit '*After*' Charging Such Commission.

*When Commission is Payable on Net Profit or Divisible Profit '**Befor**e' Charging Such Commission.*

$$\text{Commission} = \text{Net or Divisible Profit} \times \frac{\text{Rate of Commission}}{100}$$

*When Commission is Payable on Net or Divisible Profit '**After**' Charging Such Commission*

$$\text{Commission} = \text{Net or Divisible Profit} \times \frac{\text{Rate of Commission}}{100+\text{ Rate}}$$

***Example*:**

Sanju and Manju are partners in a partnership firm sharing profit and loss equally. Profits for the year ended March 31, 2012 was Rs 90,000 before charging any commission. Find out the commission payable to Sanju @ 5% on profits if:

(i) commission is payable before charging such commission

(ii) commission is payable after charging such commission

Solution

Calculation of Commission Payable to Sanju

(i) When Commission is Payable Before Charging Such Commission.

$$\text{Commission} = \text{Net or Divisible Profit} \times \frac{\text{Rate of Commission}}{100}$$

$$\text{Commission} = 90{,}000 \times \frac{5}{100} = \text{Rs } 4{,}500$$

(ii) When Commission is Payable After Charging Such Commission.

$$\text{Commission} = \text{Net or Divisible Profit} \times \frac{\text{Rate of Commission}}{100+\text{ Rate}}$$

$$\text{Commission} = 90{,}000 \times \frac{5}{105} = \text{Rs } 4{,}286 \text{ (App.)}$$

Example: Tea and Coffee are two partners sharing profits and losses in the ratio of 2 : 3. The Partnership Deed provided for the following provisions:

i. Interest on partners capital at 7%
ii. Interest on drawings at 10% p.a.
iiii. Salary to Tea Rs 5,000 and to Coffee Rs 600 p.m.
iv. Tea is entitled to a commission at 5% on net profit after charging salary to both the partners and commission to Coffee is payable at 5% on net profit after charging such commissions.

The capital balances of partners were Rs 1,35,000 and Rs 1,55,000 respectively. Tea withdraws Rs 18,000 and Coffee withdraws Rs 25,000 during the year. Coffee provided a loan of Rs 17,500 to the firm. The firm had a net profit of Rs 64,050. Prepare Profit and Loss Appropriation Account and Partners' Capital Accounts.

Solution

Profit and Loss Adjustment Account

Dr. **Cr.**

Particulars	**Amount Rs**	**Particulars**	**Amount Rs**
Interest on Coffee's Loan (17,500 × 6%)	1,050	Profit for the year	64,050
Net profit transferred to Profit and Loss Appropriation A/c	63,000		
	64,050		64,050

Profit and Loss Appropriation Account

Dr. **Cr.**

Particulars		**Amount (Rs)**	**Particulars**		**Amount (Rs)**
Interest on Capital:			Profit and Loss A/c (Profit)		63,000
Tea	9,450		Interest on Drawings:		
Coffee	10,850	20,300	Tea	900	
Salary to:			Coffee	1,250	2,150
Tea	5,000				
Coffee (Rs 600 × 12)	7,200	12,200			

Commission to:				
Tea	2,540			
Coffee	3,000	5,540		
Profit transferred to:				
Tea's Capital A/c	10,844			
Coffee's Capital A/c	16,266	27,110		
		65,150		65,150

Partners' Capital Accounts

Dr. **Cr.**

Particulars	Tea	Coffee	Particulars	Tea	Coffee
Drawings	18,000	25,000	Balance b/d	1,35,000	1,55,000
Interest on Drawings	900	1,250	Interest on Capital	9,450	10,850
Balance c/d	1,43,934	1,66,066	Salaries	5,000	7,200
			Commission	2,540	3,000
			P/L Appropriation A/c	10,844	16,266
	1,62,834	1,92,316		1,62,834	1,92,316

Working Notes:

WN 1 *Calculation of Interest on Capital*

$$\text{Interest Tea's on Capital} = 1{,}35{,}000 \times \frac{7}{100} = \text{Rs } 9{,}450$$

$$\text{Interest Coffee's on Capital} = 1{,}55{,}000 \times \frac{7}{100} = \text{Rs } 10{,}850$$

WN 2 *Calculation of Interest on Drawings*

$$\text{Interest Tea's on Drawings} = 18,000 \times \frac{10}{100} \times \frac{6}{12} = \text{Rs } 900$$

$$\text{Interest Coffee's on Drawings} = 25,000 \times \frac{10}{100} \times \frac{6}{12} = \text{Rs } 1,250$$

<u>WN 3</u> *<u>Calculation of Commission to Partners</u>*

Commission to Tea = 5% on Net Profit after Salary
Net Profit after Salary = 63,000 – 12,200 = Rs 50,800

$$\therefore \text{Commission to Tea} = 50,800 \times \frac{5}{100} = \text{Rs } 2,540$$

Commission to Coffee = 5% on Net Profit after charging such Commission

$$\therefore \text{Commission to Coffee} = \text{Net Profit} \times \frac{\text{Rate}}{100 + \text{Rate}} = 63,000 \times \frac{5}{105} = \text{Rs } 3,000$$

<u>Example</u>: M, N and O are three partners with capitals of Rs 1,50,000, Rs 1,20,000 and Rs 90,000 respectively. Their partnership deed provides for the following provisions:

i. Interest on capital at 6% p.a.
ii. Interest on drawings Rs at 8% p.a.
iii. Salary to M of Rs 750 per month.
iv. N is entitled to a commission at 10% on profit after charging interest on partners' capital and salary to M.
v. O is entitled to a commission at 6% on net profit after charging such commission.
vi. 15% of net profit should be transferred to Reserve.
vii. Partners will share profits or losses in the ratio of their capitals.
viii. On the last day of each quarter partners draw Rs 1,500, Rs 1,800 and Rs 2,100 respectively. During the year ended the firm had a net profit of Rs 1,16,600. Prepare Profit and Loss Appropriation Account and Partners' Capital Accounts.

Solution

Profit and Loss Appropriation Account

Dr. **Cr.**

Particulars		Amount (Rs)	Particulars		Amount (Rs)
Interest on Capital at 6%:			Profit and Loss A/c (Net Profit)		1,16,600
M	9,000		Interest on Drawings:		
N	7,200		M	180	
O	5,400	21,600	N	216	
Salary to M (Rs 750 × 12)		9,000	O	252	648
Commission to:					
N	8,600				
O	6,600	15,200			
Reserve (1,16,600 × 15%)		17,490			
Profit transferred to:					
M's Capital A/c	22,482.50				
O's Capital A/c	17,986.00				
N's Capital A/c	13,489.50	53,958			
		1,17,248			1,17,248

Partners' Capital Accounts

Dr. **Cr.**

Particulars	M	N	O	Particulars	M	N	O
Drawings	6,000	7,200	8,400	Balance b/d	1,50,000	1,20,000	90,000
Interest on Drawings	180	216	252	Interest on Capital	9,000	7,200	5,400
Balance c/d	1,84,302.50	1,46,370.00	1,06,837.50	Salaries	9,000		
				Commission		8,600	6,600
				P/L Appropriation A/c	22,482.50	17,986.00	13,489.50
	1,90,482.50	1,53,786.00	1,15,489.50		1,90,482.50	1,53,786.00	1,15,489.50

Working Notes:

WN 1 Calculation of Interest on Capital

$$\text{Interest M's on Capital} = 1{,}50{,}000 \times \frac{6}{100} = \text{Rs } 9{,}000$$

$$\text{Interest N's on Capital} = 1{,}20{,}000 \times \frac{6}{100} = \text{Rs } 7{,}200$$

$$\text{Interest O's on Capital} = 90{,}000 \times \frac{6}{100} = \text{Rs } 5{,}400$$

WN 2 *Calculation of Interest on Drawings*

Interest on M's Drawings

Annual Drawings = Rs 1,500 × 4 = Rs 6,000

$$\text{Interest M's on Drawings} = 6{,}000 \times \frac{8}{100} \times \frac{4.5}{12} = \text{Rs } 180$$

Interest on N's Drawings

Annual Drawings = Rs 1,800 × 4 = Rs 7,200

$$\text{Interest N's on Drawings} = 7{,}200 \times \frac{8}{100} \times \frac{4.5}{12} = \text{Rs } 216$$

Interest on O's Drawings

Annual Drawings = Rs 2,100 × 4 = Rs 8,400

$$\text{Interest O's on Drawings} = 8{,}400 \times \frac{8}{100} \times \frac{4.5}{12} = \text{Rs } 252$$

WN 3 *Calculation of Commission to Partners*

Commission to N = 10 % on Profit after charging Interest on Partners' Capital and Salary to M

Profit after charging Interest on Partners' Capital and Salary to M = 1,16,600 – 21,600 – 9,000
= Rs 86,000

$$\therefore \text{Commission to N} = 86{,}000 \times \frac{10}{100} = \text{Rs } 8{,}600$$

Commission to O = 6% on Net Profit after charging such Commission

$$\therefore \text{Commission to O} = \text{Net Profit} \times \frac{\text{Rate}}{100 + \text{Rate}} = 1{,}16{,}600 \times \frac{6}{106} = \text{Rs } 6{,}600$$

WN 4 *Calculation of Capital Ratio*

	M	:	N	:	O
Interest on Capital =	1,50,000	:	1,20,000	:	90,000

∴Capital Ratio = 5 : 4 : 3

Treatment Of Rent Paid to A Partner

As already covered in the advantages, LLP has a separate legal entity and hence the personal assets of the partner cannot be used by the firm for free. Therefore, if a firm makes use of any property belonging to the partner, it shall have to adequately pay for such a use.

In the present scenario, going by the same premise whenever a firm uses a building belonging to a partner, rent has to be paid to him. This constitutes an expense for the firm and has to be charged against the profit. So, like all other charges, it will be debited to the Profit And Loss Account, even if the firm incurs a loss and is credited to Rent Payable Account of the firm.

Guarantee of Profits

Objective

After going through this lesson, you shall be able to understand the following concepts of Guarantee of Profit to partner.

- Guarantee of Profit by one partner to another partner
- Guarantee of Profit by all other partners to one partner
- Simultaneous Guarantee by Partners and by Firm
- Guarantee of Profit by a Partner to the Firm

Guarantee of Profit

We know that every business involves certain level of risk. As a result of the risk factor, the amount of profit earned by a business firm also fluctuates. Sometimes, in order to insulate the partners against such fluctuations, a partner/s is/are assured of a minimum amount of profits by the way of Guarantee of Profits. Such guarantee can either be given by all the partners of a firm (in an agreed ratio) or by any one or some of them. The partner to whom such guarantee of profit is made is known as Guaranteed Partner and the partner who has given such guarantee is known as Guaranteeing Partner. The amount of minimum profit that is to be paid to the guaranteed partner is known as Guaranteed Profit.

Note: It should be noted that the guaranteed profit is payable to the guaranteed partner only when his/her actual share of profit (as per the profit sharing ratio) falls short of the guaranteed amount.

Different Situations of Guarantee of Profit

Guarantee of Profit can be classified under the following three cases.

a. Guarantee by one partner to another
b. Guarantee by all other partners to one partner
c. Guarantee by partners and by firm
d. Guarantee by partner to firm

Case I: *Guarantee by One Partner to Another*

In this case, a partner guarantees a minimum amount of profit to another partner. If in case, the amount of profit of the guaranteed partner (as per his profit share) falls short of the guaranteed profit, then the deficiency will be borne by the guaranteeing partner (the one who has given the guarantee). For example, Ram, Shyam and Mohan are partners sharing profits and losses in the ratio 3:2:1 and the firm earned a profit of Rs 18,000. Mohan was guaranteed by Ram to receive a minimum profit of Rs 5,000.

In this case, the share of profit as per the profit sharing ratio of 3:2:1 amounts to Rs 9,000 (to Ram), Rs 6,000 (to Shyam) and Rs 3,000 (to Mohan). As the amount of Mohan's profit falls short of the guaranteed profit of Rs 5,000, so the deficiency of Rs 2,000 (i.e. Rs 5,000 – Rs 3,000) has to be borne by Ram (as Ram has given the guarantee to Mohan). However, if Mohan's profit share would have been Rs 5,000 or above (as per the profit sharing ratio), then no deficiency was to be brone by Ram.

<u>Example</u>**:** Meena and Raj are the partners in a firm sharing profits and losses in the ratio of 2 : 3. They admit Ankit in their partnership firm for 1/6th share in profits. The new profit sharing ratio among them is 2 : 3 : 1. Raj personally given a guarantee to Ankit that his share in profit would not be less than Rs 80,000. Capital contributed by Meena, Raj and Ankit were Rs 5,00,000, Rs 4,20,000 and Rs 3,80,000 respectively. The partnership deed provides for interest on capital at 10% p.a. The profit for the year ended in March 31, 2012 were Rs 4,90,000 before providing interest on capital. Prepare Profit and Loss Appropriation Account.

Solution

Profit and Loss Appropriation Account
for the year ended March 31, 2012

Dr. **Cr.**

Particulars			Amount Rs	Particulars	Amount Rs
Interest on capital to-				Net Profit	4,90,000
Meena		50,000			
Raj		42,000			
Ankit		38,000	1,30,000		
Profit transferred to-					
Meena		1,20,000			
Raj	1,80,000				
(–) Deficiency	(20,000)	1,60,000			
Ankit	60,000				
(+) Deficiency received from Raj	20,000	80,000	3,60,000		
			4,90,000		4,90,000

Case II: *Guarantee by All Other Partners to One Partner*

In this case, a partner is assured of the guaranteed minimum profit by all the other partners of a firm. Unlike the above case, the deficiency will be borne by the other partners. ***It should be noted that deficiency can either be borne by the other partners in some specified ratio (mentioned in the question) or in their profit sharing ratio (if agreed ratio is not mentioned).*** For example, Ram, Shyam and Mohan are partners sharing profits and losses in the ratio 3:2:1 and the firm earned a profit of Rs 18,000. Mohan was guaranteed by Ram and Shyam to receive a minimum profit of Rs

5,000. In case of any deficiency to the guaranteed profit, then it will be borne by Ram and Shyam in the ratio 4:1. In this case, the share of profit as per the profit sharing ratio of 3:2:1 amounts to Rs 9,000 (to Ram), Rs 6,000 (to Shyam) and Rs 3,000 (to Mohan).

As the amount of Mohan's profit falls short of the guaranteed profit of Rs 5,000, so the deficiency of Rs 2,000 (i.e. Rs 5,000 – Rs 3,000) has to be borne by Ram and Shyam in the ratio 4:1. Ram will compensate Mohan for Rs 1,600 (i.e. Rs 2,000 × 4/5) and Shyam will compensate Mohan for Rs 400 (i.e. Rs 2,000 × 1/5). Therefore, the profit of each of the partners is:

Partners	Final Profit	Adjustment
Ram	Rs 7,400	Rs 9,000 – Rs 1,600 given to Mohan
Shyam	Rs 5,600	Rs 6,000 – Rs 400 given to Mohan
Mohan	Rs 5,000	Rs 3,000 + Rs 1,600 (from Ram) + Rs 400 (from Shyam)

We can observe that in the above example, the ratio in which the deficiency of Rs 2,000 to be borne by Ram and Shyam is mentioned (4:1). However, if this agreed ratio was not provided in the question, then the deficiency was to be borne by Ram and Shyam in the profit sharing ratio of 3:2.

Example: Pari and Pihu are the two partners in a partnership firm sharing profits an losses in the ratio of 1 : 2. Jiya is admitted into the firm with a guarantee of minimum profit of Rs 45,000. The new profit sharing ratio among them is 1 : 2 : 1. The firm earned a net profit of Rs 1,20,000 during the year. Prepare Profit and Loss Appropriation Account.

Solution: Profit of the Firm = Rs 1,20,000

New Profit Sharing Ratio = 1 : 2 : 1

Calculation of Share of Profit

Pari = $\text{Rs} 1,20,000 \times \frac{1}{4}$ = Rs 30,000

Pihu = $\text{Rs} 1,20,000 \times \frac{2}{4}$ = Rs 60,000

Jiya = $\text{Rs} 1,20,000 \times \frac{1}{4}$ = Rs 30,000

Jiya is given a guarantee of minimum profit of Rs 45,000. Her actual share of profit is Rs 30,000 which is less than her guaranteed profit.

Deficiency = Rs 45,000 – Rs 30,000 = Rs 15,000

This deficiency is to be borne by Pari and Pihu in their profit sharing ratio i.e. 1 : 2.

Pari's Share in Deficiency = $\text{Rs}15,000 \times \frac{1}{3}$ = Rs 5,000

Pihu's Share in Deficiency = $\text{Rs}15,000 \times \frac{2}{3}$ = Rs 10,000

Profit and Loss Appropriation Account

for the year ended March 31, 2012

Dr. **Cr.**

Particulars		**Amount Rs**	**Particulars**	**Amount Rs**
Profit transferred to Pari	30,000		Net Profit	1,20,000
(–) Deficiency	(5,000)	25,000		
Pihu	60,000			
(–) Deficiency	(10,000)	50,000		
Jiya	30,000			
(+) deficiency received from Pihu and Pari (5,000 + 10,000)	15,000	45,000		
		1,20,000		1,20,000

Example: Deepak, Dinesh and Ravi are partners in a partnership firm sharing profits in the ratio of 2 : 2 : 1. Ravi given a guarantee of minimum profit of Rs 65,000. The profits of the firm for the year ended March 31, 2012 was Rs 4,00,000. Prepare Profit and Loss Appropriation Account.

Solution

Profit and Loss Appropriation Account

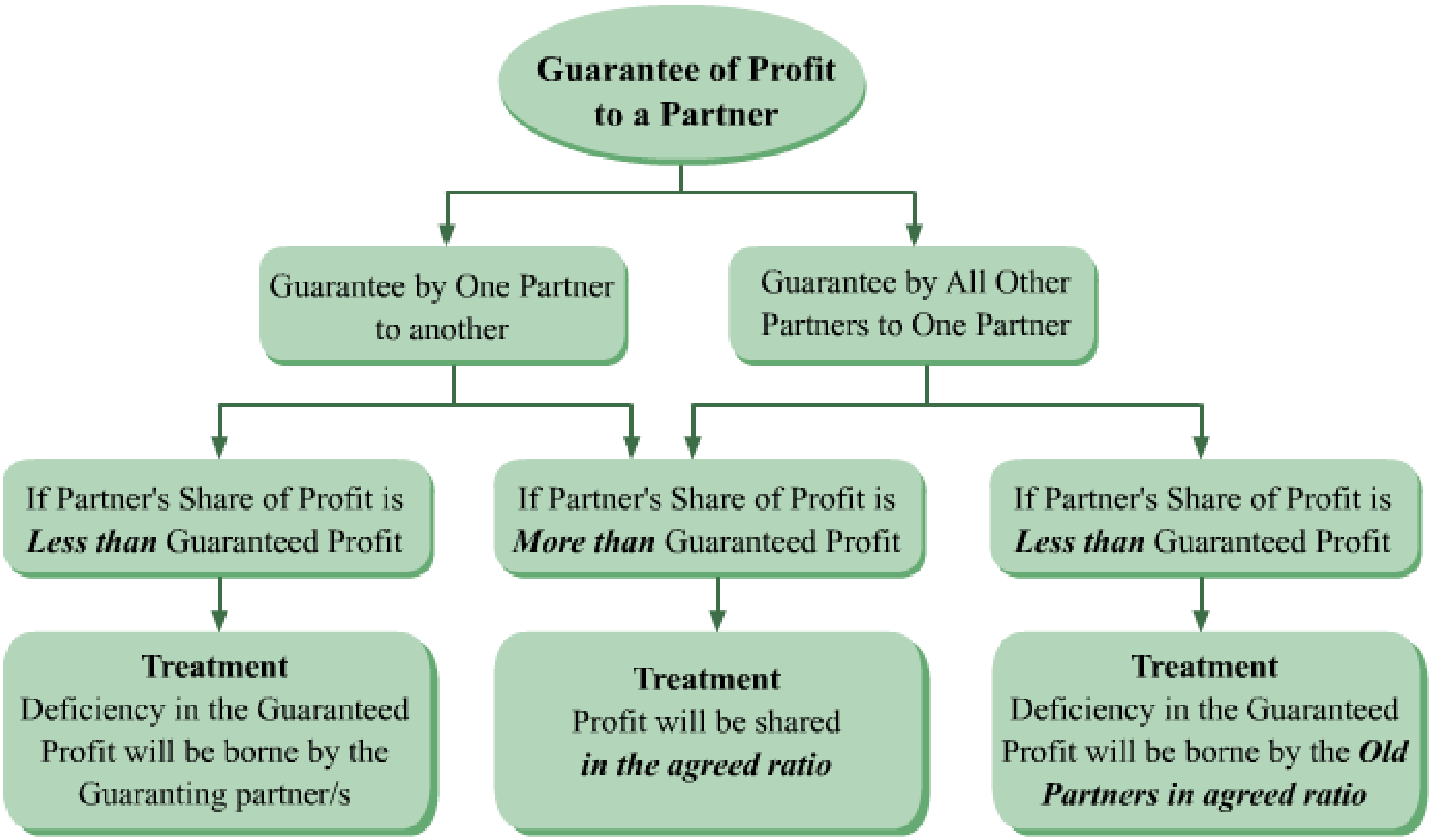
for the year ended March 31, 2012

Dr. Cr.

Particulars		Amount Rs	Particulars	Amount Rs
Profit transferred to			Net Profit	4,00,000
Deepak	1,60,000			
Dinesh	1,60,000			
Ravi	80,000	4,00,000		
		4,00,000		4,00,000

Since, the actual amount of profit share of Ravi is more than his guaranteed amount of profit therefore, his actual share of profit will be given to him instead of his guaranteed amount.

Conclusion



Simultaneous Guarantee by Partners and by Firm

Example- J, K, L and M are four partners in a partnership firm sharing profits and losses equally. Their capital account balances in the books appeared as Rs 1,00,000, Rs 1,25,000, Rs 75,000 and Rs 1,50,000 respectively.

i. Interest on capital is 10% p.a.
ii. Salary to L is 2,500 per month.
iii. Interest on partners' loan to the firm is 4% p.a.
iv. L was guaranteed by the firm of a minimum profit of Rs 50,000 p.a.
v. M on the other hand, was guaranteed by J of a minimum profit of Rs 60,000.

The profit for the year ending March 31, 2013 amounted to Rs 2,50,000. K has provided a loan of Rs 50,000 to the firm. Prepare Profit and Loss Appropriation Account showing the distribution of profit.

Solution

Profit and Loss Appropriation Account

Dr. **Cr.**

Particulars		**Amount Rs**	**Particulars**	**Amount Rs**
Interest on Capital to:			Profit and Loss A/c (2,50,000 – 2,000)	2,48,000
J	10,000			
K	12,500			
L	7,500			
M	15,000	45,000		
Salary to L (2,500 × 12)		30,000		
Profit transferred to: ***(See Video)***				
J's Capital A/c	22,000			
K's Capital A/c	41,000			
L's Capital A/c	50,000			
M's Capital A/c	60,000	1,73,000		
		2,48,000		2,48,000

***Working Notes*:**

Profit available for distribution = 2,48,000 – (45,000 + 30,000) = Rs 1,73,000

Profit sharing ratio = 1 : 1 : 1 : 1

$$\text{Profit share of each partner} = 1{,}73{,}000 \times \frac{1}{4} = \text{Rs } 43{,}250$$

L has given a guarantee of minimum profit of **Rs 50,000** by the firm.

|

Deficiency in L's profit share = 50,000 – 43,250 = Rs 6,750

This firm's deficiency is to be borne by J, K and M in equal ratio.

$$\therefore \text{Deficiency borne by J, K and M each} = 6{,}750 \times \frac{1}{3} = \text{Rs } 2{,}250$$

Profit share of J, K and M each after bearing deficiency in L's profit share = 43,250 – 2,250 = **Rs 41,000**

Also, M has been guaranteed by J of minimum profit of **Rs 60,000**.

M’s Actual Profit Share = 41,000

Deficiency in M’s profit share = 60,000 – 41,000 = Rs 19,000
This deficiency is to be borne by J alone.
Therefore, Final profit share of J = 41,000 – 19,000 = **Rs 22,000**

Case IV: Guarantee by Partner to the Firm

In this case, the partner ensures a minimum amount of profit to the firm. If in case, the amount of profit of the firm falls short of the guaranteed profit by the partner, then the deficiency will be borne by the guaranteeing partner (the one who has given the guarantee).

Example - A, B and C are partners sharing profits and losses in the ratio of 3 : 2 : 1. C gives guarantee that the gross fee earned by him for the firm shall not be less than Rs 30,000. However, C actually earned Rs 15,000 for the firm. Show the distribution of profit by preparing Profit and Loss Appropriation Account when profit earned by the firm was Rs 60,000.

Solution

Profit and Loss Appropriation Account

Dr. **Cr.**

Particulars		**Amount Rs**	**Particulars**	**Amount Rs**
Profit transferred to:			Profit and Loss A/c	60,000
A’s Capital A/c	37,500		C’s Capital A/c	15,000
B’s Capital A/c	25,000			
C’s Capital A/c	12,500	75,000		
		75,000		**75,000**

Accounting Treatment of Guarantee of Profit in case of Loss

Uncertainty of profits in business is always a matter of concern. Now, we shall focus on the accounting treatment of guarantee of profits to a partner when the firm has incurred a loss during a particular financial year. The treatment can be bifurcated under the following two cases.

Case (a) Firm to Partner Guarantee
Case (b) Partner to Partner Guarantee

Case (a) Firm to Partner Guarantee – A and B are partners in a firm. C is admitted into partnership and is guaranteed a profit of Rs 5,000. At the year end, the firm incurs a loss of Rs 15,000. In such a case, the guaranteed partner (C) has to be given the amount of profit assured to him (Rs 5,000) by all other partners (A and B). This would further increase the loss of the firm by the amount of guaranteed profit (Rs 5,000), making it Rs 20,000. The total loss would finally be borne by the partners A and B in their profit sharing ratio.

Case (b) Partner to Partner Guarantee – A and B are partners in a firm. C is admitted into partnership and is guaranteed a profit of Rs 5,000 by A. At the year end, the firm incurs a loss of Rs 15,000. In such a case, the distribution of loss shall be as follows.
(i) A will bear his share of loss and C's share of loss, along with the guaranteed profit payable to C. [A's total loss = Rs 15,000]
(ii) B will bear only his share of loss. [B's loss = Rs 5,000]

Miscellaneous Example

Example- Neel, Nitin, Mukesh and Rakesh are four partners in a firm sharing profits and losses in the ratio of 2 : 1 : 2 : 1. Their capital account balances in the books appeared as Rs 3,00,000, Rs 3,75,000, Rs 2,25,000 and Rs 4,50,000 respectively.

i. Interest on capital is 10% p.a.
ii. Salary to Nitin is 7,500 per month.
iii. Interest on partners' loan to the firm is 5% p.a.
iv. Nitin has been guaranteed by the firm of minimum profit of Rs 1,50,000 p.a.
v. Neel has been guaranteed by Mukesh of minimum profit (including his interest on Capital) of Rs 2,25,000 p.a.

Profit for year ending March 31, 2013 amounted to Rs 7,51,500. Nitin has provided a loan of Rs 1,50,000 to the firm. At the year end, Nitin requested to provide him at least minimum interest of 6% p.a. as per the Partnership Act. Prepare Profit and Loss Appropriation Account showing the distribution of profit.
Solution

Profit and Loss Appropriation Account

Dr. **Cr.**

Particulars		**Amount Rs**	**Particulars**	**Amount Rs**
Interest on Capital:			Profit and Loss A/c (7,51,500 – 7,500)	7,44,000
Neel	30,000			
Nitin	37,500			
Mukesh	22,500			

Rakesh	45,000	1,35,000		
Salary to Nitin (7,500 × 12)		90,000		
Profit transferred to:				
Neel's Capital A/c	1,95,000			
Nitin's Capital A/c	1,50,000			
Mukesh's Capital A/c	1,00,200			
Rakesh's Capital A/c	73,800	5,19,000		
		7,44,000		7,44,000

***Working Notes*:**

Profit available for distribution = 7,44,000 – (1,35,000 + 90,000) = Rs 5,19,000
Profit sharing ratio = 2 : 1 : 2 : 1

$$\text{Profit Share of Neel} = 5{,}19{,}000 \times \frac{2}{6} = 1{,}73{,}000$$

$$\text{Profit Share of Nitin} = 5{,}19{,}000 \times \frac{1}{6} = 86{,}500$$

$$\text{Profit Share of Mukesh} = 5{,}19{,}000 \times \frac{2}{6} = 1{,}73{,}000$$

$$\text{Profit Share of Rakesh} = 5{,}19{,}000 \times \frac{1}{6} = 86{,}500$$

Nitin has given a guarantee of minimum profit of **Rs 1,50,000** by the firm.

Deficiency in Nitin's profit share = 1,50,000 – 86,500 = Rs 63,500

This firm's deficiency is to be borne by Neel, Mukesh and Rakesh in the ratio of 2 : 2 : 1.

$\therefore$ Deficiency borne by Neel $= 63,500 \times \frac{2}{5} =$ Rs 25,400

Deficiency borne by Mukesh $= 63,500 \times \frac{2}{5} =$ Rs 25,400

Deficiency borne by Rakesh $= 63,500 \times \frac{1}{5} =$ Rs 12,700

Calculation of Profit Share of each partner after bearing deficiency in Nitin's Profit Share

Profit Share Neel = 1,73,000 – 25,400 = Rs 1,47,600
Profit Share Mukesh = 1,73,000 – 25,400 = Rs 1,47,600

Profit Share Rakesh = 86,500 – 12,700 = Rs 73,800

Also, Neel has been guaranteed by Mukesh of minimum profit including his interest on Capital of Rs 2,25,000.
Neel's Actual Profit Share including interest amount = 1,47,600 + 30,000 = Rs 1,77,600

Deficiency in Neel's profit share = 1,77,600 – 2,25,000 = Rs 47,400
This deficiency is to be borne by Mukesh alone.

Final profit share of Mukesh = 1,47,600 – 47,400 = Rs 1,00,200

Also, **Final profit share of Neel = 2,25,000 – Interest = 2,25,000 – 30,000 = Rs 1,95,000**

Past Adjustments

Objective

After going through this lesson, you shall be able understand the following concepts.

- Past Adjustments or Adjustments after Closing Accounts
- Capital Ratios

Past Adjustments or Adjustments After Closing Accounts

We know that every business firm closes its books of accounts at the end of each accounting period. The accounting period is usually of one year, which can be either a calendar year (i.e. from January 01 to December 31) or a financial year (i.e.

from April 01 to March 31). Sometimes after the books are closed, it may happen that a few mistakes or errors are detected. Once the books are closed, it is not advisable to rectify such mistakes or errors by altering the accounts.

In stead such mistakes or errors can be directly rectified through Partners' Capital Account by passing the adjusting Journal entries. These adjustments that are made to rectify the errors without altering the already prepared accounts are collectively known as past adjustments. Some of the common errors that are usually detected after the closing of the books are as follows.

a. Omission of Interest on Capital
b. Omission of Interest on Drawings
c. Interest Rate Wrongly Charged/Provided
d. Wrong distribution of Profits or Losses

Let us understand how different errors are rectified by the past adjustments with the help of the following examples.

Interest on Capital: Omission

Example: Ajay and Vijay are the partners sharing profits and losses equally. Their capital balances as on April 01, 2011 were Rs 30,000 and Rs 36,000 respectively. After preparing the final accounts it was discovered that the interest on capital @ 8% p.a. has not been provided to the partners. Pass the necessary Journal entry to rectify the error.

Solution

Statement Showing Adjustment

Particulars		Ajay	Vijay	Total
Interest on Capital to be credited	(Cr.)	2,400	2,880	5,280
Sharing of above Loss (1 : 1)	(Dr.)	(2,640)	(2,640)	(5,280)
Net Effect		(240) (Dr.)	240 (Cr.)	NIL

Adjusting Journal Entry

Ajay's Capital A/c		Dr.	240	
	To Vijay's Capital A/c			240

Interest on Capital: When Actual Rate is *less* than Provided Rate

Example: Jiya, Riya and Piya are the partners in a firm sharing profits and losses in the ratio of 2 : 1 : 1. Their capital balances were Rs 2,00,000, Rs 1,50,000 and Rs, 1,80,000 respectively. The interest on capital was agreed at 9% p.a. but wrongly credited to them at 12% p.a. Pass the adjusting Journal entry to rectify the error.

Solution

Statement Showing Adjustment

Particulars		Jiya	Riya	Piya	Total
Interest wrongly Credited reversed (at 12% p.a.)	(Dr.)	24,000	18,000	21,600	63,600
Interest on Capital to be Credited (at 9% p.a.)	(Cr.)	(18,000)	(13,500)	(16,200)	(47,700)
For sharing above profit (2 : 1 : 1)	(Cr.)	(7,950)	(3,975)	(3,975)	(15,900)
Net Effect		(1,950) (Cr.)	525 (Dr.)	1,425 (Dr.)	NIL

Previously interest on capital was wrongly provided @ 12% p.a. instead of the actual rate of 9% p.a. This implies that the partners received interest amounts that were higher than what they were actually supposed to receive. Due to higher interest amounts, the profits of the firm reduced to the extent of Rs 15,900 (i.e. 12% – 9%).

Difference in Amount of Interest (12% Interest Amount – 9% Interest Amount) = Rs 63,600 – Rs 47,700 = Rs 15,900

The amount (Profit) will be distributed among the patners in their profit sharing ratio i.e. 2 : 1 : 1

Adjusting Journal Entry

Riya's Capital A/c		Dr.	525	
Piya's Capital A/c		Dr.	1,425	
	To Jiya's Capital A/c			1,950
(Interest on capital exess charged, now rectified)				

Interest on Capital: When Actual Rate is *more* than Provided Rate

Example: Mohan, Rohan and Sohan are partners in a firm sharing profits and losses in the ratio of 2 : 1 : 1. Their capital balances were Rs 2,00,000, Rs 1,50,000 and Rs 1,80,000 respectively. The interest on capital was agreed at 15% p.a. but wrongly credited to them at 11% p.a. Pass the necessary Journal entry for rectification.

Solution

Interest on capital to the partners is to be provided at 15% p.a. but it was wrongly credited to them at a lower rate of 11% p.a. Therefore, the remaining interest on capital that is the difference of 4% (15% – 11%) is to be provided to the partners.

<u>*Calculation of Remaining Interest Amount to the Partners*</u>

Interest on Mohan's Capital	=	$\text{Rs}2,00,000 \times \frac{4}{100}$	=	8,000
Interest on Rohan's Capital	=	$\text{Rs}1,50,000 \times \frac{4}{100}$	=	6,000
Interest on Sohan's Capital	=	$\text{Rs}1,80,000 \times \frac{4}{100}$	=	7,200
Total Interest			=	21,200

Statement Showing Adjustment

Particulars		Mohan	Rohan	Sohan	Total
Interest to be Credited	(Cr.)	8,000	6,000	7,200	21,200
Sharing of above Loss (2 : 1 : 1)	(Dr.)	(10,600)	(5,300)	(5,300)	(21,200)
Net Effect		(2,600) (Dr.)	700 (Cr.)	1,900 (Cr.)	NIL

<u>*Adjusting Journal Entry*</u>

Mohan's Capital A/c		Dr.	2,600	
	To Rohan's Capital A/c			700
	To Sohan's Capital A/c			1,900

(Interest on capital less charged, now rectified)

Interest on Capital: Provided when not specified in the deed

Example: X , Y and Z were equal partners. Interest on capital of Rs 2,500, Rs 5,000 and Rs 7,500 was provided to the partners. However, there was no provision for interest in the partnership deed. Pass the necessary adjustment entry to rectify the error.

Solution

Interest on Capital wrongly provided = 2,500 + 5,000 + 7,500 = 15,000
Amount of Rs 15,000 will be distributed among the partners in their profit sharing ratio

$$\mathrm{X} = 15,000 \times \tfrac{1}{3} = \mathrm{Rs}\ 5,000$$
$$\mathrm{Y} = 15,000 \times \tfrac{1}{3} = \mathrm{Rs}\ 5,000$$
$$\mathrm{Z} = 15,000 \times \tfrac{1}{3} = \mathrm{Rs}\ 5,000$$

Statement Showing Adjustment

Particulars	**X**	**Y**	**Z**	**Total**
Profit that is to be distributed among the partners ***Less***: Interest on Capital wrongly provided	5,000 (2,500)	5,000 (5,000)	5,000 (7,500)	(15,000) 15,000
Net Effect	2,500 Cr.	-	(2,500) Dr.	NIL

<u>*Adjusting Journal Entry*</u>

Z's Capital A/c		Dr.	2,500	
	To X's Capital A/c			2,500
(Interest on capital not required to be provided, now rectified)				

Interest on Drawings: Omission

Example: P, Q, and R are the partners in a firm sharing profits and losses equally. After the preparation of final accounts, it was discovered that the interest on drawings has not been charged. The interest on drawings of the partners were Rs 1,200, Rs 1,300 and Rs 1,100 respectively. Pass the necessary Journal entry for the rectification of such error.

Solution

Statement Showing Adjustment

Particulars		P	Q	R	Total
Interest on Drawings to be Debited	(Dr.)	1,200	1,300	1,100	3,600
Sharing of above Profit (1 : 1 : 1)	(Cr.)	(1,200)	(1,200)	(1,200)	(3,600)
Net Effect		Nil	100 (Dr.)	100 (Cr.)	NIL

Adjusting Journal Entry

Q's Capital A/c		Dr.	100	
	To R's Capital A/c			100
(Rectification of omission of interest on drawings)				

Interest on Drawings: When Actual Rate is *less* than Charged Rate

Example: A, B and C were partners sharing profits and losses in the ratio of 2 : 2 : 1. During the year amount withdrawn by A, B and C was Rs 50,000, Rs 60,000 and Rs 70,000 respectively. Interest on drawings is to be charged @ 6% p.a. However, it was charged @ 10% p.a. Pass the necessary adjustment entry to rectify the error.

Solution

Statement Showing Adjustment				
Particulars	**A**	**B**	**C**	**Total**
Interest on Drawings @ 4%	2,000	2,400	2,800	(7,200)
Less: Profits wrongly distributed	(2,880)	(2,880)	(1,440)	7,200
Net Effect	(880) Dr.	(480) Dr.	1,360 Cr.	NIL

Calculation of Excess Amount of Interest on Drawings Charged @ 4%

$$\text{A} = 50,000 \times \frac{4}{100} = \text{Rs } 2,000$$

$$\text{B} = 60,000 \times \frac{4}{100} = \text{Rs } 2,400$$

$$\text{C} = 70,000 \times \frac{4}{100} = \text{Rs } 2,800$$

Adjusting Entry

A's Capital A/c	Dr.	880	
B's Capital A/c	Dr.	480	
To C's Capital A/c			1,360
(Interest on drawing excess charged, now rectified)			

Interest on Drawings: When Actual Rate is *more* than Charged Rate

***Example*:** X and Y were partners sharing profits and losses in the ratio of 3 : 2. During the year amount withdrawn by them was Rs 20,000 and Rs 30,000 respectively. After closing the books of accounts, it was discovered that interest on drawings was charged @ 8% p.a. instead of 10% p.a. Pass the necessary adjustment entry to rectify the error.

Solution

Statement Showing Adjustment			
Particulars	**X**	**Y**	**Total**
Interest on Drawings @ 2%	(400)	(600)	1,000
Less: Profits to be distributed	600	400	(1,000)
Net Effect	200 Cr.	(200) Dr.	NIL

Calculation of Deficit Amount of Interest on Drawings @ 2%

$$\mathrm{X} = 20,000 \times \frac{2}{100} = \mathrm{Rs}\ 400$$
$$\mathrm{Y} = 30,000 \times \frac{2}{100} = \mathrm{Rs}\ 600$$

Adjusting Entry

Y's Capital A/c	Dr.	200	
To X's Capital A/c			200
(Interest on Drawing less charged, now rectified)			

Interest on Drawings: Charged when not specified in the deed

Example: P, Q and R were partners sharing profits and losses equally. Interest on drawings amounted to Rs 1,500, Rs 2,000 and Rs 2,500 was charged from the partners. However, there was no provision for interest in the partnership deed. Pass the necessary adjustment entry to rectify the error.

Solution

Interest on Drawings wrongly charged = 1,500 + 2,000 + 2,500 = 6,000
Amount of Rs 6,000 wrongly distributed among the partners in their profit sharing ratio

$$\mathrm{P} = 6,000 \times \tfrac{1}{3} = \mathrm{Rs}\ 2,000$$
$$\mathrm{Q} = 6,000 \times \tfrac{1}{3} = \mathrm{Rs}\ 2,000$$
$$\mathrm{R} = 6,000 \times \tfrac{1}{3} = \mathrm{Rs}\ 2,000$$

Statement Showing Adjustment				
Particulars	**P**	**Q**	**R**	**Total**
Interest on Drawings wrongly debited ***Less***: Profits wrongly distributed	1,500 (2,000)	2,000 (2,000)	2,500 (2,000)	(6,000) 6,000
Net Effect	(500) Dr.	-	500 Cr.	NIL

Adjusting Entry

P's Capital A/c		Dr.	500	
	To R's Capital A/c			500
(Interest on Drawing less charged, now rectified)				

Wrong Distribution of Profits and Losses

Example: Ginny, Vinny and Sunny are the partners in a firm sharing profits and losses in the ratio of 2 : 1 : 2. During the year the firm earned a profit of Rs 3,30,000. The profit by mistake was distributed among the partners equally. Pass the necessary Journal entry to rectify the error.

Solution

Statement Showing Adjustment					
Particulars		**Ginny**	**Vinny**	**Sunny**	**Total**
Wrong Distribution of Profit written back (1 : 1 : 1)	(Dr.)	1,10,000	1,10,000	1,10,000	3,30,000
Right distribution of Profit (2 : 1 : 2)	(Cr.)	(1,32,000)	(66,000)	(1,32,000)	(3,30,000)
Net Effect		(22,000) (Cr.)	44,000 (Dr.)	(22,000) (Cr.)	Nil

Adjusting Journal Entry

Vinny's Capital A/c		Dr.	44,000	
	To Ginny's Capital			22,000
	To Sunny's Capital			22,000
(Profits distributed in wrong ratio, now rectified)				

When Adjustment Journal Entries in place Of Single Adjustment Entries are passed:

Under this method, a separate entry has to be passed for each adjustment instead of a single Journal Adjustment Entry. So, we do not prepare analytical table to determine the net effect of all the adjustments instead Journal entries are passed for each error or omission by debiting or crediting Profit And Loss Adjustments Account. After passing these entries, Profit And Loss Adjustment Account is closed by debiting or crediting with the corresponding credit or debit to the Partner's Current Account, if fixed capital method is followed or Partner's capital account, if fluctuating capital method is followed.

Accounting Entries

Following are the Journal entries to be recorded in Profit And Loss Adjustment A/c:

1) Adjustment entries for items which are to be credited to Partner's Capital/Current A/c:

Date	Particulars	L.F.	Dr. (Rs.)	Cr.(Rs.)

	Profit And Loss Adjustment A/c Dr. To Partner's Capital/Current A/cs (Being adjustment entry for previously omitted, now recorded)			

2) Adjustment entries for items which are to be debited to Partner's Capital/Current A/c:

Date	Particulars	L.F.	Dr. (Rs.)	Cr.(Rs.)
	Partner's Capital/Current A/cs Dr. To Profit And Loss Adjustment A/c (Being adjustment entry for previously omitted, now recorded)			

3) For Net Profit/Loss due to above adjustments:

(a) For Profit

Date	Particulars	L.F.	Dr. (Rs.)	Cr.(Rs.)
	Profit & Loss Adjustment A/c Dr.			

	To Partner's Capital/Current A/cs (Being the profit on adjustment credited to Partner's Capital/Current Accounts)			

(b) For Loss

Date	Particulars	L.F.	Dr. (Rs.)	Cr.(Rs.)
	Partner's Capital/Current A/cs Dr. To Profit & Loss Adjustment A/c (Being the loss on adjustment credited to Partner's Capital/Current Accounts)			

Note: *If capitals of the partners are fixed, adjustment entries are passed through Partner's Current Accounts.*

Example:X, Y and Z are partners in a firm. Their Capital Accounts stood at Rs.3,00,000; Rs. 2,80,000; Rs. 2,50,000 respectively on 1st April, 2017.

As per the deed: (i) X was allowed a salary of Rs. 40,000 per annum, (ii) Interest @ 8% per annum was to be provided on Capital and (iii) Profits are to be distributed in the ratio of 2:2:1. Ignoring the above term, net profit of Rs. 2,70,000 for the year ended 31st March, 2018 was distributed among the three partners equally.
Pass Journal entries of the above error.

Answer:

JOURNAL

Date	**Particulars**	**L.F.**	**Dr.**	**Cr.**

				(Rs.)	(Rs.)
2018 April 1	X's Capital A/c Y's Capital A/c Z's Capital A/c To Profit & Loss Adjustment A/c (Being share of profit wrongly credited to partners, now reversed)	Dr. Dr. Dr.		90,000 90,000 90,000	 2,70,000
	Profit & Loss Adjustment A/c To X's Capital A/c (Being salary credited to X's capital A/c	Dr.		40,000	 40,000
	Profit & Loss Adjustment A/c To X's Capital A/c To Y's Capital A/c To Z's Capital A/c (Being the interest on capitals @ 8% p.a. credited to the Capital Accounts)	Dr.		66,400	 24,000 22,400 20,000
	Profit & Loss Adjustment A/c To X's Capital A/c To Y's Capital A/c To Z's Capital A/c (Being the divisible credited to the Capital Accounts in the ratio of 2:2:1)	Dr.		2,70,000	 1,08,000 1,08,000 54,000

Treatment of Manager Admitted as a Partner with Retrospective Effect

Sometimes when the partners are duly impressed and satisfied with a manager's performance and his commitment towards the firm, they may mutually decide to admit him as a partner to the firm. He is then usually admitted as a partner with retrospective effect (i.e. to be considered as a partner for the previous years apart from the current year as specified). In such a case, the profit for those years, etc., is adjusted to give effect to the terms of partnership. A separate entry can be passed for each adjustment or a single entry giving the net effect can be passed. The following steps can be followed to compute the net effect:

Step 1: Calculate the amount paid as remuneration to the manager.

Step 2: Calculate the amount to be given to the manager as a partner.
Step 3: Compute the difference and if amount as per Step 2 above is more, it is credited to his account and debited to old partners in their old profit sharing ratio. If the amount as per step 1 above is more then manager's account and credit Old Partner's Capital A/c in their old profit-sharing ratio.

Example: X and Y are partners in a firm sharing profits and losses in the ratio of 3:2. At the end of the year, i.e., on 31st March, 2019, (after diving the profits), they decided to take z into the partnership with effect from 1st April, 2016. As Z was getting annual salary of ₹50,000.
During the three financial years, firm's profit after adjusting Z's salary and interest on capital of the partners were as follows:

Year Ended
31st March, 2017:Profit ₹ 3,00,000
31st March, 2018:Loss ₹ 1,00,000
31st March, 2019:Profit ₹ 5,00,000

According to the new agreement, Z will get an annual salary of Rs. 30,000 and $1/5^{th}$ share of profits. He will contribute capital to the tune of Rs. 3,00,000 by way of cash and similar to other partners, his capital will carry interest @ 5% p.a.
Record necessary Journal entries of the above arrangement.

Answer:

JOURNAL

Date	**Particulars**		**L.F.**	**Dr. (Rs.)**	**Cr. (Rs.)**
2019 April 1	Cash A/c To Z's Capital A/c (Being capital brought in by Z by way of cash)	Dr.		3,00,000	 3,00,000
2019 April 1	Z's Capital A/c To X's Capital A/c To Y's Capiatl A/c	Dr.		92,000	 55,200 36,800

	(Being the excess credit given to Z borne by X and Y in 3:2)			

Working Notes:

1 Year ended 31st March	2 Profit/Loss ₹	3 Salary paid as Manager ₹	4 Interest on Capital Payable as Partner (Rs.)	5 Salary as partner ₹	6 Adjusted Profit (2+3-4-5) ₹
2017	3,00,000	50,000	15,000	30,000	3,05,000
2018	(1,00,000)	50,000	-	-	(50,000)
2019	5,00,000	50,000	15,000	30,000	5,05,000
	7,00,000	1,50,000	30,000	60,000	7,60,000

I. Z's Total share (As a partner):	**Rs.**
Z's Share in Profit (1/5 x7,60,000)	1,52,000
Interest Payable on Z's capital	30,000
Salary	60,000
	2,42,000
II. Paid to Z as a Manager	
Salary (for 3 years)	**1,50,000**
III. Credit to be given to Z to be borne by	
X and Y in the ratio of 3:2 (I-II)	**92,000**

<u>Miscellaneous Examples</u>

<u>Example</u>: A and B are partners sharing profits and losses in the ratio 3:2. On March 31, 2013 loss Rs 5,000 distributed equally after allowing interest on capital. Interest on A's capital and B's capital were Rs 5,000 and Rs 3,000 respectively. As per the partnership deep there is no such agreement that interest on capitals are to be provided even firm involves in the loss.

Make correction through passing Journal entry without opening interest on capital account and profit and loss account.

Solution

Journal

Date	**Particulars**	**Debit Amount (₹)**	**Credit Amount Rs**
	A's Capital A/c Dr. To B's Capital A/c (Profit and interest on capital adjusted)	625	625

<u>WN1</u> *<u>Loss wrongly distributed between A and B</u>*

$$\text{A's Share of Loss} = 5{,}000 \times \frac{1}{2} = \text{Rs } 2{,}500$$

$$\text{B's Share of Loss} = 5{,}000 \times \frac{1}{2} = \text{Rs } 2{,}500$$

<u>WN2</u>

$$\text{Profit before distribution of Loss} = \text{Interest on A's capital} + \text{Interest on B's capital} - \text{Loss}$$

$$= 5{,}000 + 3{,}000 - 5{,}000 = \text{Rs } 3{,}000$$

Profit before interest on capital is Rs 3,000 which is *less than* the total amount of interest on capital Rs 8,000 (5,000 + 3,000) and there is no clear agreement for providing interest on capital. Hence, interest to the partners will be paid to the extent of available profits i.e. Rs 3,000. It will be paid in the ratio of interest on capital of the partners.

<u>WN 3</u> *<u>Calculation of Interest on Capital Ratio</u>*

A : B

Interest on Capital = 5,000 : 3,000

Interest on Capital Ratio = 5 : 3

WN 4 *Calculation of Interest on Capital to the Partners*

Interest A's on Capital $= 3{,}000 \times \frac{5}{8} =$ Rs 1,875

Interest B's on Capital $= 3{,}000 \times \frac{3}{8} =$ Rs 1,125

WN 5

Statement Showing Adjustment

Particulars	A	B	Total
Right Distribution			
Interest on Capital (to be credited) (***WN 4***)	1,875	1,125	3,000
Wrong Distribution			
Interest on Capital (to be debited)	(5,000)	(3,000)	(8,000)
Loss wrongly distributed (to be credited)	2,500	2,500	5,000
Net Effect	(625) (Dr.)	625 (Cr.)	Nil

Example: M, P and Q are partners sharing profits and losses equally. On March 31, 2013 profit had been distributed without charging interest on M's and Q's drawings of Rs 5,000 and 4,000 respectively.
Pass single Journal entry to adjust the amount of interest on drawings without opening Interest on Drawings Account.
Solution

Journal

Date	Particulars		Debit Amount Rs	Credit Amount Rs
	M's Capital A/c	Dr.	2,000	
	Q's Capital A/c	Dr.	1,000	
	To P's Capital A/c			3,000
	(Adjustment made in capital accounts for interest on drawings)			

Statement Showing Adjustment

Particulars	M	P	Q	Total
Interest on Drawings omitted (to be debited)	(5,000)	-	(4,000)	(9,000)
For sharing above profit (1 : 1 : 1)	3,000	3,000	3,000	9,000
Net Effect	(2,000) (Dr.)	3,000 (Cr.)	(1,000) (Dr.)	Nil

Example: A and B are partners sharing profit or losses in the ratio of 3:2. After division of profit for the year ended March 31, 2013, capital balances of A and B were Rs 90,000 and Rs 80,000 respectively. It was further discovered that profit of Rs 30,000 had been wrongly distributed among the partners in the ratio of 7:3 without providing interest on capital at 5%, salary of B Rs 2,000 and commission to A Rs 3,000.

Pass the Journal entry for the adjustment of omitted items without opening Profit and Loss Adjustment Account.

Solution

Journal

Date	Particulars	Debit Amount Rs	Credit Amount Rs
	A's Capital A/c Dr. To B's Capital A/c (Adjustment made for omitted items and wrong distribution of profit)	3,750	3,750

Working Notes:

WN 1Calculation of Opening Capital Balance

Particulars	A	B
Capital at the end (Closing Capital)	90,000	80,000
Less: Share of Profit wrongly distributed (7 : 3)	(21,000)	(9,000)
Capital in the beginning (Opening Capital)	69,000	71,000

WN 2Calculation of Interest on Capital

$$\text{Interest on A's Capital} = 69{,}000 \times \frac{5}{100} = \text{Rs } 3{,}450$$

$$\text{Interest on B's Capital} = 71{,}000 \times \frac{5}{100} = \text{Rs } 3{,}550$$

$$\text{Total Amount of Interest} = 3{,}450 + 3{,}550 = \text{Rs } 7{,}000$$

WN 3 Commission to A = Rs 3,000

WN 4 Salary to B = Rs 2,000

WN 5 Calculation *of Profit available for Distribution*

Profit available for Distribution = Profit as on March, 31 – Interest on Capital – Commission to A – Salary to B

= 30,000 – 7,000 – 3,000 – 2,000 = Rs 18,000

WN 6 *Right Distribution of Profit* (3 : 2)

$$\text{A's Profit Share} = 18{,}000 \times \frac{3}{5} = \text{Rs } 10{,}800$$

$$\text{B's Profit Share} = 18{,}000 \times \frac{2}{5} = \text{Rs } 7{,}200$$

WN 7

Statement Showing Adjustment

Particulars	**A**	**B**	**Total**
Interest on Capital	3,450	3,550	7,000
Commission to A	3,000	-	3,000
Salary to B	-	2,000	2,000
Right Distibution of Profit	10,800	7,200	18,000
Wrong Distribution of Profit to be reversed	(21,000)	(9,000)	(30,000)
Net Effect	(3,750) (Dr.)	3,750 (Cr.)	Nil

Example: A and B are partners sharing profits and losses in the ratio 3:2. On March 31, 2013 Profit Rs 50,000 distributed equally after allowing interest on capital but without charging interest on drawings at 5% and commission to A and B Rs 2,000 and 1,000 respectively. Interest on A's capital and B's capital were Rs 5,000 and Rs 3,000 respectively.
Drawings made by A and B were as:

A drew Rs 8,000 on April 01, 2012 and Rs 12,000 on July 01, 2012
B drew Rs 4,000 at the end of each quarter.

Make correction through passing Journal entry without opening Profit and Loss Adjustment Account.

Solution

Journal

Date	Particulars	Debit Amount Rs	Credit Amount Rs
	B's Capital A/c Dr. To A's Capital A/c (Interest on drawings, partner's commission and profit adjusted in partners' capital accounts)	5,280	5,280

Working Notes:

WN1 *Profit wrongly distributed between A and B*

$$\text{A's Share} = 50{,}000 \times \frac{1}{2} = \text{Rs } 25{,}000$$

$$\text{B's Share} = 50{,}000 \times \frac{1}{2} = \text{Rs } 25{,}000$$

WN2 *Calculation of Drawings made by A and B*
A's Drawings = 8,000 + 12,000 = Rs 20,000
B's Drawings = 4,000 × 4 = Rs 16,000

WN3 *Calculation of Interest on Drawings*

Note: Interest on drawings will be charged for whole year because the word '*per annum*' is not suffixed with the rate of interest on drawings.

$$\text{Interest A's on drawings} = 20,000 \times \frac{5}{100} = \text{Rs } 1,000$$

$$\text{Interest B's on drawings} = 16,000 \times \frac{5}{100} = \text{Rs } 800$$

WN4 *Calculation of Profit to be distributed in the profit sharing ratio*

$$\begin{aligned}\text{Profit available for distribution} &= \text{Profit after Interest on Capital} + \text{Interest on Partners' drawings} \\ &\quad - \text{Commission to Partners} \\ &= 50,000 + (1,000 + 800) - (2,000 + 1,000) = \text{Rs } 48,800\end{aligned}$$

WN5 *Calculation Right Distribution of Profit*

$$\text{A's share} = 48,800 \times \frac{3}{5} = \text{Rs } 29,280$$

$$\text{B's share} = 48,800 \times \frac{2}{5} = \text{Rs } 19,520$$

WN6

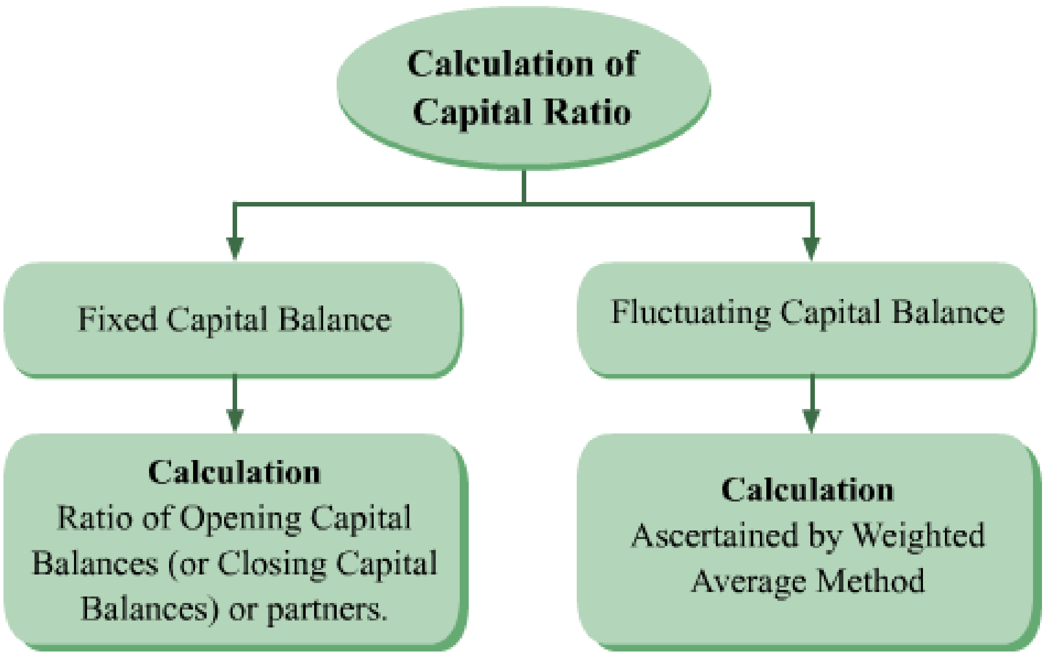
Statement Showing Adjustment

Particulars	**A**	**B**	**Total**
Commission to A and B (to be credited)	2,000	1,000	3,000
Share of Profit (to be credited)	29,280	19,520	48,800
Interest on Drawings (to be debited)	(1,000)	(800)	(1,800)
Wrong Distribution of Profit ((to be debited)	(25,000)	(25,000)	(50,000)
Net Effect	5,280 (Cr.)	(5,280) (Dr.)	Nil

Capital Ratio

We know that the profits of a partnership firm are distributed among all the partners in an agreed ratio that is mentioned in their partnership deed. But if the deed is silent regarding the profit sharing ratio, then profits are distributed equally among all the partners. However at times, it may happen that the partners decide to share the profits and losses in the ratio of their capital balances and not in their profit sharing ratio. In such a situation, capital ratio of the partners is to be ascertained. The calculation of the capital ratio depends on the following two situations.

i. Fixed Capital Balance (When there is no change in the Capital Balances)
ii. Fluctuating Capital Balance (When there is a change in the Capital Balances i.e. when capital is withdrawn or introduced during the year)



Fixed Capital Balance- In this case, the capital balances of the partners remain the same throughout an accounting period. That is, in other words, the opening capital balance and the closing capital balance of the partner are equal. Therefore, in this case, ratio can be computed either using opening or closing capital balance. For example, if the capital balances of two partners A and B are Rs 90,000 and Rs 45,000, then the capital ratio is 2 : 1.

Example: A and B are the partners in a business with capitals of Rs 1,00,000 and Rs 80,000 as on January 01, 2011. Calculate their capital ratio.

Solution

	A		B
Capital Balance =	1,00,000		80,000
∴Capital Ratio =	5	:	4

Fluctuating Capital Balance- In this case, the capital balances fluctuate (or vary) during an accounting period. As a result, the closing and opening capital balances differ from each other. The capital balances vary because of withdrawals of capital (drawings) or introduction of fresh capital during the year. In this case, the capital ratio is ascertained by ***Weighted Average Method***. In this method, weights are assigned to the capital balances as per the number of months it remained in the business.

For example, if Rs 50,000 remained in the business from January 01 to September 30, so weight of 9 is assigned. After assigning the weights, product is computed by multiplying capital balances with their respective weights. The sum total of products gives the total capital balances of the partners on which the capital ratio can be computed.

Example: A an B are the partners in a partnership firm. Use the following information to compute the capital ratio of the partners.

Particulars	A	B
Opening Balances (January 01, 2012)	Rs 1,00,000	Rs 80,000
Drawings (July 01, 2012)	Rs 20,000	-
Additional Capital Introduced (July 01, 2012)	-	Rs 20,000
Additional Capital Introduced (October 01, 2012)	Rs 30,000	-

Solution

Total Capital Balance of A

During 2012	A's Capital Balances	Weights	Product

From Jan. 01 to June 30	1,00,000	6	Rs 1,00,000 × 6 = Rs 6,00,000
From July 01 to Sept. 30	80,000	3	Rs 80,000 × 3 = Rs 2,40,000
From Oct. 01 to Dec. 31	1,10,000	3	Rs 1,10,000 × 3 = Rs 3,30,000
Total			**Rs 11,70,000**

Total Capital Balance of B

During 2012	**B's Capital Balances**	**Weights**	**Product**
From Jan. 01 to June 30	80,000	6	Rs 80,000 × 6 = Rs 4,80,000
From July 01 to Dec. 31	1,00,000	6	Rs 1,00,000 × 6 = Rs 6,00,000
Total			**Rs 10,80,000**

Calculation of Capital Ratio

	A	:	B
Capital Balance =	11,70,000	:	10,80,000
∴Capital Ratio =	117	:	108