UNIT 3

ACCOUNTS OF PARTNERSHIP FIRMS–FUNDAMENTALS

Contents

3.1 Introduction
3.2 Meaning, definition and features of partnership
3.3 Partnership deed
3.4 Application of the provisions of the Indian Partnership Act, 1932 in the absence of partnership deed
3.5 Final accounts of partnership firms
3.6 Methods of maintaining capital accounts of partners
3.7 Interest on capital and interest on drawings of partners
3.8 Salary and commission to partners
3.9 Interest on loan from partners
3.10 Division of profits among partners
3.11 Profit and loss appropriation account

Points to recall

The following points are to be recalled before learning the accounts of partnership firms–fundamentals:

- Forms of organisation
- Accounting cycle

Learning objectives

To enable the students to

- Understand the meaning and features of partnership
- Understand fixed and fluctuating capital methods of maintaining capital accounts of partners
- Understand the calculation and accounting treatment of interest on capital, interest on drawings, remuneration to partners and interest on loan from partners
- Understand the division of profits among partners

Key terms to know

- Partner
- Partnership firm
- Partnership deed
- Fixed capital
- Fluctuating capital
- Interest on capital
- Interest on drawings
- Profit and loss appropriation account

3.1 Introduction

Student activity 3.1

Think: Ramu is a successful sole trader. His business has been progressing steadily for the past 10 years. Now, he finds it difficult to manage the business all alone. His friend wants to join his business and likes to have equal status as Ramu has. But, Ramu does not want to give up his ownership and control over the business. Is it possible for Ramu to accept his friend's willingness to join him without losing his ownership and control over his business?

Partnership firm is a form of organisation where two or more persons carry on some business activity on the basis of agreement among them. The persons who have agreed to carry on the partnership business are individually called 'partners' and collectively called as 'firm'. The name under which the business of a firm is carried on is called the 'firm name'. In the case of partnership, the purpose of many persons joining together may be to raise more capital, to pool expertise, to share responsibilities and liabilities, etc. Thus, to overcome the limitations of sole proprietorship such as limited capital, small size of business, etc, partnership firms are formed. The profit or loss arising from the partnership business is shared by the partners in the agreed ratio.

In India, partnership firms are governed by the Indian Partnership Act, 1932. Registration of partnership firm is not compulsory. It is optional. However, it is safer for the partnership firms to get registered so that the partners can avail the benefits of registration.

3.2 Meaning, definition and features of partnership

3.2.1 Meaning and definition of partnership

When two or more persons join together to form a business to share the profit or loss arising therefrom in an agreed ratio, the relationship among them is called partnership. The business may be carried on by all or any of them acting for all.

According to Section 4 of the Indian Partnership Act, 1932, partnership is defined as, "the relation between persons who have agreed to share the profits of a business carried on by all or any of them acting for all".

3.2.2 Features of partnership

Following are the essential features of partnership:

1. Partnership is an association of two or more persons. The maximum number of partners is limited to 50.
2. There should be an agreement among the persons to share the profit or loss of the business. The agreement may be oral or written or implied.
3. The agreement must be to carry on a business and to share the profits of the business.
4. The business may be carried on by all the partners or any of them acting for all.

DO YOU KNOW?

The maximum number of partners is not specified/ prescribed in the Indian Partnership Act, 1932. But, the Indian Companies Act, 2013 specifies the maximum number of partners.

As per Section 464(1) of the Indian Companies Act, 2013, no association or partnership consisting of more than such number of persons as may be prescribed shall be formed for the purpose of carrying on any business, provided that the number of persons which may be prescribed under this sub-section shall not exceed one hundred.

Rule 10 of Companies (Miscellaneous) Rules 2014 specifies the limit as 50. Thus, the maximum number of partners in a partnership firm is 50.

3.3 Partnership deed

Partnership deed is a document in writing that contains the terms of the agreement among the partners. It is not compulsory for a partnership to have a partnership deed as per the Indian Partnership Act, 1932. But, it is desirable to have a partnership deed as it serves as an evidence of the terms of the agreement among the partners.

3.3.1 Contents of partnership deed

Generally, partnership deed contains the following:

1. Name of the firm and nature and place of business
2. Date of commencement and duration of business
3. Names and addresses of all partners
4. Capital contributed by each partner
5. Profit sharing ratio
6. Amount of drawings allowed to each partner
7. Rate of interest to be allowed on capital
8. Rate of interest on drawings of partners
9. Rate of interest on loans provided by partners
10. Amount of salary to be allowed to any partner
11. Maintenance of accounts and audit procedures
12. Procedure for admission of a new partner
13. Procedure for retirement of a partner and settlement of dues to the retired partner
14. Method of valuation of goodwill and valuation of assets and liabilities at the time of admission or retirement or death of a partner.
15. Appointment of executors in case of death of a partner and settlement of dues to the legal heirs.
16. Settlement of accounts on dissolution of the firm.

Student activity 3.2

Raja and Ravi entered into a partnership. They orally agreed to share profits and losses in the ratio of 2:1. At the end of the year, Raja demands 3/4 of the profit as he worked more than Ravi. Ravi does not agree to this. How can this situation be dealt with?

3.4 Application of the provisions of the Indian Partnership Act, 1932 in the absence of partnership deed

If there is no partnership deed or when there is no express statement in the partnership deed, then the following provisions of the Act will apply:

(i) **Remuneration to partners**
No salary or remuneration is allowed to any partner. [Section 13(a)]

(ii) **Profit sharing ratio**
Profits and losses are to be shared by the partners equally. [Section 13(b)]

(iii) **Interest on capital**
No interest is allowed on the capital. Where a partner is entitled to interest on capital contributed as per partnership deed, such interest on capital will be payable only out of profits. [Section 13(c)]

(iv) **Interest on loans advanced by partners to the firm**
Interest on loan is to be allowed at the rate of 6 per cent per annum. [Section 13(d)]

(v) **Interest on drawings**
No interest is charged on the drawings of the partners.

Illustration 1

A, B, C and D are partners in a firm. There is no partnership deed. How will you deal with the following?

(i) A has contributed maximum capital. He demands interest on capital at 12% per annum.
(ii) B has withdrawn ₹ 1,000 per month. Other partners ask B to pay interest on drawings @ 10% per annum to the firm. But, B does not agree to it.
(iii) Loan advanced by C to the firm is ₹ 10,000. He demands interest on loan @ 9% per annum. A and B do not agree with this.
(iv) D demands salary at the rate of ₹ 5,000 per month as he spends full time for the business. B and C do not agree with this.
(v) A demands the profit to be shared in the capital ratio. But, B, C and D do not agree.

Solution

Since there is no partnership deed, provisions of the Indian Partnership Act, 1932 will apply.

(i) No interest on capital is payable to any partner. Therefore, A is not entitled to interest on capital.

(ii) No interest is chargeable on drawings made by the partner. Therefore, B need not pay interest on drawings.

(iii) Interest on loan is payable at 6% per annum. Therefore C is to get interest at 6% per annum on ₹ 10,000.

(iv) No remuneration is payable to any partner. Hence, D is not entitled to salary.

(v) Profits should be distributed equally.

3.5 Final accounts of partnership firms

The final accounts prepared by partnership firms are:

(a) Manufacturing account – if manufacturing activity is carried on

(b) Trading and profit and loss account – to ascertain profitability

(c) Profit and loss appropriation account – to show the disposal of profits and surplus

(d) Balance sheet – to ascertain the financial status.

The procedure for preparation of final accounts of a partnership firm is the same like sole proprietorship business except the following:

(i) In sole proprietorship, the profit or loss in the profit and loss account is transferred directly to the sole proprietor's capital account. In partnership, profit and loss appropriation account is prepared to which net profit or loss from profit and loss account is transferred. In the profit and loss appropriation account, adjustments for interest on capital, interest on drawings, salary and other remuneration due to the partners are shown. Finally, the balance in the appropriation account is transferred to the partners' capital account in the profit sharing ratio.

(ii) Capital account balance of the sole proprietor alone is shown in the balance sheet of sole proprietorship. The balance sheet of a partnership concern shows the balances in the individual capital accounts (and current accounts) of the partners.

3.6 Methods of maintaining capital accounts of partners

Amount invested by partners in the partnership business is called partners' capital. Capital may be contributed by a partner in cash or in the form of assets, etc. For each partner, a separate capital account is maintained. Capital accounts of partners of a firm may be maintained by following two methods: (i) Fixed capital method and (ii) Fluctuating capital method.

3.6.1 Fixed capital method

Under fixed capital method, the capital of the partners is not altered and it remains generally fixed. Two accounts are maintained for each partner namely (a) Capital account and (b) Current account. The transactions relating to initial capital introduced, additional capital introduced and capital permanently withdrawn are entered in the capital account and all other transactions are recorded in the current account.

(a) Partners' capital account

Capital account is credited with the original amount of capital introduced by a partner into the business and any additional capital introduced by him/her in the subsequent years. The account is debited with the amount of capital permanently withdrawn by a partner from the business. No other items are debited or credited to this account. Capital account will always show credit balance under this method. The balance of capital account remains the same unless any additional capital is introduced or capital is permanently withdrawn.

Format of partners' capital account under fixed capital method

Dr. **Partners' capital account** **Cr.**

Date	Particulars	A ₹	B ₹	Date	Particulars	A ₹	B ₹
	To Cash/Bank A/c	xxx	xxx		By Balance b/d	xxx	xxx
	(permanent withdrawal of capital)				By Cash/Bank A/c (additional capital introduced)	xxx	xxx
	To Balance c/d	xxx	xxx				
		xxx	xxx			xxx	xxx

(b) Partners' current account

Partners' current account is prepared for recording all transactions between the partner and the firm other than initial capital introduced, additional capital introduced and capital permanently withdrawn. This account is credited with interest on capital, partner's salary or commission and share of profit to the partner. This account is debited with drawings, interest on drawings and share of loss of the partner. As a result, the balance in this account changes periodically. Current account may show either credit balance or debit balance.

Format of partners' current account under fixed capital method

Dr. **Partners' current account** **Cr.**

Date	Particulars	A ₹	B ₹	Date	Particulars	A ₹	B ₹
	To Balance b/d*	xxx	xxx		By Balance b/d*	xxx	xxx
	To Drawings A/c	xxx	xxx		By Interest on capital A/c	xxx	xxx
	To Interest on drawings A/c	xxx	xxx		By Salary A/c	xxx	xxx
	To Profit and loss appropriation A/c (share of loss)	xxx	xxx		By Commission A/c	xxx	xxx
					By Profit and loss appropriation A/c (share of profit)	xxx	xxx
	To Balance c/d**	xxx	xxx		By Balance c/d**	xxx	xxx
		xxx	xxx			xxx	xxx

Note: * The opening balance may be either credit balance or debit balance for a partner.

** The closing balance may be either credit balance or debit balance for a partner.

Credit balance is the amount due to the partner from the firm. It is shown on the liabilities side of the balance sheet. Debit balance is the amount due from the partner to the firm. It is shown on the assets side of the balance sheet.

Illustration 2

From the following information, prepare capital accounts of partners Shanthi and Sumathi, when their capitals are fixed.

Particulars	Shanthi ₹	Sumathi ₹
Capital on 1st January 2018	1,00,000	80,000
Current account on 1st January 2018 (Cr.)	5,000	3,000
Additional capital introduced on 1st June 2018	10,000	20,000
Drawings during 2018	20,000	13,000
Interest on drawings	500	300
Share of profit for 2018	10,000	8,000
Interest on capital	6,300	5,400
Salary	9,000	Nil
Commission	Nil	1,200

Solution

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

Date	Particulars	Shanthi ₹	Sumathi ₹	Date	Particulars	Shanthi ₹	Sumathi ₹
2018				2018			
				Jan 1	By Balance b/d	1,00,000	80,000
Dec 31	To Balance c/d	**1,10,000**	**1,00,000**	June 1	By Bank (Additional capital)	10,000	20,000
		1,10,000	1,00,000			1,10,000	1,00,000
				2019			
				Jan 1	By Balance b/d	1,10,000	1,00,000

Dr. **Partners' Current Account** **Cr.**

Date	Particulars	Shanthi ₹	Sumathi ₹	Date	Particulars ₹	Shanthi ₹	Sumathi ₹
	To Drawings	20,000	13,000		By Balance b/d	5,000	3,000
	To Interest on drawings	500	300		By Profit and loss appropriation A/c (share of profit)	10,000	8,000
	To Balance c/d	**9,800**	**4,300**		By Interest on capital	6,300	5,400
					By Salary	9,000	-
					By Commission	-	1,200
		30,300	17,600			30,300	17,600
					By Balance b/d	9,800	4,300

Illustration 3

Bragathish and Naresh are partners who maintain their capital accounts under fixed capital method. From the following particulars, prepare capital accounts of partners.

Particulars	Bragathish ₹	Naresh ₹
Capital on 1st April 2018	4,00,000	6,00,000
Current account on 1st April 2018	20,000(Cr.)	15,000(Dr.)
Additional capital introduced during the year	50,000	Nil
Drawings made during the year	45,000	60,000
Interest on drawings	2,000	3,000
Share of profit for the year	80,000	1,20,000
Interest on capital	20,000	30,000
Commission	17,000	Nil
Salary	Nil	38,000

Solution

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

Date	Particulars	Bragathish ₹	Naresh ₹	Date	Particulars	Bragathish ₹	Naresh ₹
	To Balance c/d	**4,50,000**	**6,00,000**		By Balance b/d	4,00,000	6,00,000
					By Bank A/c (Additional capital)	50,000	-
		4,50,000	6,00,000			4,50,000	6,00,000
					By Balance b/d	4,50,000	6,00,000

Dr. **Partners' Current Account** **Cr.**

Date	Particulars	Bragathish ₹	Naresh ₹	Date	Particulars	Bragathish ₹	Naresh ₹
	To Balance b/d	-	15,000		By Balance b/d	20,000	-
	To Drawings A/c	45,000	60,000		By Profit and loss appropriation A/c (share of profit)	80,000	1,20,000
	To Interest on drawings A/c	2,000	3,000				

	To Balance c/d	**90,000**	**1,10,000**		By Interest on capital A/c	20,000	30,000
					By Commission A/c	17,000	-
					By Salary A/c	-	38,000
		1,37,000	1,88,000			1,37,000	1,88,000
					By Balance b/d	90,000	1,10,000

3.6.2 Fluctuating capital method

Under this method, only capital account is maintained for each partner. All the transactions between the partner and the firm are recorded in the capital account. This account is credited with initial and additional capital introduced by the partner, interest on capital, partner's salary or commission and share of profit of the partner. The account is debited with capital withdrawn, drawings, interest on drawings and share of loss of the partner. As a result, the balance in this account goes on fluctuating periodically. Under this method, the partner's capital account may show either credit balance or debit balance.

Format of capital account under fluctuating capital method

Dr. **Partners' capital account** **Cr.**

Date	Particulars	A ₹	B ₹	Date	Particulars	A ₹	B ₹
	To Cash / Bank A/c (capital withdrawn)	xxx	xxx		By Balance b/d	xxx	xxx
	To Drawings A/c	xxx	xxx		By Cash / Bank A/c (additional capital introduced)	xxx	xxx
	To Interest on drawings A/c	xxx	xxx		By Interest on capital A/c	xxx	xxx
	To Profit and loss appropriation A/c (share of loss)	xxx	xxx		By Salary A/c	xxx	xxx
					By Commission A/c	xxx	xxx
	To Balance c/d	xxx	xxx		By Profit and loss appropriation A/c (share of profit)	xxx	xxx
		xxx	xxx			xxx	xxx

Illustration 4

From the following information, prepare capital accounts of partners Mannan and Sevagan, when their capitals are fluctuating.

Particulars	Mannan ₹	Sevagan ₹
Capital on 1st January 2018 (Cr. balance)	2,00,000	1,75,000
Drawings during 2018	40,000	35,000
Interest on drawings	1,000	500
Share of profit for 2018	21,000	16,500
Interest on capital	12,000	10,500
Salary	18,000	Nil
Commission	Nil	2,500

Solution

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

Particulars	Mannan ₹	Sevagan ₹	Particulars	Mannan ₹	Sevagan ₹
To Drawings A/c	40,000	35,000	By Balance b/d	2,00,000	1,75,000
To Interest on drawings A/c	1,000	500	By Profit and loss appropriation A/c	21,000	16,500
To Balance c/d	**2,10,000**	**1,69,000**	By Interest on capital A/c	12,000	10,500
			By Salary A/c	18,000	-
			By Commission A/c	-	2,500
	2,51,000	2,04,500		2,51,000	2,04,500
			By Balance b/d	2,10,000	1,69,000

3.6.3 Differences between fixed capital method and fluctuating capital method

Following are the differences between fixed capital method and fluctuating capital method of maintaining capital accounts of partners:

Basis of distinction	Fixed capital method	Fluctuating capital method
1. Number of accounts	Two accounts are maintained for each partner, that is, capital account and current account.	Only one account, that is, capital account is maintained for each partner.

2. Change in capital	The amount of capital normally remains unchanged except when additional capital is introduced or capital is withdrawn permanently.	The amount of capital changes from period to period.
3. Closing balance	Capital account always shows a credit balance. But, current account may show either debit or credit balance.	Capital account generally shows credit balance. It may also show a debit balance.
4. Adjustments	All adjustments relating to interest on capital, interest on drawings, salary or commission, share of profit or loss are done in current account.	All adjustments relating to interest on capital, interest on drawings, salary or commission, share of profit or loss are done in the capital account.

3.7 Interest on capital and interest on drawings of partners

3.7.1 Interest on capital

Interest on capital is the interest allowed on capital of the partners. In general, if the capitals of partners are disproportionate to the profit sharing ratio the partners may agree to allow interest on capital. It will compensate the partners who have contributed high amount towards capitals. The rate of interest on capital is generally agreed by the partners and is mentioned in the partnership deed. It is allowed only when there is profit and it is provided before division of profits among the partners. No interest is allowed on the capitals of partners, if it is not specifically mentioned in the partnership deed.

When the firm incurs loss, interest on capital will not be provided. If there is insufficient profit, that is, the net profit is less than the amount of interest on capital, interest on capital will not be provided, but the profit will be distributed among the partners in their capital ratio.

Following are the journal entries to be made in the books of the partnership firm.

(a) For providing interest on capital

Date	Particulars	L.F.	Debit ₹	Credit ₹
	Interest on capital A/c Dr.		xxx	
	To Partner's capital / current A/c			xxx

Note: Interest on capital is due to the partners from the firm hence partner's capital/current account is credited and interest on capital account is debited.

(b) For closing interest on capital account

Date	Particulars	L.F.	Debit ₹	Credit ₹
	Profit and loss appropriation A/c Dr.		xxx	
	To Interest on capital A/c			xxx

3.7.2 Calculation of interest on capital

Interest on capital is to be calculated on the capitals at the beginning for the relevant period. If there is any additional capital introduced or capital withdrawn during the year, it will cause change in the capitals and interest is to be calculated proportionately on the changed capitals for the relevant period.

Interest on capital = Amount of capital x Rate of interest per annum x Period of interest

Tutorial note: If capital at the beginning is not given, then it can be calculated as below:

Particulars	₹	₹
Capital at the end		xxx
Add: Drawings during the year (if fluctuating capital)	xxx	
Capital withdrawn during the year	xxx	xxx
		xxx
Less: Profit credited during the year (if fluctuating capital)	xxx	
Additional capital introduced during the year	xxx	xxx
Capital at the beginning		xxx

Illustration 5

Mannan and Ramesh share profits and losses in the ratio of 3:1. The capital on 1st April 2017 was ₹ 80,000 for Mannan and ₹ 60,000 for Ramesh and their current accounts show a credit balance of ₹ 10,000 and ₹ 5,000 respectively. Calculate interest on capital at 5% p.a. for the year ending 31st March 2018 and show the journal entries.

Solution

Calculation of interest on capital:

Interest on capital = Amount of capital x Rate of interest

Interest on Mannan's capital = 80,000 x 5/100 = ₹ 4,000

Interest on Ramesh's capital = 60,000 x 5/100 = ₹ 3,000

Note: Balance of current account will not be considered for calculation of interest on capital.

Date	Particulars	L.F.	Debit ₹	Credit ₹
2018 March 31	Interest on capital A/c Dr.		7,000	
	To Mannan's current A/c			4,000
	To Ramesh's current A/c			3,000
	(Interest on capital provided)			

,,	Profit and loss appropriation A/c Dr.			7,000	
	To Interest on capital A/c				7,000
	(Interest on capital closed)				

Illustration 6

Antony and Akbar were partners who share profits and losses in the ratio of 3:2. Balance in their capital account on 1st January 2018 was Antony ₹ 60,000 and Akbar ₹ 40,000. On 1st April 2018 Antony introduced additional capital of ₹ 10,000. Akbar introduced additional capital of ₹ 5,000 during the year. Calculate interest on capital at 6% p.a. for the year ending 31st December 2018.

Solution

Calculation of interest on capital:

Interest on Antony's capital:

On opening capital for 1 year $= 60{,}000 \times \frac{6}{100}$ = ₹ 3,600

On additional capital for 9 months $= 10{,}000 \times \frac{6}{100} \times \frac{9}{12}$ = ₹ 450

Interest on capital ₹ 4,050

Interest on Akbar's capital:

On opening capital for 1 year $= 40{,}000 \times \frac{6}{100}$ = ₹ 2,400

On additional capital for 6 months $= 5{,}000 \times \frac{6}{100} \times \frac{6}{12}$ = ₹ 150

Interest on capital ₹ 2,550

Note: Since the date of additional capital introduced by Akbar is not given, interest on additional capital is calculated for an average period of 6 months.

Illustration 7

The capital account of Arivazhagan and Srinivasan on 1st January 2017 showed a balance of ₹ 15,000 and ₹ 10,000 respectively. On 1st July 2017, Arivazhagan introduced an additional capital of ₹ 5,000 and on 1st September 2017 Srinivasan introduced an additional capital of ₹ 10,000.

Calculate interest on capital at 6% p.a. for the year ending 31st December 2017.

Solution

Calculation of interest on capital:

Arivazhagan:

On opening capital for 1 year $= 15{,}000 \times \frac{6}{100}$ = ₹ 900

On additional capital for 6 months $= 5{,}000 \times \frac{6}{100} \times \frac{6}{12}$ = ₹ 150

Interest on capital ₹ 1,050

Srinivasan:

On opening capital for 1 year	$= 10{,}000 \times \frac{6}{100}$	= ₹ 600
On additional capital for 4 months	$= 10{,}000 \times \frac{6}{100} \times \frac{4}{12}$	= ₹ 200
Total interest on capital		₹ 800

Illustration 8

From the following balance sheets of Subha and Sudha who share profits and losses equally, calculate interest on capital at 6% p.a. for the year ending 31st December 2017.

Balance sheet as on 31st December 2017

Liabilities	₹	Assets	₹
Capital accounts:		Fixed assets	30,000
Subha	15,000	Current assets	20,000
Sudha	20,000		
Current liabilities	15,000		
	50,000		50,000

Drawings of Subha and Sudha during the year were ₹ 2,500 and ₹ 3,500 respectively. Profit earned during the year was ₹ 15,000.

Solution

Particulars	Subha ₹	Sudha ₹
Capital on 31st December 2017	15,000	20,000
Add: Drawings	2,500	3,500
	17,500	23,500
Less: Profit already credited	7,500	7,500
Capital on 1st January 2017	10,000	16,000

Calculation of interest on capital:

Subha:

On opening capital $= 10{,}000 \times \frac{6}{100}$ = ₹ 600

Sudha:

On opening capital $= 16{,}000 \times \frac{6}{100}$ = ₹ 960

Illustration 9

From the following balance sheets of Brindha and Praveena who share profits and losses in the ratio of 3:4, calculate interest on capital at 6% p.a. for the year ending 31st December 2017.

Balance sheet as on 31st December 2017

Liabilities	₹	Assets	₹
Capital accounts:		Sundry assets	80,000
Brindha	30,000		
Praveena	40,000		
Profit and loss appropriation A/c	10,000		
	80,000		80,000

On 1st July 2017, Brindha introduced an additional capital of ₹ 6,000 and on 1st October 2017, Praveena introduced ₹ 10,000. Drawings of Brindha and Praveena during the year were ₹ 5,000 and ₹ 7,000 respectively. Profit earned during the year was ₹ 31,000.

Solution

Particulars	Brindha		Praveena	
	₹	₹	₹	₹
Capital on 31st December 2017		30,000		40,000
Add: Drawings		5,000		7,000
		35,000		47,000
Less:				
Additional capital	6,000		10,000	
Profit already credited*	9,000	15,000	12,000	22,000
Capital on 1st January 2017		20,000		25,000

* Profit credited = Profit earned ₹ 31,000 – Balance profit as per balance sheet ₹ 10,000 = ₹ 21,000. This amount is distributed in their profit sharing ratio of 3:4.

Calculation of interest on capital:

Brindha:

On opening capital for 1 year $= 20{,}000 \times \frac{6}{100}$ = ₹ 1,200

On additional capital for 6 months $= 6{,}000 \times \frac{6}{100} \times \frac{6}{12}$ = ₹ 180

Total interest on capital ₹ 1,380

Praveena:

On opening capital for 1 year $= 25{,}000 \times \frac{6}{100}$ = ₹ 1,500

On additional capital for 3 months $= 10{,}000 \times \frac{6}{100} \times \frac{3}{12}$ = ₹ 150

Total interest on capital ₹ 1,650

Illustration 10

A and B contribute ₹ 4,00,000 and ₹ 2,00,000 respectively as capital. Their respective share of profit is 3:2 and the profit before interest on capital for the year is ₹ 27,000. Compute the amount of interest on capital in each of the following situations:

(i) if the partnership deed is silent as to the interest on capital

(ii) if interest on capital @ 3% is allowed as per the partnership deed

(iii) if the partnership deed allows interest on capital @ 5% p.a.

Solution

(i) Interest on capital will not be allowed as the partnership deed is silent as to the interest on capital.

(ii) Profit before interest on capital is ₹ 27,000.

Computation of interest on capital:

A: $4{,}00{,}000 \times \frac{3}{100}$ = ₹ 12,000

B: $2{,}00{,}000 \times \frac{3}{100}$ = ₹ 6,000

Since there is sufficient profit, interest on capital will be provided.

(iii) Profit before interest on capital is ₹ 27,000.

Computation of interest on capital:

A: $4{,}00{,}000 \times \frac{5}{100}$ = ₹ 20,000

B: $2{,}00{,}000 \times \frac{5}{100}$ = ₹ 10,000

Since the profit is insufficient, interest on capital will not be provided. Profit of ₹ 27,000 will be distributed to the partners in their capital ratio of 2:1.

3.7.3 Interest on drawings

Interest is charged on drawings made by the partners only when there is an agreement among the partners in this regard. The rate of interest on drawings will be the rate agreed by the partners. Following are the journal entries to be made in the books of the partnership firm.

(a) For charging interest on drawings

Date	Particulars	L.F.	Debit ₹	Credit ₹
	Partner's capital/ current A/c Dr.		xxx	
	To Interest on drawings A/c			xxx

Note: Interest on drawings is due from the partner to the firm and hence partner's capital/ current account is debited and interest on drawings account is credited.

(b) For closing interest on drawings account

Date	Particulars	L.F.	Debit ₹	Credit ₹
	Interest on drawings A/c Dr.		xxx	
	To Profit and loss appropriation A/c			xxx

3.7.4 Calculation of interest on drawings

Interest on drawings can be computed by following either direct method or product method. Also if the partners withdraw fixed amount at fixed time interval, interest on drawings may be calculated on the basis of the average period method. Based on the dates of drawings and the amount of drawings, different methods can be followed for calculating interest on drawings.

(i) Direct method

Interest is calculated on drawings for the period from the date of drawings to the date of closing date of the accounting year. The following formula is used to compute the interest on drawings:

Interest on drawings = Amount of drawings × Rate of interest × Period of interest

Period of interest refers to the period from the date of drawings to the closing date of the accounting year. This method is suitable when different amounts are withdrawn at different time intervals.

Illustration 11

Velan is a partner who withdrew ₹ 20,000 on 1st April 2018. Interest on drawings is charged at 10% per annum. Calculate interest on drawings on 31st December 2018 and pass journal entries by assuming fluctuating capital method.

Solution

Interest on drawings = Amount of drawings x Rate of interest x Period of interest

$$= ₹\ 20{,}000 \times \frac{10}{100} \times \frac{9}{12} = ₹\ 1{,}500$$

Date	Particulars		L.F.	Debit ₹	Credit ₹
2018 Dec. 31	Velan's capital A/c	Dr.		1,500	
	To Interest on drawings A/c				1,500
	(Interest on drawings charged)				
,,	Interest on drawings A/c	Dr.		1,500	
	To Profit and loss appropriation A/c				1,500
	(Interest on drawings account closed)				

Illustration 12

Arun is a partner in a partnership firm. As per the partnership deed, interest on drawings is charged at 12% p.a. During the year ended 31st December 2018 he drew as follows:

Date	₹
March 1	6,000
June 1	4,000
September 1	5,000
December 1	2,000

Calculate the amount of interest on drawings.

Solution

Interest on drawings = Amount of drawings x Rate of interest x Period of interest

Withdrawal on March 1 $= ₹\ 6,000 \times \frac{12}{100} \times \frac{10}{12} = ₹\ 600$

Withdrawal on June 1 $= ₹\ 4,000 \times \frac{12}{100} \times \frac{7}{12} = ₹\ 280$

Withdrawal on September 1 $= ₹\ 5,000 \times \frac{12}{100} \times \frac{4}{12} = ₹\ 200$

Withdrawal on December1 $= ₹\ 2,000 \times \frac{12}{100} \times \frac{1}{12} = ₹\ 20$

Total interest on drawings = ₹ 1,100

Illustration 13

Arul is a partner in a partnership firm. As per the partnership deed, interest on drawings is charged at 12% p.a. During the year ended 31st December 2018 he drew as follows:

Date	₹
March 1	3,000
June 1	3,000
September 1	3,000
December 1	3,000

Calculate the amount of interest on drawings.

Solution

Interest on drawings = Amount of drawings × Rate of interest × Period of interest

Withdrawal on March 1 $= ₹\ 3,000 \times \frac{12}{100} \times \frac{10}{12} = ₹\ 300$

Withdrawal on June 1 $= ₹\ 3,000 \times \frac{12}{100} \times \frac{7}{12} = ₹\ 210$

Withdrawal on September 1 $= ₹\ 3,000 \times \frac{12}{100} \times \frac{4}{12} = ₹\ 120$

Withdrawal on December 1 $= ₹\ 3,000 \times \frac{12}{100} \times \frac{1}{12} = ₹\ 30$

Total interest on drawings $= ₹\ 660$

Illustration 14

Rajan is a partner who withdrew ₹ 30,000 during the year 2018. Interest on drawings is charged at 10% per annum. Calculate interest on drawings on 31st December, 2018.

Solution

Interest on Drawings

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

Note: Since, date of drawings is not given, interest is calculated for an average period of six months.

(ii) Product method

Under product method, interest is calculated on the total of the products, that is, the product of amount of drawings and the period for which the amount remained withdrawn. If the product is calculated in terms of months, then interest is calculated on the total of products at the rate per month. If the product is calculated in terms of days, then interest is calculated on the total of products at the rate per day. This method can be used in all situations as an alternative to direct method.

DO YOU KNOW?

Product method is based on the principle that interest on the amount for a number of days/months is the same as interest for one day/month on the sum of the products of amount withdrawn and the period of interest.

The procedure for calculating interest on drawings under product method is as follows:

(i) Multiply each amount withdrawn by the relevant period (in months) to find out the individual product.

(ii) Find out the sum of all the individual products.

(iii) Calculate interest at the prescribed rate for one month by using the following formula.

Interest on drawings = Sum of products x Rate of interest p.a. $\times \frac{1}{12}$

Tutorial note

If the period of interest is taken in days, each amount withdrawn is to be multiplied by the relevant period (in days) to find out the individual product and the following formula is to be used to find out the interest on drawings.

Interest on drawings = Sum of products x Rate of interest p.a. $\times \frac{1}{365}$

Illustration 15

Anbu is a partner in a partnership firm. As per the partnership deed, interest on drawings is charged at 12% p.a. During the year ended 31st December 2018 he drew as follows:

Date	₹
March 1	6,000
June 1	4,000
September 1	5,000
December 1	2,000

Calculate the amount of interest on drawings by using product method.

Solution

Calculation of interest on drawings under product method

Date of drawings	Amount withdrawn ₹	Period up to December 31 (months)	Product ₹
March 1	6,000	10	60,000
June 1	4,000	7	28,000
September 1	5,000	4	20,000
December 1	2,000	1	2,000
Sum of product			1,10,000

Interest on drawings = Sum of product x Rate of interest $\times \frac{1}{12}$

$$= 1,10,000 \times \frac{12}{100} \times \frac{1}{12} = ₹\ 1,100$$

(iii) Average period method

If the partners withdraw fixed amount at fixed time interval, interest on drawings may be calculated on the basis of the average period. Fixed time interval refers to withdrawal made monthly, quarterly, half-yearly, once in 2 months and once in 4 months. The following formula may be used to calculate interest on drawings:

$$\text{Interest on drawings} = \left[\begin{array}{c}\text{Total amount of drawings}\\ \text{made during the year}\end{array}\right] \times \left[\begin{array}{c}\text{Rate of interest}\\ \text{per annum}\end{array}\right] \times \left[\frac{\text{Average period}}{12}\right]$$

$$\text{Average period} = \frac{\left[\begin{array}{c}\text{Number of months from}\\ \text{the date of first withdrawal}\\ \text{to the end of the year}\end{array}\right] + \left[\begin{array}{c}\text{Number of months from}\\ \text{the date of last withdrawal}\\ \text{to the end of the year}\end{array}\right]}{2}$$

Average period is computed as follows:

The following table shows the average period in months for withdrawal made at the beginning, in the middle and at the end of every month, quarter and half-year of the year.

Frequency of withdrawal	**Average period (in months)**		
	Time of withdrawal		
	At the beginning	**In the middle**	**At the end**
Monthly	$\frac{(12+1)}{2} = 6.5$	$\frac{(11.5+0.5)}{2} = 6$	$\frac{(11+0)}{2} = 5.5$
Quarterly	$\frac{(12+3)}{2} = 7.5$	$\frac{(10.5+1.5)}{2} = 6$	$\frac{(9+0)}{2} = 4.5$
Half-yearly	$\frac{(12+6)}{2} = 9$	$\frac{(9+3)}{2} = 6$	$\frac{(6+0)}{2} = 3$

Illustration 16

John is a partner in a firm. He withdraws ₹ 1,000 p.m. regularly. Interest on drawings is charged @ 5% p.a. Calculate the interest on drawings using average period, if he draws

(i) at the beginning of every month

(ii) in the middle of every month

(iii) at the end of every month

Solution

Total amount withdrawn = 1,000 × 12 = ₹ 12,000

(i) If drawings are made at the beginning of every month:

Average period = 6.5

$$\text{Interest on drawings} = \text{Total amount of drawings} \times \text{Rate of interest} \times \frac{\text{Average period}}{12}$$

$$= ₹\ 12{,}000 \times \frac{5}{100} \times \frac{6.5}{12} = ₹\ 325$$

(ii) If drawings are made in the middle of every month:

Average period = 6

Interest on drawings $= \text{Total amount of drawings} \times \text{Rate of interest} \times \frac{\text{Average period}}{12}$

$$= ₹\ 12{,}000 \times \frac{5}{100} \times \frac{6}{12} = ₹\ 300$$

(iii) If drawings are made at the end of every month:

Average period = 5.5

Interest on drawings $= \text{Total amount of drawings} \times \text{Rate of interest} \times \frac{\text{Average period}}{12}$

$$= ₹\ 12{,}000 \times \frac{5}{100} \times \frac{5.5}{12} = ₹\ 275$$

Illustration 17

Priya and Kavitha are partners. Priya draws ₹ 4,000 at the end of each quarter. Interest on drawings is chargeable at 6% p.a. Calculate interest on drawings for the year ending 31st December 2018 using average period.

Solution

Calculation of interest on drawings of Priya (using average period)

Total amount of drawings = 4,000 x 4 = ₹ 16,000

If drawings are made at the end of every quarter, average period = 4.5

Interest on drawings $= \text{Total amount of drawings} \times \text{Rate of interest} \times \frac{\text{Average period}}{12}$

$$= ₹\ 16{,}000 \times \frac{6}{100} \times \frac{4.5}{12} = ₹\ 360$$

Illustration 18

Vennila and Eswari are partners. Vennila draws ₹ 5,000 at the beginning of each half year. Interest on drawings is chargeable at 4% p.a. Calculate interest on drawings for the year ending 31st December 2018 using average period.

Solution

Calculation of interest on drawings of Vennila (using average period)

Total amount of drawings = 5,000 × 2 = ₹ 10,000

If drawings are made at the end of every half year, average period = 9

Interest on drawings $= \text{Total amount of drawings} \times \text{Rate of interest} \times \frac{\text{Average period}}{12}$

$$= ₹\ 10{,}000 \times \frac{4}{100} \times \frac{9}{12} = ₹\ 300$$

3.8 Salary and commission to partners

In some firms, remuneration may be allowed to the partners in the form of salary or commission for the contribution of the partners to the firm in the form of sharing skill and expertise, managerial work done, etc. In such cases, it must be specifically mentioned in the partnership deed. The following are the journal entries to be passed in the books:

(a) For partners' salary and commission due

Date	Particulars	L.F.	Debit ₹	Credit ₹
	Partner's salary A/c Dr.		xxx	
	Partner's commission A/c Dr.		xxx	
	To Partner's capital / current A/c			xxx

(b) For closing partners' salary and commission account at the end of the accounting year

Date	Particulars	L.F.	Debit ₹	Credit ₹
	Profit and loss appropriation A/c Dr.		xxx	
	To Partner's salary A/c			xxx
	To Partner's commission A/c			xxx

Tutorial note: Partners are entitled to remuneration only if there is a profit in the firm. Hence, Profit and loss appropriation account is debited. As the remuneration is due to the partners, capital/current account of partners is credited.

Commission to partners may be allowed as a percentage of net profit before charging such commission or as a percentage of net profit after charging such commission. In such cases, commission is calculated as below:

(i) Commission as a percentage of net profit before charging such commission

$$= \text{Net profit before commission} \times \frac{\text{\% of commission}}{100}$$

(ii) Commission as a percentage of net profit after charging such commission

$$= \text{Net profit before commission} \times \frac{\text{\% of commission}}{100 + \text{\% of commission}}$$

Illustration 19

Syed, Samuel and Sudhakar are partners in a firm sharing profits and losses equally. As per the terms of the partnership deed, Samuel is allowed a monthly salary of ₹ 2,000 and Sudhakar is allowed a commission of ₹ 6,000 per annum for their contribution to the business of the firm. You are required to pass the necessary journal entry. Assume that their capitals are fluctuating.

Solution

Salary to Samuel = 2,000 x 12 = ₹ 24,000

Commission to Sudhahar = ₹ 6,000

Journal entry

Date	Particulars	L.F.	Dr. ₹	Cr. ₹
	Samuel's salary A/c Dr.		24,000	
	To Samuel's capital A/c			24,000
	(Samuel's salary transferred to his capital account)			
	Sudhahar's commission A/c Dr.		6,000	
	To Sudhahar's capital A/c			6,000
	(Sudhahar's commission transferred to his capital account)			
	Profit and loss appropriation A/c Dr.		30,000	
	To Saumel's salary A/c			24,000
	To Sudhahar's commission A/c			6,000
	(Salary and commission account transferred)			

Illustration 20

Murali and Sethu are partners in a firm. Murali is to get a commission of 10% of net profit before charging any commission. Sethu is to get a commission of 10% on net profit after charging all commission. Net profit for the year ended 31st March 2019 before charging any commission was ₹ 1,10,000. Find the amount of commission due to Murali and Sethu.

Solution

Calculation of commission:

Commission to Murali:

$$= \text{Net profit before commission} \times \frac{\text{\% of commission}}{100}$$

$$= 1,10,000 \times \frac{10}{100} = ₹\ 11,000$$

Commission to Sethu:

Net profit after Murali's commission = 1,10,000 – 11,000 = ₹ 99,000

$$\text{Sethu's commission} = \text{Net profit after Murali's commission} \times \frac{\text{\% of commission}}{(100 + \text{\% of commission})}$$

$$= 99,000 \times \frac{10}{(100+10)} = ₹\ 9,000$$

3.9 Interest on loan from partners

Sometimes, a partner may provide loan or advance to the firm. In such cases, partner's loan or advance account is to be separately maintained in the books. The partners are entitled to interest on the loan or advance at the rate agreed by them. If there is no such agreement, the partners are entitled to an interest at the rate of 6 per cent per annum [Section 13(d) of the Indian Partnership Act, 1932]. The following journal entries are to be made in the books of the firm:

(a) For providing interest on partner's loan

Date	Particulars		L.F.	Debit ₹	Credit ₹
	Interest on partner's loan A/c	Dr.		xxx	
	To Partner's loan A/c				xxx

Note: Interest on partner's loan being an expense to the firm is debited in firm's books. Interest on loan is due to the partner and it is generally added to the loan amount due and hence partner's loan account is credited.

(b) For closing interest on partner's loan account

Date	Particulars		L.F.	Debit ₹	Credit ₹
	Profit and loss A/c	Dr.		xxx	
	To Interest on partner's loan A/c				xxx

Tutorial note: Interest on partners' loan is a charge against profit, that is, whether there is profit or loss for the firm, this interest is to be provided. Hence, interest on partners' loan is transferred to profit and loss account.

3.10 Division of profits among partners

The net profit as per the profit and loss account of a firm is subject to the adjustment of interest on capital, interest on drawings, etc. These adjustments are made by preparing a profit and loss appropriation account. The resultant profit of the firm being the balance in the profit and loss appropriation account is to be divided among the partners according to their profit sharing ratio. In the absence of profit sharing ratio, profit is divided among the partners equally. The following is the journal entry to be passed in the books for the division of profit among the partners.

Date	Particulars		L.F.	Debit ₹	Credit ₹
	Profit and loss appropriation A/c	Dr.		xxx	
	To Partner's capital/current A/c				xxx

Note: If there is a loss, the reverse entry is made.

3.11 Profit and loss appropriation account

The profit and loss appropriation account is an extension of profit and loss account prepared for the purpose of adjusting the transactions relating to amounts due to and amounts due from partners. It is nominal account in nature. It is credited with net profit, interest on drawings and it is debited with interest on capital, salary and other remuneration to the partners. The balance being the profit or loss is transferred to the partners' capital or current account in the profit sharing ratio.

3.11.1 Format of Profit and loss appropriation account

The following is the format of profit and loss appropriation account:

Dr. **Profit and loss appropriation account** **Cr.**

Particulars	₹	Particulars	₹
To Interest on partners' capital A/c	xxx	By Profit and loss A/c *	xxx
To Partners' salary A/c	xxx	By Interest on partners'	
To Partners' commission A/c	xxx	drawings A/c	xxx
To Partners' capital/current A/c (Profit)	xxx		
	xxx		xxx

*Amount of profit transferred from profit and loss account.

Illustration 21

Arulappan and Nallasamy are partners in a firm sharing profits and losses in the ratio of 4:1. On 1st January 2018, their capitals were ₹ 20,000 and ₹ 10,000 respectively. The partnership deed specifies the following:

(a) Interest on capital is to be allowed at 5% per annum.

(b) Interest on drawings charged to Arulappan and Nallasamy are ₹ 200 and ₹ 300 respectively.

(c) The net profit of the firm before considering interest on capital and interest on drawings amounted to ₹ 18,000.

Give necessary journal entries and prepare Profit and loss appropriation account for the year ending 31st December 2018. Assume that the capitals are fluctuating.

Solution

Journal entries

Date	Particulars		L.F.	Dr. ₹	Cr. ₹
2018	Interest on capital A/c	Dr.		1,500	
Dec. 31	To Arulappan's capital A/c				1,000
	To Nallasamy's capital A/c				500
	(Interest on capital @ 5% provided)				
,,	Profit and loss appropriation A/c	Dr.		1,500	
	To Interest on capital A/c				1,500
	(Interest on capital account closed)				
,,	Arulappan's capital A/c	Dr.		200	
	Nallasamy's capital A/c	Dr.		300	
	To Interest on drawings A/c				500
	(Interest on drawings charged)				
,,	Interest on drawings A/c	Dr.		500	
	To Profit and loss appropriation A/c				500
	(Interest on drawings account closed)				
,,	Profit and loss appropriation A/c	Dr.		17,000	
	To Arulappan's capital A/c				13,600
	To Nallasamy's capital A/c				3,400
	(Profit transferred)				

Dr. Profit and loss appropriation account for the year ended 31st December 2018 Cr.

Particulars	₹	₹	Particulars	₹
To Interest on capital A/c:			By Profit and loss A/c	18,000
Arulappan		1,000	By Interest on drawings A/c	
Nallasamy		500	Arulappan	200
To Partners' capital A/c (profit)			Nallasamy	300
Arulappan (4/5)	13,600			
Nallasamy (1/5)	3,400	**17,000**		
		18,500		18,500

Illustration 22

Durai and Velan entered into a partnership agreement on 1st April 2018, Durai contributing ₹ 25,000 and Velan ₹ 30,000 as capital. The agreement provided that:

(a) Profits and losses to be shared in the ratio 2:3 as between Durai and Velan.
(b) Partners to be entitled to interest on capital @ 5% p.a.
(c) Interest on drawings to be charged Durai: ₹ 300 Velan: ₹ 450
(d) Durai to receive a salary of ₹ 5,000 for the year, and
(e) Velan to receive a commission of ₹ 2,000

During the year, the firm made a profit of ₹ 20,000 before adjustment of interest, salary and commission. Prepare the Profit and loss appropriation account.

Solution

Dr. Profit and loss appropriation account for the year ended 31st March 2019 Cr.

Particulars	₹	₹	Particulars	₹
To Interest on capital A/c:			By Profit and loss A/c	20,000
Durai (25,000 x 5%)		1,250	By Interest on drawings A/c	
Velan (30,000 x 5%)		1,500	Durai	300
To Salary to Durai A/c		5,000	Velan	450
To Commission to Velan A/c		2,000		
To Partners' capital A/c				
(profit transferred)				
Durai (11,000 x 2/5)	4,400			
Velan (11,000 x 3/5)	6,600	**11,000**		
		20,750		20,750

Illustration 23

Richard and Rizwan started a business on 1st January 2018 with capitals of ₹ 3,00,000 and ₹ 2,00,000 respectively.

According to the Partnership Deed

(a) Interest on capital is to be provided @ 6% p.a.
(b) Rizwan is to get salary of ₹ 50,000 per annum.
(c) Richard is to get 10% commission on profit (after interest on capital and salary to Rizwan) after charging such commission.
(d) Profit-sharing ratio between the two partners is 3:2.

During the year, the firm earned a profit of ₹ 3,00,000.

Prepare profit and loss appropriation account. The firm closes its accounts on 31st December every year.

Solution

Dr. Profit and loss appropriation account for the year ended 31st December 2018 Cr.

Particulars	₹	₹	Particulars	₹
To Interest on capital A/c:			By Profit and loss A/c	3,00,000
Richard (3,00,000 x 6%)	18,000			
Rizwan (2,00,000 x 6%)	12,000	30,000		
To Salary to Rizwan		50,000		
To Commission to Richard		20,000		
To Partners' capital A/c (profit)				
Richard (3/5)	1,20,000			
Rizwan (2/5)	80,000	**2,00,000**		
		3,00,000		3,00,000

Note:

Calculation of commission:

Profit before commission = 3,00,000 – (50,000+30,000) = ₹ 2,20,000

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

$$\text{Commission} = 2{,}20{,}000 \times \frac{10}{110} = ₹\ 20{,}000$$

Limited Liability Partnership (LLP)

Limited Liability Partnership (LLP) is a type of partnership in which the liability of the partners is limited to the extent of their capital contribution. It is a legal entity separate from that of its partners. It is formed as per the provisions of The Limited Liability Partnership Act, 2008. It has perpetual succession. Any change in the partners of LLP shall not affect the existence, rights or liabilities of LLP. Provisions of the Partnership Act, 1932 will not apply to a Limited Liability Partnership. An individual or a body corporate can become a partner. Partners are not personally liable for the obligations of the partnership unless the obligations arise due to their own wrongful acts or omissions.

Points to remember

- ❖ Profits and losses are shared among the partners of a firm in the profit sharing ratio. In the absence of agreed ratio, the profits and losses are to be shared by the partners equally.
- ❖ In the absence of agreement, no interest is allowed on capital, no interest is charged on drawings and no salary or other remuneration is given to the partners.
- ❖ Partners are entitled to interest on the loans advanced by them to the firm at a rate agreed by them. If the rate of interest on partners' loan is not agreed, the partners are entitled to interest on loans at 6% per annum.
- ❖ When fixed capital method is adopted by a firm, current accounts are opened for each partner apart from the capital account of each partner.
- ❖ When fluctuating capital method is followed, all the adjustments regarding additional capital introduced, share of profit, interest on capital, interest on drawings, etc. are done in the capital account.
- ❖ In Profit and loss appropriation account, adjustments are made for interest on capital, interest on drawings and partners' remuneration, the resultant profit is shared by the partners in their profit sharing ratio.

Self–examination questions

I Multiple choice questions

Choose the correct answer

1. In the absence of a partnership deed, profits of the firm will be shared by the partners in

(a) Equal ratio (b) Capital ratio
(c) Both (a) and (b) (d) None of these

2. In the absence of an agreement among the partners, interest on capital is

(a) Not allowed (b) Allowed at bank rate
(c) Allowed @ 5% per annum (d) Allowed @ 6% per annum

3. As per the Indian Partnership Act, 1932, the rate of interest allowed on loans advanced by partners is

(a) 8% per annum (b) 12% per annum
(c) 5% per annum (d) 6% per annum

4. Which of the following is shown in Profit and loss appropriation account?

(a) Office expenses (b) Salary of staff
(c) Partners' salary (d) Interest on bank loan

5. When fixed capital method is adopted by a partnership firm, which of the following items will appear in capital account?

(a) Additional capital introduced (b) Interest on capital
(c) Interest on drawings (d) Share of profit

6. When a partner withdraws regularly a fixed sum of money at the middle of every month, period for which interest is to be calculated on the drawings on an average is
   (a) 5.5 moths (b) 6 months
   (c) 12 months (d) 6.5 months
7. Which of the following is the incorrect pair?
   (a) Interest on drawings – Debited to capital account
   (b) Interest on capital – Credited to capital account
   (c) Interest on loan – Debited to capital account
   (d) Share of profit – Credited to capital account
8. In the absence of an agreement, partners are entitled to
   (a) Salary (b) Commission
   (c) Interest on loan (d) Interest on capital
9. Pick the odd one out
   (a) Partners share profits and losses equally
   (b) Interest on partners' capital is allowed at 7% per annum
   (c) No salary or remuneration is allowed to partners
   (d) Interest on loan from partners is allowed at 6% per annum.
10. Profit after interest on drawings, interest on capital and remuneration is ₹ 10,500. Geetha, a partner, is entitled to receive commission @ 5% on profits after charging such commission. Find out commission.
   (a) ₹ 50 (b) ₹ 150
   (c) ₹ 550 (d) ₹ 500

Answers

1 (a)	**2(a)**	**3(d)**	**4(c)**	**5 (a)**	**6(b)**	**7(c)**	**8(c)**	**9(b)**	**10(d)**

II Very short answer questions

1. Define partnership.
2. What is a partnership deed?
3. What is meant by fixed capital method?
4. What is the journal entry to be passed for providing interest on capital to a partner?
5. Why is Profit and loss appropriation account prepared?

III Short answer questions

1. State the features of partnership.
2. State any six contents of a partnership deed.
3. State the differences between fixed capital method and fluctuating capital method.

4. Write a brief note on the applications of the provisions of the Indian Partnership Act, 1932 in the absence of partnership deed.
5. Jayaraman is a partner who withdrew ₹ 10,000 regularly in the middle of every month. Interest is charged on the drawings at 6% per annum. Calculate interest on drawings for the year ended 31st December, 2018.

(Ans: Interest on drawings: ₹ 3,600)

IV Exercises

1. Akash, Bala, Chandru and Daniel are partners in a firm. There is no partnership deed. How will you deal with the following?
   (i) Akash has contributed maximum capital. He demands interest on capital at 10% per annum.
   (ii) Bala has withdrawn ₹ 3,000 per month. Other partners ask Bala to pay interest on drawings @ 8% per annum to the firm. But, Bala did not agree to it.
   (iii) Akash demands the profit to be shared in the capital ratio. But, others do not agree.
   (iv) Daniel demands salary at the rate of ₹ 10,000 per month as he spends full time for the business.
   (v) Loan advanced by Chandru to the firm is ₹ 50,000. He demands interest on loan @ 12% per annum.

(Answer: (i) No interest on capital is payable to any partner (ii) No interest is chargeable on drawings made by the partner (iii) Profits should be distributed equally(iv) No remuneration is payable to any partner (v) Interest on loan is payable at 6% per annum)

2. From the following information, prepare capital accounts of partners Rooban and Deri, when their capitals are fixed.

Particulars	Rooban ₹	Deri ₹
Capital on 1st April, 2018	70,000	50,000
Current account on 1st April, 2018 (Cr.)	25,000	15,000
Additional capital introduced	18,000	16,000
Drawings during 2018 – 2019	10,000	6,000
Interest on drawings	500	300
Share of profit for 2018 – 2019	35,000	25,800
Interest on capital	3,500	2,500
Salary	Nil	18,000
Commission	12,000	Nil

(Answer: Capital account balance: Rooban: ₹ 88,000 (Cr.); Deri: ₹ 66,000 (Cr.)
Current account balance: Rooban: ₹ 65,000 (Cr.); Deri: ₹ 55,000 (Cr.))

3. Arun and Selvam are partners who maintain their capital accounts under fixed capital method. From the following particulars, prepare capital accounts of partners.

Particulars	Arun ₹	Selvam ₹
Capital on 1st January, 2018	2,20,000	1,50,000
Current account on 1st January, 2018	4,250(Dr.)	10,000(Cr.)
Additional capital introduced during the year	Nil	70,000
Withdrew for personal use	10,000	20,000
Interest on drawings	750	600
Share of profit for 2018	22,000	15,000
Interest on capital	1,100	750
Commission	6,900	Nil
Salary	Nil	6,850

(Answer: Capital account balance: Arun: ₹ 2,20,000 (Cr.); Selvam: ₹ 2,20,000 (Cr.)
Current account balance: Arun: ₹ 15,000 (Cr.); Selvam: ₹ 12,000 (Cr.))

4. From the following information, prepare capital accounts of partners Padmini and Padma, when their capitals are fluctuating.

Particulars	Padmini ₹	Padma ₹
Capital on 1st January 2018 (Cr. balance)	5,00,000	4,00,000
Drawings during 2018	70,000	40,000
Interest on drawings	2,000	1,000
Share of profit for 2018	52,000	40,000
Interest on capital	30,000	24,000
Salary	45,000	Nil
Commission	Nil	21,000

(Answer: Capital account balance: Padmini: ₹ 5,55,000 (Cr.); Padma: ₹ 4,44,000 (Cr.))

5. Mannan and Ramesh share profits and losses in the ratio of 3:2 and their capital on 1st April, 2018 was Mannan ₹ 1,50,000 and Ramesh ₹ 1,00,000 respectively and their current accounts show a credit balance of ₹ 25,000 and ₹ 20,000 respectively. Calculate interest on capital at 6% p.a. for the year ending 31st March, 2019 and show the journal entries.

(Answer: Interest on capital: Mannan: ₹ 9,000; Ramesh: ₹ 6,000)

6. Prakash and Supria were partners who share profits and losses in the ratio of 5:3. Balance in their capital account on 1st April, 2018 was Prakash ₹ 3,00,000 and Supria ₹ 2,00,000. On 1st July, 2018 Prakash introduced additional capital of ₹ 60,000. Supria introduced additional capital of ₹ 30,000 during the year. Calculate interest on capital at 6% p.a. for the year ending 31st March, 2019 and show the journal entries.

(Answer: Interest on capital: Prakash: ₹ 20,700; Supria: ₹ 12,900)

7. The capital account of Begum and Fatima on 1st January, 2018 showed a balance of ₹ 50,000 and ₹ 40,000 respectively. On 1st October, 2018, Begum introduced an additional capital of ₹ 10,000 and on 1st May, 2018 Fatima introduced an additional capital of ₹ 9,000.

   Calculate interest on capital at 4% p.a. for the year ending 31st December, 2018.

(Answer: Interest on capital: Begum: ₹ 2,100; Fatima: ₹ 1,840)

8. From the following balance sheets of Subha and Sudha who share profits and losses in 2:3, calculate interest on capital at 5% p.a. for the year ending 31st December, 2018.

Balance sheet as on 31st December, 2018

Liabilities	₹	₹	Assets	₹
Capital accounts:			Fixed assets	70,000
Subha	40,000		Current assets	50,000
Sudha	60,000	1,00,000		
Current liabilities		20,000		
		1,20,000		1,20,000

Drawings of Subha and Sudha during the year were ₹ 8,000 and ₹ 10,000 respectively. Profit earned during the year was ₹ 30,000.

(Answer: Interest on capital: Subha: ₹ 1,800; Sudha: ₹ 2,600)

9. From the following balance sheets of Rajan and Devan who share profits and losses 2:1, calculate interest on capital at 6% p.a. for the year ending 31st December, 2018.

Balance sheet as on 31st December, 2018

Liabilities	₹	₹	Assets	₹
Capital accounts:			Sundry assets	2,20,000
Rajan	1,00,000			
Devan	80,000	1,80,000		
Profit and loss appropriation A/c		40,000		
		2,20,000		2,20,000

On 1st April, 2018, Rajan introduced an additional capital of ₹ 40,000 and on 1st September, 2018, Devan introduced ₹ 30,000. Drawings of Rajan and Devan during the year were ₹ 20,000 and ₹ 10,000 respectively. Profit earned during the year was ₹ 70,000.

(Answer: Interest on capital: Rajan: ₹ 5,400; Devan: ₹ 3,600)

10. Ahamad and Basheer contribute ₹ 60,000 and ₹ 40,000 respectively as capital. Their respective share of profit is 2:1 and the profit before interest on capital for the year is ₹ 5,000. Compute the amount of interest on capital in each of the following situations:

(i) if the partnership deed is silent as to the interest on capital

(ii) if interest on capital @ 4% is allowed as per the partnership deed

(iii) if the partnership deed allows interest on capital @ 6% per annum.

(Answer: (i) No interest on capital is allowed
(ii) Since there is sufficient profit, interest on capital will be provided.
Ahamad: ₹ 2,400; Basheer: ₹ 1,600;
(iii) Since the profit is insufficient, interest on capital will not be provided.
Profit of ₹ 5,000 will be distributed to the partners in their capital ratio of 3:2.)

11. Mani is a partner, who withdrew ₹ 30,000 on 1st September, 2018. Interest on drawings is charged at 6% per annum. Calculate interest on drawings on 31st December, 2018 and show the journal entries by assuming that fluctuating capital method is followed.

(Answer: Interest on drawings of Mani: ₹ 600)

12. Santhosh is a partner in a partnership firm. As per the partnership deed, interest on drawings is charged at 6% per annum. During the year ended 31st December, 2018 he withdrew as follows:

Date	₹
February 1	2,000
May 1	10,000
July 1	4,000
October 1	6,000

Calculate the amount of interest on drawings.

(Answer: Interest on drawings of Santhosh: ₹ 720)

13. Kumar is a partner in a partnership firm. As per the partnership deed, interest on drawings is charged at 6% per annum. During the year ended 31st December, 2018 he withdrew as follows:

Date	₹
March 1	4,000
June 1	4,000
September 1	4,000
December 1	4,000

Calculate the amount of interest on drawings.

(Answer: Interest on drawings of Kumar: ₹ 440)

14. Mathew is a partner who withdrew ₹ 20,000 during the year 2018. Interest on drawings is charged at 10% per annum. Calculate interest on drawings on 31st December 2018.

(Answer: Interest on drawings of Mathew: ₹ 1,000)

15. Santhosh is a partner in a partnership firm. As per the partnership deed, interest on drawings is charged at 6% per annum. During the year ended 31st December, 2018 he withdrew as follows:

Date	₹
February 1	2,000
May 1	10,000
July 1	4,000
October 1	6,000

Calculate the amount of interest on drawings by using product method.

(Answer: Interest on drawings of Santhosh: ₹ 720)

16. Kavitha is a partner in a firm. She withdraws ₹ 2,500 p.m. regularly. Interest on drawings is charged @ 4% p.a. Calculate the interest on drawings using average period, if she draws

(i) at the beginning of every month
(ii) in the middle of every month
(iii) at the end of every month

(Answer: Interest on drawings of Kavitha: (i) ₹ 650 (ii) ₹ 600 (iii) ₹ 550)

17. Kevin and Francis are partners. Kevin draws ₹ 5,000 at the end of each quarter. Interest on drawings is chargeable at 6% p.a. Calculate interest on drawings for the year ending 31st March 2019 using average period.

(Answer: Interest on drawings of Kevin: ₹ 450)

18. Ram and Shyam were partners. Ram withdrew ₹ 18,000 at the beginning of each half year. Interest on drawings is chargeable @ 10% p.a. Calculate interest on the drawings for the year ending 31st December 2018 using average period.

(Answer: Interest on drawings of Ram: ₹ 2,700)

19. Janani, Kamali and Lakshmi are partners in a firm sharing profits and losses equally. As per the terms of the partnership deed, Kamali is allowed a monthly salary of ₹ 10,000 and Lakshmi is allowed a commission of ₹ 40,000 per annum for their contribution to the business of the firm. You are required to pass the necessary journal entry. Assume that their capitals are fluctuating.

20. Sibi and Manoj are partners in a firm. Sibi is to get a commission of 20% of net profit before charging any commission. Manoj is to get a commission of 20% on net profit after charging all commission. Net profit for the year ended 31st December 2018 before charging any commission was ₹ 60,000. Find the commission of Sibi and Manoj. Also show the distribution of profit.

**(Answer: Commission to Sibi: ₹ 12,000; Commission to Manoj: ₹ 8,000
Share of profit: Sibi: ₹ 20,000; Manoj: ₹ 20,000)**

21. Anand and Narayanan are partners in a firm sharing profits and losses in the ratio of 5:3. On 1st January 2018, their capitals were ₹ 50,000 and ₹ 30,000 respectively. The partnership deed specifies the following:

(a) Interest on capital is to be allowed at 6% per annum.

(b) Interest on drawings charged to Anand and Narayanan are ₹ 1,000 and ₹ 800 respectively.

(c) The net profit of the firm before considering interest on capital and interest on drawings amounted to ₹ 35,000.

Give necessary journal entries and prepare profit and loss appropriation account as on 31st December 2018. Assume that the capitals are fluctuating.

(Answer: Share of profit: Anand: ₹ 20,000; Narayanan: ₹ 12,000)

22. Dinesh and Sugumar entered into a partnership agreement on 1st January 2018, Dinesh contributing ₹ 1,50,000 and Sugumar ₹ 1,20,000 as capital. The agreement provided that:

(a) Profits and losses to be shared in the ratio 2:1 as between Dinesh and Sugumar.

(b) Partners to be entitled to interest on capital @ 4% p.a.

(c) Interest on drawings to be charged Dinesh: ₹ 3,600 and Sugumar: ₹ 2,200

(d) Dinesh to receive a salary of ₹ 60,000 for the year, and

(e) Sugumar to receive a commission of ₹ 80,000

During the year ended on 31st December 2018, the firm made a profit of ₹ 2,20,000 before adjustment of interest, salary and commission.
Prepare the Profit and loss appropriation account.

(Answer: Share of profit: Dinesh: ₹ 50,000; Sugumar: ₹ 25,000)

23. Antony and Ranjith started a business on 1st April 2018 with capitals of ₹ 4,00,000 and ₹ 3,00,000 respectively. According to the Partnership Deed, Antony is to get salary of ₹ 90,000 per annum, Ranjith is to get 25% commission on profit after allowing salary to Antony and interest on capital @ 5% p.a. but after charging such commission. Profit-sharing ratio between the two partners is 1:1. During the year, the firm earned a profit of ₹ 3,65,000.

Prepare profit and loss appropriation account. The firm closes its accounts on 31st March every year.

**(Answer: Commission to Ranjith: ₹ 48,000; Share of profit: Antony: ₹ 96,000;
Ranjith: ₹ 96,000)**

CASE STUDY

Malar and Mani are good friends and wanted to start a business of buying and selling of sports materials. So, they formed a partnership firm. They contributed equal amount of capital. Apart from the capital, Mani gave loan to the business. However, there was no partnership deed. Malar is good at marketing and adds value to the business with her skills. The firm maintains two separate accounts- capital and current accounts. The business gained popularity and reputation. But, the business could not cover its expenses and hence made a loss. At the end of the first year of the business, they had some misunderstanding on the following:

1) Malar claims salary of ₹ 10,000 per month, for her extra efforts. Mani does not agree to this.
2) Mani claims interest on the loan. But, Malar does not agree for this saying that the business made a loss.
3) Mani wants to admit his relative into the existing firm, but Malar does not agree for this.

They both need your help to solve these issues.

To explore further

A business has gained good reputation. Can this be valued in terms of money and be recorded in the books of accounts?

Reference

1. M C Shukla, T S Grewal and S C Gupta, Advanced Accounts, 19th ed., 2017, S.Chand Publishing, New Delhi.
2. R L Gupta and V K Gupta, Financial Accounting, 11th ed., 2014, Sultan Chand and Sons, New Delhi.
3. S P Jain and K L Narang, Advanced Accountancy Vol – I, 2016, Kalyani Publishers, New Delhi.
4. Dalston L Cecil and Jenitra L Merwin, Financial Accounting, 3rd ed., 2017, Learntech Press, Trichy.
5. Fundamentals of Accounting, 2017, The Institute of Chartered Accountants of India, New Delhi.