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22

PARTNERSHIP : AN INTRODUCTION

You have already learnt about preparation of accounts of sole proprietory form of business organisation. But, when a business expands, it goes beyond the capacity of one person to provide the capital and manage the affairs of the expanded business. A need is felt to combine his/her efforts and capital with those of another person/persons. This gives rise to the partnership form of organisation.

As far as recording of business transactions in the books of original entry, their posting to ledger and preparing financial statements are concerned there is no difference between a sole proprietor or a partnership firm. But there are certain issues which are specific to partnership firm and require separate accounting treatment. These issues are appropriation of profits of the firm, treatment of goodwill on various occasions and so on. This lesson focuses on such issues related to partnership firms.

OBJECTIVES

After going through this lesson, you will be able to :

- state the meaning and characteristics of partnership;
- explain the meaning of partnership deed and its contents;
- describe accounting treatment of specific issues related to partnership in the absence of partnership deed;
- state the meaning and preparation of capital account:
- distinguish between fluctuating and fixed capital account;

Notes

- calculate interest on capital and interest on drawings;
- state the meaning and purpose of Profit and Loss Appropriation account and its preparation;
- make adjustment for gaurantee of profit and
- make adjustments for errors made after preparing Balance Sheet.

22.1 PARTNERSHIP AND PARTNERSHIP DEED

Partnership is a form of business organisation, where two or more persons join hands to run a business. They share the profits and losses according to the agreement amongst them.

According to the Indian Partnership Act 1932,

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

For example, one of your friends has passed class XII from National Institute of Open Schooling (NIOS) and wants to start a business. He/she approaches you to join in this venture. He/she wants you to contribute some money and participate in the business activities. Both of you if join hands, constitute a partnership.

Following are the characteristics of partnership :

- **Agreement :** A partnership is formed by an agreement. The agreement may be either oral or in writing. It defines the relationship between the persons, who agree to carry on business. It may contain the terms of sharing profit and the capital to be invested by each partner, etc. The written agreement is known as partnership deed.
- **Number of persons :** There must be at least two persons to form a partnership. The maximum number of partners in a partnership firm can be 50 according to Companies Act 2013.
- **Business :** The Partnership is formed to carry on business with a purpose of earning profits. The business should be lawful. Thus, if two or more persons agree to carry on unlawful activities, it will not be termed as partnership.
- **Sharing Profits :** The partners agree to share profits in the agreed ratio. In case of loss, all the partners have to bear it in the same agreed profit sharing ratio.

- **Mutual Agency :** Every partner is an agent of the other partners. Every partner can bind the firm and all other partners by his/her acts. Each partner will be responsible and liable for the acts of all other partners.
- **Unlimited liability :** The liability of each partner, except that of a minor, is unlimited. Their liability extends to their personal assets also. If the assets of the firm are insufficient to pay off its debts, the partners' personal property can be used to satisfy the claim of the creditors of the partnership firm.
- **Management :** All the partners have a right to mange the business. However, they may authorize one or more partners to manage the affairs of the business on their behalf.
- **Transferability of Share :** No partner can transfer his/her share to any one including his/her family member without the consent of all other partners.

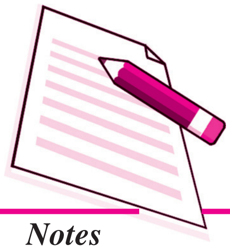
Important Terms

- **Partner :** The persons who have agreed to carry on a business and share its profits and losses. They are the persons who have agreed upon the terms and conditions of partnership.
- **Firm :** Partners who carry on the business are collectively known as firm. The name under which the business is carried on is called firm name.
- **The Indian Partnership Act 1932 :** It is an Act that governs the partnership firms. In case, Partnership Deed is silent on an issue, provisions of the Indian Partnership Act, 1932 are applied.
- **Partnership deed :** Agreement forms the basis of partnership. The written form of the agreement is which is a document of partnership. It contains terms and conditions regarding the conduct of the business. It also explains relationship between the partners. This document is called partnership deed.

  Every firm can frame its own partnership deed in which the rights, duties and liabilities of the partners are stated in detail. It helps in settling the disputes arising among the partners during the general conduct of business.
- **Contents of Partnership Deed :** The partnership deed generally contains the following :

  (i) Name and address of the partnership firm;

  (ii) Nature and objectives of the business;



Notes

(iii) Name and address of each partner;

(iv) Ratio in which profits is to be shared;

(v) Capital contribution by each partner;

(vi) Rate of Interest on capital if allowed;

(vii) Salary or any other remuneration to partners, if allowed;

(viii) Rate of interest on loans and advances by a partner to the firm;

(ix) Drawings of partners and interest thereon, if any

(x) Method of valuation of goodwill and revaluation of assets and liabilities on the reconstitution of the partnership i.e. on the admission, retirement or death of a partner;

(xi) Settlement of disputes by arbitration;

(xii) Settlement of accounts at the time of retirement or death of a partner;

(xiii) Circumstances in which the firm can be dissolved;

(xiv) Settlement of accounts at the time of dissolution of a firm.

- **In the Absence of the Partnership Deed :** The partnership deed lays down the terms and conditions of partnership in regard to rights, duties and obligations of the partners. In the absence of partnership deed, there may arise a controversy on certain issues like profit sharing ratio, interest on capital, interest on drawings, interest on loan and salary of the partners. In such cases, the provisions of the Indian Partnership Act becomes applicable:

Some of the Issues are

(i) ***Distribution of Profit :*** Partners are entitled to share profits equally.

(ii) ***Interest on Capital :*** Interest on capital is not allowed.

(iii) ***Interest on Drawings :*** No interest on drawing of the partners is to be charged.

(iv) ***Interest on Partner's Loan :*** A Partner is allowed interest @ 6% per annum on the amount of loan given to the firm by him/her.

(v) ***Salary and Commission to Partner :*** A partner is not entitled to any salary or commission or any other remuneration for managing the business.

INTEXT QUESTIONS 22.1

I. Fill in the blanks with appropriate word/words :

(i) There must be at least .... persons to form a partnership.

(ii) A partnership is formed by ....

(iii) Agreement of partnership can be .... or ....

(iv) The written form of agreement of a partnership is called ....

(v) The liability of each partner is ....

II. Asha and Rahul are partners in a firm . If there is no partnership deed, how will you deal with the following? Give your answer in yes or no.

(i) Asha wants a salary of Rs.3000 per month to be paid to her. Can she claim the salary?

(ii) Rahul has advanced a loan to the firm. He claims interest @ 6% p.a. is it permissible?

(iii) Asha and Rahul contribute Rs. 50,000 each as capital. Rahul wants more profit than Asha. Is it permissible?

(iv) Asha gets contracts for the firm. She wants 2% commission on the amount of contract. Is she entitled to such commission?

(v) Rahul withdraws ₹ 500 p.m. for personal use. Asha wants interest to be charged on Rahul's drawings. Can it be charged?

22.2 CAPITAL ACCOUNT : MEANING AND PREPARATION

Partners contribute their share of capital in business. These are recorded in their respective accounts named as capital accounts. Suppose there are two partners A and B, there will be A's capital account and B's capital account. These accounts may be maintained in two ways :

(a) Fixed Capital Account

In fixed capital account, the closing balance of the capital account is same as that of opening balance except when additional capital is introduced or there is permanent withdrawal during the current accounting year. Items relating to capital account such as interest on capital, interest on drawings and share of profit etc, are recorded in capital account. But in this case a separate account is opened for each partner to record these items. This account is known as 'current account'. A current account may show a debit or a credit balance. Format of the fixed capital account and the current account is as under :

Notes

Partner's Capital Account

Dr. Cr.

Date	*Particulars*	*J.F.*	*Amount (₹)*	*Date*	*Particulars*	*J.F.*	*Amount (₹)*
	Bank (Permanent withdrawal of Capital)		xxx		Balance b/d (Capital contribution opening balance)		xxx
	Balance c/d (Closing balance)		xxx		Bank (Additional Capital introduced)		xxx
			xxx				xxx

Partner's Current Account

Dr. Cr.

Date	*Particulars*	*J.F.*	*Amount (₹)*	*Date*	*Particulars*	*J.F.*	*Amount (₹)*
	Balance b/d (in case of debit opening Balance)		xxx		Balance b/d (in case of credit Opening Balance)		xxx
	Drawings A/c		xxx		Salary		xxx
	Interest on Drawings A/c		xxx		Interest on capital		xxx
	Profit and Loss Appropriation (for share of loss)		xxx		Profit and loss Appropriation (for share of profit)		xxx
	Balance c/d (in case of credit closing balance)				Balance c/d (in case of debit closing balance)		
			xxx				xxx

Notes

(b) Fluctuating Capital Account

When capital account for each partner is so maintained that in addition to the capital amount other items related to capital account such as interest on capital, drawings, net profit or net loss etc. are written in this account, it is termed as fluctuating capital. In this case there is no need to maintain a separate account for recording of these adjustments.

In the absence of any information, the capital account should be prepared by this method. The format of fluctuating capital account is as follows:

Partner's Capital Account

Dr. Cr.

Date	*Particulars*	*JF*	*Amount (₹)*	*Date*	*Particulars*	*JF*	*Amount (₹)*
	Balance b/d (in case of Debit opening balance)		xxx		Balance b/d (in case of Credit opening balance)		xxx
	Drawings		xxx		Bank (Additional Capital introduced) A/c		xxx
					Salaries A/c		xxx
	Interest on Drawings		xxx		Interest on Capital		xxx
	Profit and Loss Appropriation (for share of loss)		xxx		Profit and Loss Appropriation (for share of profit)		xxx
	Balance c/d (in case of credit closing balance)		xxx		Balance c/d (in case of debit closing balance)		xxx
			xxx				xxx

Illustration 1

Rohan and Monika are partners in a firm. Following information is provided as on 31 December, 2013:

	Rohan (₹)	*Monika* (₹)
Capital (as on 1.01.2013)	40,000	30,000
Drawings	3,000	2,000
Interest on Capital	2,000	1,500
Interest on Drawings	360	180
Share of Profit	5,000	4,000

Notes

Prepare capital account of each partner if capital is : (a) fixed, (b) fluctuating.

Solution :

(a) Fixed capital account

Capital Account

Dr. Cr.

Date 2013	Particulars	JF	Rohan (₹)	Monika (₹)	Date 2013	Particulars	JF	Rohan (₹)	Monika (₹)
Dec.31	Balance c/d		40,000	30,000	Jan.1	Balance b/d		40,000	30,000
			40,000	30,000				40,000	30,000

Current Account

Dr. Cr.

Date 2013	Particulars	JF	Rohan (₹)	Monika (₹)	Date 2013	Particulars	JF	Rohan (₹)	Monika (₹)
Dec.31	Drawings		3,000	2,000	Dec.31	Interest on capital		2,000	1,500
Dec.31	Interest on drawings		360	180	Dec.31	Profit and Loss Appropriation A/c		5,000	4,000
Dec.31	Balance c/d		3,640	3,320					
			7,000	5,500				7,000	5,500
					Jan.1	Balance b/d		3,640	3,320

(b) Fluctuating capital Account

Capital Account

Dr. Cr.

Date	Particulars	JF	Rohan (₹)	Monika (₹)	Date	Particulars	JF	Rohan (₹)	Monika (₹)
	Drawings		3,000	2,000		Balance b/d		40,000	30,000
	Interest on drawings		360	180		Interest on capital		2,000	1,500
	Balance c/d		43,640	33,320		Profit & Loss Appropriation A/c		5,000	4,000
			47,000	35,500				47,000	35,500
						Balance b/d		43,640	33,320

Distinction between Fixed and Fluctuating Capital Accounts

The main points of difference between the Fixed and Fluctuating capital accounts are as under:

S. No.	Basis of Distinction	Fixed Capital Account	Fluctuating Capital Account
1.	Number of accounts	Two separate accounts are prepared for each partner i.e. 'capital account' and 'current account'.	Only one account for each partner is prepared i.e. capital account.
2.	Adjustments	All adjustments are recorded in the current account and not in the capital account.	Adjustments are recorded directly in the capital accounts, as no current account is opened.
3.	Fixed balance	The capital account balance, normally remains, unchanged except under special circumstances.	The balance of the capital account fluctuates from period to period.
4.	Balance	Capital accounts always show a credit balance only.	The capital account can show a debit balance or a credit balance at the end of the period.

INTEXT QUESTIONS 22.2

Fill in the blanks with suitable word/words :

(i) Fixed Capital account always show .... balance only.

(ii) A .... capital account may show a debit or a credit balance.

(iii) Two separate accounts are kept for each partner, if capital is ....

(iv) Interest on capital is shown on the .... side of the current account.

(v) Interest on drawings is shown on the .... side of the current account.

22.3 ACCOUNTING TREATMENT OF INTEREST ON CAPITAL AND INTEREST ON DRAWINGS

Interest on Capital

Let us now study about calculation of interest on capital. As you know that, interest on capital is allowed when it is provided in the Partnership Deed. If it is so provided, the rate of interest will be as agreed upon by the partners. Interest is charged on the opening balance of the partner's capital account. When additional capital is introduced and some capital is withdrawn permanently, the interest will be calculated on the amount of the capital used in the business during a particular period. Interest is treated as an expense as it is a charge on the profits of the firm. The following journal entry will be made :

For Interest on Capital

Interest on Capital A/c Dr.
To Partner's Capital A/c (Individually)
(Crediting 'Interest on Capital' to Capital Account)

Interest can be calculated directly i.e. simple interest is to be calculated by taking the principal amount, period and rate of interest. Alternately interest can be calculated by product method i.e. by converting the principal amount into monthly products depending upon number of months for which principal amount remained in business. Then the interest is calculated by taking monthly rate of interest. The following example will illustrate both the methods of calculating interest on capital.

Illustration 2

Shilpa and Sanju are partners with a capital of ₹ 1,00,000 and ₹ 1,60,000 on January 1,2013 respectively. Shilpa introduced additional capital of ₹ 30,000 on July 1, 2013 and another ₹ 20,000 on October 31,2013. Calculate interest on capital for the year ending 2013. The rate of interest is 9% p.a.

Solution:

Interest on Capital (Shilpa):

On ₹ 1,00,000 for 12 month @ 9%	=	1,00,000 × 9/100 × 12/12
	=	₹ 9,000
On ₹ 30,000 for 6 month @ 9%	=	30,000 × 9/100 × 6/12
	=	₹ 1,350
On ₹ 20,000 for 2 month @ 9%	=	20,000 × 9/100 × 2/12
	=	₹ 300
Total interest on shilpa capital	=	₹ 9,000 + ₹ 1350 + ₹ 300
	=	₹10,650

By product method

Amount ₹	*Months*	*Product*
1,00,000	12	12,00,000
30,000	6	1,80,000
20,000	2	40,000
Total product		14,20,000

$$\text{Interest on Capital} = 14{,}20{,}000 \times \frac{9}{100} \times \frac{1}{12}$$

$$= ₹\ 10650$$

Interest on Capital (Sanju):

On ₹ 1,60,000 for 12 month @ 9% $= 1{,}60{,}000 \times 9/100 \times 12/12$

$= ₹\ 14{,}400$

By product method : $= 1{,}60{,}000 \times 12 = 19{,}20{,}000$

$$= 14{,}20{,}000 \times \frac{9}{100} \times \frac{1}{12}$$

$= ₹\ 14{,}400$

22.4 INTEREST ON DRAWINGS

When a partner withdraws cash from the firm for domestic use, the withdrawal of cash is termed as drawings. If the partnership deed has a provision of charging interest on drawings, the firm may charge interest on drawings from partners. Interest on drawing is a gain for the firm. It is calculated at the agreed rate. The amount of interest on drawings will be credited to Profit and Loss Appropriation Account and will be debited to partner's capital account/current account (Individually). The journal entry will be:

Partners Capital/Current A/c Dr.

To Interest on Drawings A/c

(Charging interest on drawings to Partner's Capital account)

Calculation of interest on Drawings :

There are two methods of calculating interest on drawings

- Simple Average method
- Product method

Notes

1. SIMPLE AVERAGE METHOD

A fixed amount may be withdrawn every month/ half yearly/ annually. The interest has to be calculated for the period for which the amount has been utilised for personal purposes by the partners. The calculation of amount of interest to be charged in different situations is shown as under :

I. When Fixed Amounts are Withdrawn at Equal Time Intervals

A fixed amount is withdrawn by the partners, at equal time interval, say each month or each quarter. The calculation of total time period, in such situations will depend upon whether the money was withdrawn at the beginning of the month, middle of the month or at the end of the month.

For example, Manisha withdrew ₹ 1,000 per month from the firm for her personal use during the year ending December 31, 2013. interest is charged at the rate of 12% per annum. The calculation of average period and the interest on drawings in different situations would be as follows:

(a) When money is withdrawn at the beginning of the period

Date of Drawings	*Amount Withdrawn (₹)*	*Period (in Month)*
1 January 2013	1,000	12
1 February 2013	1,000	11
1 March 2013	1,000	10
1 April 2013	1,000	9
1 May 2013	1,000	8
1 June 2013	1,000	7
1 July 2013	1,000	6
1 August 2013	1,000	5
1September 2013	1,000	4
1 October 2013	1,000	3
1 November 2013	1,000	2
1 December 2013	1,000	1
Total	**12,000**	**78**

When money is withdrawn in the beginning of the month, the average period is calculated as under:

Notes

Average Period = Total of months/12

= 78months/12

= 6½ months

OR,

$$\text{Average Period} = \frac{\text{Max. Period of Drawing + Min. Period of Drawing}}{2}$$

$$= \frac{12 + 1}{2} = \frac{13}{2} = 6\frac{1}{2} \text{ months}$$

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

= ₹ 780

(b) When money is withdrawn at the end of the period

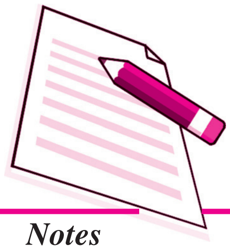
Date of drawings	*Amount Withdrawn (₹)*	*Period (in Month)*
31 January 2013	1,000	11
28/29 February 2013	1,000	10
31 March 2013	1,000	9
30April 2013	1,000	8
31 May 2013	1,000	7
30 June 2013	1,000	6
31July 2013	1,000	5
31 August 2013	1,000	4
30 September 2013	1,000	3
31 October 2013	1,000	2
30 November 2013	1,000	1
31December 2013	1,000	0
	12,000	**66**

When money is withdrawn at the end of the month, the average period is calculated as under:

Average Period = Total of months/12

= 66 months/12

= 5 ½ months



Notes

OR,

$$\text{Average Period} = \frac{\text{Max. Period of Drawing + Min. Period of Drawing}}{2}$$

$$= \frac{10 + 1}{2} = \frac{11}{2} = 5\frac{1}{2} \text{ months}$$

$$\text{Interest on Drawings} = 12{,}000 \times \frac{12}{100} \times \frac{11}{2} \times \frac{1}{2}$$

$$= ₹\ 660$$

(c) When money is withdrawn in the middle of the month:

Date of Drawings	*Amount Withdrawn (₹)*	*Period (in Month)*
15 January 2013	1,000	11.5
14 February 2013	1,000	10.5
15 March 2013	1,000	9.5
15 April 2013	1,000	8.5
15 May 2013	1,000	7.5
15 June 2013	1,000	6.5
15 July 2013	1,000	5.5
15 August 2013	1,000	4.5
15 September 2013	1,000	3.5
15 October 2013	1,000	2.5
15 November 2013	1,000	1.5
15 December 2013	1,000	0.5
Total	**12,000**	**72**

When money is withdrawn in the middle of the month, the average period is calculated as under:

Average Period = Total of months/12
= 72 months/12
= 6 months

OR,

$$\text{Average Period} = \frac{\text{Max. Period of Drawing + Min. Period of Drawing}}{2}$$

Notes

$$= \frac{11.5 + 0.5}{2} = \frac{12}{2} = 6 \text{ months}$$

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

$$= ₹\ 720$$

(d) Withdrawal of Fixed amounts at equal time intervals (Beginning of each quarter)

If the money is withdrawn by the partners in the beginning of each quarter, the interest is calculated on total money withdrawn during the year for an average period of seven and half months.

Illustration 3

Sunny and Himanshu are partners in a firm sharing profits and losses equally. During financial year 2013, Sunny withdrew ₹20,000 quarterly at the beginning of each quarter. If interest is to be charged on drawings @ 8% per annum, calculate the amount of interest to be charged at the end of the year.

Solution :

Statement Showing Calculation of Interest on Drawings

Date	*Amount (₹)*	*Time Period*	*Interest (₹)*
Jan. 1, 2013	20,000	12 months	$20{,}000 \times \frac{8}{100} \times \frac{12}{12}$ = ₹1,600
April 1, 2013	20,000	9 months	$20{,}000 \times \frac{9}{12} \times \frac{8}{100}$ = ₹ 1,200
July 1, 2013	20,000	6 months	$20{,}000 \times \frac{6}{12} \times \frac{8}{100}$ = ₹800
Oct. 1, 2013	20,000	3 months	$20{,}000 \times \frac{3}{12} \times \frac{8}{100}$ = ₹ 400
Total	80,000		= ₹4,000

Alternatively, the interest can be calculated on the total sum withdrawn during the accounting year, which is ₹ 80,000 in this case, for a period of 7½ months

$$\frac{(12+9+6+3)}{4} = 7\frac{1}{2} = \frac{15}{2}$$

Notes

Thus,

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

$$= 80{,}000 \times \frac{8}{100} \times \frac{15}{2} \times \frac{1}{12}$$

$$= ₹\ 4{,}000.$$

(e) When fixed amount is withdrawn at the end of each quarter

When the amounts are withdrawn at the end of each quarter the amount of interest is calculated on total drawings for a period of four and a half months.

In the previous illustration, if the money is withdrawn at the end of each quarter, the average period for calculation of interest will be taken as four and half months. The calculation of interest can be shown as follows:

Statement of Calculation of Interest on Drawings

Date	*Amount (₹)*	*Time Period*	*Interest (₹)*
March 31	20,000	9 months	$20{,}000 \times \frac{9}{12} \times \frac{8}{100}$ = ₹ 1,200
June 30	20,000	6 months	$20{,}000 \times \frac{6}{12} \times \frac{8}{100}$ = ₹ 800
September 30	20,000	3 months	$20{,}000 \times \frac{3}{12} \times \frac{8}{100}$ = ₹ 400
December 31	20,000	0 months	₹ 0
Total	**80,000**	**18 months**	**= ₹ 2,400**

Alternatively, the interest on ₹ 80,000 for a period 4½ months is calculated as :

$$\frac{(9+6+3+0)}{4} = 4\frac{1}{2} = \frac{9}{2}$$

$$\text{Interest on Drawings} = 80{,}000 \times \frac{8}{100} \times \frac{9}{12} \times \frac{1}{12}$$

$$= ₹\ 2{,}400$$

(f) When fixed amount is withdrawn at the middle of each quarter

When the amounts are withdrawn at the middle of each quarter the amount of interest is calculated on total drawings for a period of six months.

(g) When no specific period of drawing is given in the question

If no time period is mentioned in the question for which the drawings will be charged for a period of on an average of six months.

PRODUCT METHOD

When different amounts are withdrawn at different intervals

Under the product method, for each withdrawal, the money withdrawn is multiplied by the period for which it remained withdrawn during the financial year. The period is calculated from the date of the withdrawal to the last day of the accounting year. The products so calculated are totalled and interest for 1 month at the specified rate is found out on the total of the products. The calculation of interest can be explained with the help of the preceding illustration.

Statement showing calculation of interest on Drawings

Date	*Amount (₹)*	*Time Period*	*Product (₹)*
Jan. 1, 2013	20,000	12 months	2,40,000
April 1, 2013	20,000	9 months	1,80,000
July 1, 2013	20,000	6 months	1,20,000
Oct. 1, 2013	20,000	3 months	60,000
Total	**80,000**		**6,00,000**

Interest on drawing = Total of Product x interest rate x1/12

= ₹6,00,000 × 8/100 × 1/12

= ₹ 4,000

INTEXT QUESTIONS 22.3

I. Fill in the blanks with appropriate word/words :

(i) Interest on capital is .... in partner's capital account.

(ii) Interest on drawings is .... in partner's capital account.

(iii) Interest is charged on the .... of the partner's capital account.

(iv) When money is withdrawn in the begining of the each month, the average period is .... for charging interest.

II. Reema and Anish are partners with a capital of ₹50,000 and ₹80,000 on April 2013, respectively. Reema introduced additional capital of ₹50,000 on 1st Jan 2014. Calculate interest on capital @10 p.a. on March 31, 2014.

III. Ashu withdrew ₹2000 p.m. from business for personal use at the end of every month during the year. Calculate interest on Drawing @10 p.a.

22.5 PROFIT AND LOSS APPROPRIATION ACCOUNT: MEANING AND PREPARATION

Profit and Loss Appropriation Account is merely an extension of the Profit and Loss Account of the firm. The profit of the firm has to be distributed amongst the partners in their respective profit sharing ratio. But before its distribution it needs to be adjusted. All Adjustments like partner's salary, partner's commission, interest on capital, interest on drawings etc. are made in this account. These adjustments will reduce the amount of profit for distribution. This adjusted profit will be distributed amongst the partners in their profit sharing ratio. To prepare it, at first, the balance of Profit and Loss Account is transferred to this account. The journal entries for the preparation of Profit and Loss Appropriation Account are given below:

1. For transfer of the balance of Profit and Loss Account to Profit and Loss Appropriation Account

(a) In case of Net Profit :

Profit and Loss A/c Dr.

To Profit and Loss Appropriation A/c

(Net Profit transferred to Profit and Loss Appropriation A/c)

(b) In case of Net Loss :

Profit and Loss Appropriation A/c Dr.

To Profit and Loss A/c

(Net Loss transferred to Profit and Loss Appropriation A/c)

2. *For Interest on Capital*

For transferring on Interest on Capital :

Profit and Loss Appropriation A/c Dr.

To Interest on Capital A/c

(Interest on capital transferred to Profit & Loss Appropriation A/c)

3. *For Interest on Drawings*

For transferring Interest on Drawings :

Interest on Drawings A/c Dr.

To Profit and Loss Appropriation A/c

(Interest on drawing transferred to Profit & Loss Appropriation A/c)

4. *For Partner's Salary*

For transfer of partner's Salary

Profit and Loss Appropriation A/c Dr.

To Salary A/c

(Salary transferred to profit & Loss Appropriation A/c)

5. *For Partner's Commission*

For transferring commission

Profit and Loss Appropriation A/c Dr.

To Commission A/c

(Commission transferred to Profit and Loss Appropriation A/c)

6. *For Transfer of agreed amount to General Reserve*

Profit and Loss Appropriation A/c Dr.

To General Reserve A/c

(Transfer to General Reserve)

7. *For share of Profit or Loss appropriation*

(a) If Profit

Profit and Loss Appropriation A/c Dr.

To Partner's Capital/Current A/c

(Profit transferred to capital/current A/c)

(b) If Loss

Partner's Capital/ Current A/c Dr.

To Profit and Loss Appropriation A/c

(Loss transferred to capital/current A/c)

The format of Profit and Loss Appropriation Account is given as follows.

Notes

Profit and Loss Appropriation Account

for the year ended on ....

Dr. Cr.

Particulars	*Amount (₹)*	*Particulars*	*Amount (₹)*
Profit and Loss A/c (if there is loss)	xxx	Profit and Loss A/c (if there is profit)	xxx
Interest on Partners' Capital's A/c	xxx	Interest on Drawings	xxx
Partners' Salary A/c	xxx	Partner's capital A/c (distribution of loss)	xxx
Partners' Commission A/c	xxx		
Interest on Partners' Loan A/c	xxx		
General Reserve	xxx		
Partners' Capital A/c (distribution of profit)	xxx		
	xxx		**xxx**

Illustration 4

Monika and Krishan are partners with a capital of ₹ 80,000 and ₹ 1,00,000 respectively. They agree on the followings:

(a) To share profit equally.

(b) Interest allowed on capital @ 9% p.a.

(c) Interest charged on drawing @ 6% p.a.

(d) Salary to be paid to Krishan @ ₹ 600 per month.

(e) Monika withdrew ₹ 8,000 and Krishan ₹ 6,000 during the year.

Profit for the year ending December 31, 2013 was ₹ 56,000. You are required to prepare Profit and Loss Appropriation account.

Solution :

Working Notes:

First you should calculate the interest on capital and the interest on drawings.

Notes

Interest on Capital

Monika = ₹ 80,000 × 9/100
= ₹ 7,200

Krishan = ₹ 1,00,000 × 9/100
= ₹ 9,000

Interest on Drawings

Monika's Drawings = ₹ 8,000

Interest = ₹ 8,000 × 6/100
= ₹ 0.480

Krishan's Drawings = ₹ 6,000

Interest = ₹ 6,000 × 6/100
= ₹ 360

Profit and Loss Appropriation Account

Dr. Cr.

Particulars		*Amount (₹)*	*Particulars*		*Amount (₹)*
Interest on Capital's A/c :			Profit and Loss		56,000
Monika	7,200		Interest on Drawings :		
Krishan	9,000	16,200	Monika	480	
Krishan Salary		7,200	Krishan	360	840
Profit transferred to					
Partners' Capital A/c :					
Monika	16,720				
Krishan	16,720	33,440			
		56,840			56,840

INTEXT QUESTIONS 22.4

(i) List the items which usually appear on the debit side of Profit and loss Appropriation Account.

(ii) If, balance of Profit and Loss Account is debit, what entry will be recorded for transferring the amount to Profit and Loss Appropriation account?

Notes

(iii) When interest on drawings is to be transferred to Profit and Loss Appropriation account, what journal entry is to be recorded in the books?

22.6 GUARANTEE OF PROFIT

Sometimes, a partner is admitted in the firm on guarantee in respect of his minimum share of profit from the business. Such a gurantee can be given even to an existing partner also. Such a guarantee to the incoming partner is given either by :

(a) the firm *i.e.* by all the old partners in an agreed ratio, or

(b) some of the old partners or any one of the old partners

When all the partners guarantee that one of the partners shall be given a minimum amount of profit, we should calculate the following two amounts separately:

i. Share of profit of the guaranted partner as per profit sharing ratio, and

ii. Minimum guaranteed amount of profit of the guanteed partner.

The higher of the above two is to be given to that partner. The balance of profit (total profit minus profit given to the guaranteed partner) is to be shared by the remaining partners in their respective profit -sharing ratio.

When the new partner's share of profit is more than the guaranteed amount, his actual share of profit is given to him instead of the guaranteed amount of profit.

Illustration 5 (Guarantee given by the firm to a partner)

X and Y share profits & Losses in the ratio of 2 : 1 as from 1st April, 2013, they admited Z as a partner who was to have one-tenth share of profit with a guaranteed amount of ₹1,60,000. X and Y continue to share profits as before. The profit for the year ended 31st March 2014 amounted to ₹ 10,00,000.

Prepare Profit & Loss Appropriation A/c for the year ended March 31, 2014.

Solution :

Profit & Loss Appropriation Account
for the year ended 31st March, 2014

Dr. Cr.

Particulars	₹	*Particulars*	₹
To Partner's Capital A/cs (Note)		By Profit & Loss A/c	
X 5,60,000		- Profit for the year	10,00,000

Notes

Y	2,80,000			
Z	1,60,000	10,00,000		
		10,00,000		10,00,000

Note : Z will get higher of the following:

(i) Share of profit as per profit-sharing ratio,

i.e., $\frac{1}{10}$ of ₹ 10,00,000 = ₹ 1,00,000

(ii) Minimum guaranteed profit, i.e., ₹ 1,60,000

Therefore, from ₹ 10,00,000; ₹ 1,60,000 is to be given (being higher) to Z first and balance of ₹ 8,40,000 (₹ 10,00,000 - ₹ 1,60,000) will be shared by X and Y in the ratio of 2 : 1.

In effect :

X will get ₹ 5,60,000 $\left(\frac{2}{3} \text{ of Rs.8,40,000}\right)$; Y will get ₹ 2,80,000 $\left(\frac{1}{3} \text{ of Rs.8,40,000}\right)$ and Z will get ₹ 1,60,000 (guaranteed profit).

When the guarantee is given not by all the partners or the firm but by any one of the partner or some of the partners then the difference between the guaranteed amount and his share of profit shall be borne by the partner or partners who have given the guarantee either in the old profit sharing ratio or in any other agreed ratio as the case may be.

Illustration : 6 (Guarantee of Profits by one partner)

A, B and C are partners in a firm. Their profit sharing ratio is 5 : 3 : 2. However, C is guaranteed a minimum amount of ₹ 50,000 as share of profit every year. Any deficiency arising on that amount shall be met by B. The profits for the two years ended 31st March, 2010 and 2011 were ₹ 2,00,000 and ₹ 3,00,000 respectively. Prepare the Profit & Loss Appropriation A/c for the two years.

Solution :

Profit and Loss Appropriation Account

for the year ended 31st March 2010

Dr. Cr.

Particulars	*Amt. (₹)*	*Particulars*	*Amt. (₹)*
To Profit transferred to :		By Profit and Loss A/c	2,00,000
A's Capital A/c (5/10)	1,00,000	(Net Profit)	

B's Capital A/c (3/10)	60,000			
Less: Transferred to C	10,000	50,000		
C's Capital A/c (2/10)	40,000			
Add: Transferred from B	10,000	50,000		
		2,00,000		2,00,000

Profit and Loss Appropriation Account
for the year ended 31st March 2011

Dr. Cr.

Particulars	*Amt. (₹)*	*Particulars*	*Amt. (₹)*
To Profit transferred to :		By Profit and Loss A/c	3,00,000
A's Capital A/c (5/10)	1,50,000	(Net Profit)	
B's Capital A/c (3/10)	90,000		
C's Capital A/c (2/10)	60,000		
	3,00,000		3,00,000

Note : C's share of profits is more than the guaranteed amount, so there is no need for any adjustment.

Illustration : 7 (Minimum Profit Guaranteed to a partner by another Partner of the Firm)

P, Q and R entered into partnership on 1st April 2010 to share profits and losses in the ratio of 5 : 3 : 2. P, guarnateed that R's share of profits, after charging interest on capital @ 5% p.a., would not be less than ₹ 30,000 in any year.

The capital was provided as follows : A- ₹ 3,20,000; B- ₹ 2,00,000 and C- ₹ 1,60,000. The profits for the year ended 31st March 2011 amounted to ₹ 1,59,000 before providing for interest on capital.

Prepare Profit and Loss Appropriation A/c for the year ended 31st March 2011.

Solution :

Profit and Loss Appropriation Account
(for the year ended 31st March 2011)

Dr. Cr.

Particulars		*Amt. (₹)*	*Particulars*	*Amt. (₹)*
To Interest on Capitals :			By Profit and Loss A/c	1,59,000
P	16,000		(Net Profit)	

Q 10,000			
R 8,000	34,000		
To Share of Profit :		By Balance b/d	1,25,000
P : 5/10 of ₹ 1,25000 62,500			
Less: Adjustment for			
guarantee 5,000	57,500		
Q 3/10 of ₹ 1,25,000	37,500		
R 2/10 of ₹ 1,25,000 25,000			
Add: Adjustment for			
guarantee 5,000	30,000		
	1,25,000		1,25,000

Notes

Illustration 8

M and N were in partnership sharing profits and losses in the ratio of 3 : 2. In appreciation of the services of O, their manager who was in receipt of a salary of ₹ 24,000 and a commission of 5% of net profit after charging salary and commission. They took him into partnership from 1st April, 2010 giving him 1/8th share of profits. The agreement provided that any excess over his former remuneration to which O becomes entitled will be borne by M and N in the ratio of 2 : 3. The profits for the year ended 31st March, 2011 amounted to ₹ 4,44,000.

Prepare the Profit and Loss Appropriation Account, for the year ended on March 31, 2011.

Solution :

Profit and Loss Appropriation Account

for the year ended 31st March, 2011

Dr. Cr.

Particulars	*Amt. (₹)*	*Particulars*	*Amt. (₹)*
To Profit transferred to		By Profit as per Profit	
M's Capital A/c 2,40,000		and Loss A/c	4,44,000
Less: Trfd. to C 4,600	2,35,400		
N's Capital A/c 1,60,000			
Less: Trfd. A/c 6,900	1,53,100		
O's Capital A/c 44,000			
Add: From A 4,600			
From B 6,900	55,500		
	4,44,000		4,44,000

Notes

Working Notes :

				₹
1.	Profit for the year			
	O's Share as partner (1/8 x ₹ 4,44,000)	=		55,500
	Less: Amount payable to O as employee :			
	Salary	=	24,000	
	Commission $\frac{5}{105}$ (₹ 4,44,000 - ₹ 24,000)	=	20,000	44,000
	Deficiency			11,500

Deficiency chargeable to M and N in the ratio 2 : 3

∴ A to bear = 11,500 x 2/5 = 4,600

B to bear = 11,500 x 3/5 = 6,900

2. Profit for the year available to M and N (₹ 4,44,000 - C's share as Manager ₹ 44,000) = ₹ 4,00,000

A's Share = ₹ 4,00,000 x 3/5 = ₹ 2,40,000 - Share in deficiency

B's Share = ₹ 4,00,000 x 2/5 = ₹ 1,60,000 - Share in deficiency

Illustration 9 (Minimum earning Guaranteed by a Partner to the Firm and Minimum Profit Guaranteed by the Firm to a Partner)

Three Chartered Accountants A, B and C form a partnership, sharing profits and losses in the ratio of 3 : 2 : 1 subject to the following conditions:

i. C's share of profits is guaranteed to be not less than ₹ 3,00,000 p.a.

ii. B gives a guarantee to the effect that the gross fee earned by him for the firm shall not be less than the average gross fee earned by him during the preceding five years, when he was carrying on the profession alone (the average of which work out at ₹ 5,00,000)

The profits for the first year (year ended 31st March, 2011) of the partnership are ₹ 15,00,000. The gross fees earned by B for the firm are ₹ 3,20,000.

You are required to show the Profit and Loss Appropriation Account (after giving effect to the above).

Notes

Solution :

Profit and Loss Appropriation Account
for the year ended 31st March, 2011

Dr. Cr.

Particulars		*Amt. (₹)*	*Particulars*	*Amt. (₹)*
To Profit transferred to :			By Profit and Loss A/c	
A's Capital A/c	8,40,000		-Net Profit	15,00,000
Less: Deficiency of			By B's Capital A/c	1,80,000
C transferred	12,000	8,28,000	(W.N. 1)	
(W.N. 2)				
B's Capital A/c	5,60,000			
Less: Deficiency of				
C transferred	8,000	5,52,000		
(W.N. 2)				
C's Capital A/c	2,80,000			
Add: From A	12,000			
B	8,000	3,00,000		
		16,80,000		16,80,000

Working Notes :

	₹
1. Profits for the first year of partnership	15,00,000
Add: Difference between the guaranteed fees to be earned by B and actual fees earned (₹ 5,00,000 - ₹ 3,20,000)	1,80,000
Projected net profit of the firm	16,80,000

A's Share = ₹ 16,80,000 x 3/6 = ₹ 8,40,000

B's Share = ₹ 16,80,000 x 2/6 = ₹ 5,60,000

C's Share = ₹ 16,80,000 x 1/6 = ₹. 2,80,000

2. C was guaranteed a minimum sum of ₹ 3,00,000. Hence, the deficiency of ₹ 20,000 will be borne by A and B in the ratio of 3 : 2 as follows :

A - ₹ 20,000 x 3/5 = ₹ 12,000; B - ₹ 20,000 x 2/5 = ₹ 8,000

Thus, A's Share of Profit = ₹ 8,40,000 - ₹ 12,000 = ₹. 8,28,000

B's Share of Profit = ₹ 5,60,000 - ₹ 8,000 = ₹ 5,52,000

C's Share of Profit = ₹ 2,80,000 + ₹ 12,000 (A) + ₹ 8,000 (B)

Notes

In case, a partner has been guaranteed a minimum profit by the firm and also by a partner, first the guarantee given by a partner's shall be effected. This will be clear from the following illustration.

Illustration 10 (Guarantee by the Firm as well as by Partners)

P, Q, R and S are partners sharing profits and losses in the ratio of 4:3:2:1. Their capitals as on 1st April, 2012 were ₹ 3,00,000; ₹ 2,50,000; ₹ 1,50,000 and ₹ 1,00,000 respectively.

S's share of profits excluding interest on capital has been guaranteed by the firm to be not less than ₹ 2,50,000. R's share of profits including interest on capital and salary guaranteed by P is not less than ₹ 2,60,000.

The profits for the year ended 31st March, 2014 were ₹ 9,00,000 before interest on capital @ 10% and salary to R @ ₹ 10,000 per month.

Prepare the Profit and Loss Appropriation Account for the year ended on March 31, 2014.

Solution :

Profit and Loss Appropriation Account
for the year ended 31st March, 2014

Dr. Cr.

Particulars		*Amt. (₹)*	*Particulars*	*Amt. (₹)*
To Interest on Capitals :			By Profit and Loss A/c	
P (₹ 3,00,000 x 10/100)	30,000		- Profit	9,00,000
Q (₹ 2,50,000 x 10/100)	25,000			
R (₹ 1,50,000 x 10/100)	15,000			
S (₹ 1,00,000 x 10/100)	10,000	80,000		
To R's Salary (₹ 10,000 x 12)		1,20,000		
To Share of Profit :				
(₹ 9,00,000 - ₹ 80,000 -				
₹ 1,20,000) = ₹ 7,00,000				
P:4/10 of ₹ 7,00,000 =	2,80,000			
Less: Firms Deficiency				
borne (W.N.1)				
(₹ 1,80,000 x 4/9)	80,000			
Deficiency borne	25,000	1,75,000		
Q:3/10 of ₹ 7,00,000 =	2,10,000			

Notes

Less: Firm's Deficiency				
(₹1,80,000 x 3/9)	60,000	1,50,000		
R:2/10 of ₹ 7,00,000 =	1,40,000			
Less: Firm's Deficiency				
(₹ 1,80,000 x 2/9)	40,000			
	1,00,000			
Add: Deficiency recovered				
from P (W.N. 2)	25,000	1,25,000		
S:1/10 of ₹ 7,00,000 =	70,000			
Add: Deficiency recovered				
from P, Q and R	1,80,000	2,50,000		
		9,00,000		9,00,000

Working Notes :

1. Calculation of firm's deficiency :		₹
S's share of profit excluding interest on Capital has been guaranteed by firm		2,50,000
Less: S's share of profit (₹ 7,00,000 x 1/10)		70,000
Firm's deficiency borne by P, Q and R		1,80,000
2. Calculation fo deficiency recovered by R from P :-		
R's share of profits (₹ 7,00,000 x 2/10)		1,40,000
Less: R's share in firm's deficiency (₹ 1,80,000 x 2/9)		40,000
		1,00,000
Add : Interest on Capital	15,000	
Salary	1,20,000	1,35,000
		2,35,000
Deficiency recovered from P (Balancing Figure)		25,000
R's share of profits including interest on capital and salary is guaranteed by P		2,60,000

PAST ADJUSTMENT (Relating To Interest on Capital, Interest on Drawings, Salary and Change in Profit Sharing Ratio)

Sometimes, after closing the accounts of the partnership firm at the end of the financial year, it is discovered that there had been some errors or omissions in the accounts. In such cases, instead of altering the old accounts and the signed Balance Sheet an adjustment entry for such errors or omissions is made at the beginning of the next year. Usually the following types of adjustments are made:-

i. Omission of Interest on Capital or on Drawings.

ii. Distribution of Profit and Loss among the partners in the wrong proportion.

iii. Altering of Profit sharing ratio with effect from some past data i.e. respectively partner.

iv. Omission of salary or commission payable to a partner.

Illustration 11

P, Q and R are partners sharing profits and losses in the ratio of 3 : 2 : 1. After the final accounts have been prepared, it was discovered that interest on drawings had not been taken into consideration. The Interest on drawing of partners amounted to P - ₹ 500; Q - ₹ 360 and R - ₹ 200. Give the necessary adjusting journal entry.

Solution :

Interest charged on P's drawings	=	₹ 500
Interest charged on Q's drawings	=	₹ 360
Interest charged on R's drawings	=	₹ 200
Total interest to be charged from partners		₹ 1060

This amount of ₹ 1060 is an item of income for the firm but this has not been recorded on the credit side of P & L A/c of the previous year. As such the profit of the previous year will now be increased by this amount. Hence, this profit ₹ 1060 will be shared by the partners in their profit sharing ratio of 3:2:1 which amount to P ₹ 265, Q Rs. 177 and R ₹ 88.

Table Showing Adjustment

		P ₹	*Q* ₹	*R* ₹	*Total* ₹
Interest on Drawing	(Dr.)	500	360	200	1,060
Division of ₹ 530 in 3:2:1	(Cr.)	530	354	176	1,060
Difference		Cr. 30	Dr. 6	Dr. 24	----

Hence, the adjusting entry will be :

Journal Entry

	Particulars		*Dr.* ₹	*Cr.* ₹
	Q's Capital A/c	Dr.	6	

	R's Capital A/c Dr. To P's Capital A/c (Adjustment in respect of interest on drawing omitted in previous year's accounts)	24	30

Illustration 12

A, B and C are partners sharing profits and losses in the ratio of 3 : 2 : 1. After the final accounts have been prepared, it was discovered that interest on drawings @5% p.a. had not been taken into consideration. The drawings of the partners were : A - ₹ 75,000; B - ₹ 63,000; C - ₹ 60,000. Give the necessary adjusting journal entry.

Solutions :

Calculation of Interest on Drawings :

Since date of drawings are not given, interest will be charged for 6 months.

A : 5% on ₹ 75,000 for 6 months	=	1875
B : 5% on ₹ 63,000 for 6 months	=	1575
C : 5% on ₹ 60,000 for 6 months	=	1500
Total		4,950

Table Showing Adjustment

		A ₹	*B* ₹	*C* ₹	*Total* ₹
Interest on Drawings	(Dr.)	1,875	1,575	1,500	4,950
Division of Rs. 4,950 in 3:2:1	(Cr.)	2,475	1,650	825	4,950
		Cr. 600	Cr. 75	Dr. 675	-----

Journal Entry

Particulars	*Dr.* ₹	*Cr.* ₹
C's Capital A/c Dr.	675	
To A's Capital		600
To B's Capital		75
(Adjustment of omission of interest on drawings)		

Notes

Illustration 13

M and N were partners in a firm sharing profits in 3 : 2 ratio. Their respective fixed capitals were ₹ 2,00,000 and ₹ 3,00,000. The partnership deed provided the following:

i. Interest on capital @ 10% p.a.

ii. Interest on drawing @ 12% p.a.

During the year ended 31-3-2014, M's drawings were ₹. 1,000 per month drawn at the end of every month and N's drawings were ₹. 2,000 per month drawn in the beginning of the every month. After the preparation of final accounts for the year ended 31-3-2014 it was discovered that interest on M's drawings was not taken into consideration.

Calculate interest on M's drawings and give necessary adjusting entry for the same.

Solution :

Calculation of Interest on N's Drawings :

Total drawings for the year = ₹ 1,000 x 12 = ₹ 12,000

When equal amount is withdrawn at the end of every month, interest is calculated for an average period of months :

$$\text{Interest on Drawings} = 12{,}000 \times \frac{12}{100} \times \frac{5.5}{12} = ₹\,660$$

Table Showing Adjustment

		M ₹	N ₹	Total ₹
Interest on Drawings	(Dr.)	660		660
Division of Rs. 660 in 3 : 2	(Cr.)	396	264	660
	Difference	Dr. 264	Cr. 264	----

Adjustment Entry

	Particulars	Dr. ₹	Cr. ₹
	M's Current A/c Dr.	264	
	To N's Current A/c		264
	(Adjustment of omission of interest on drawings)		

Illustration : 14

X, Y and Z are partners sharing profits in the ratio of 5 : 4 : 3. Their capitals on 1st April 2013 were ₹ 5,00,000; ₹. 4,00,000 and ₹ 2,00,000 respectively. After closing the accounts on 31st March 2014 it was found out that according to the partnership agreement interest at 10% p.a. on partners' capital's a salary of ₹ 60,000 per year to B and a salary of ₹ 70,000 per year to C was not provided before distribution of profit. It was agreed among the partners to make the adjustment entry at the begining of the next year rather than to alter the Balance Sheet. Pass the necessary journal entry assuming that capitals are not fixed.

Solution :

Table Showing Adjustments

	X ₹	*Y* ₹	*Z* ₹	*Total* ₹
Interest on Capital @ 10% p.a.	50,000	40,000	20,000	1,10,000
Salaries	---	60,000	70,000	1,30,000
Total Amt. Payable (Cr.)	50,000	1,00,000	90,000	2,40,000
Division of firm's loss of ₹ 2,40,000 in 5 : 4 : 3 (Dr.)	1,00,000	80,000	60,000	2,40,000
	(Dr.) 50,000	(Cr.) 20,000	(Cr.) 30,000	-------

Journal Entry

Date	*Particulars*	*Dr.* ₹	*Cr.* ₹
Mar. 31	X's Capital A/c Dr.	50,000	
	To Y's Capital A/c		20,000
	To Z's Capital A/c		30,000
	(The adjustment for the omission of interest on capital and salary)		

Illustration 15

Ram and Rahim were partners in a firm sharing profits in the ratio of 7 : 5. Their respective fixed capitals were Ram ₹ 10,00,000 and Rahim ₹ 7,00,000. The partnership deed provided for the following :

i. Interest on Capital @ 12% p.a.

ii. Ram's Salary ₹ 72,000 per year and Rahim's salary ₹ 5,000 per month.

Notes

The profit for the year ended 31-3-2014 was ₹ 5,04,000 which was distributed equally, without providing for the above. Pass the adjustment entry.

Solution :

Statement of Adjustments

		Ram ₹	*Rahim* ₹	*Total* ₹
Interest on Capital	(Cr.)	1,20,000	84,000	2,04,000
Salary	(Cr.)	72,000	60,000	1,32,000
Profit remaining after allowing interest on capital and salary will be ₹ 5,04,000 - ₹ 2,04,000 - ₹ 1,32,000 = ₹ 1,68,000. It will be divided in their profit sharing ratio, *i.e.,* 7 : 5		98,000	70,000	1,68,000
Net amount which should have been received	(Cr.)	2,90,000	2,14,000	5,04,000
Less: Profit already distributed equally	(Dr.)	2,52,000	2,52,000	5,04,000
Net Effect		(Cr.) 38,000	(Dr.) 38,000	

Adjustment Entry

Date	*Particulars*		*Dr.* ₹	*Cr.* ₹
2014	Rahim's Current A/c	Dr.	38,000	
Apr. 1	To Ram's Current A/c			38,000
	(Adjustment for interest on capital, salary and wrongly distribution of profit)			

Illustration 16 (Cancellation of excessive interest)

P, Q and R are partners in a firm sharing profits and losses in the ratio of 2:3:5. Their fixed capital were ₹ 5,00,000; ₹ 10,00,000 and ₹ 20,00,000 respectively. For the year 2013 interest on capital was credited to them @12% instead of 10%. Pass the necessary adjustment entry.

Solution :

Table Showing Adjustment

		P	*Q*	*R*	*Total*
Excess interest	(Dr.)	10,000	20,000	40,000	70,000
Division in 2:3:5 ratio	(Cr.)	14,000	21,000	35,000	70,000
Net Effect		(Cr.) 4,000	(Cr.) 1,000	(Dr.) 5,000	----

Notes

Adjustment Entry

Date		₹	₹
Jan. 1	R's Current A/c Dr.	5,000	
	To P's Current A/c		4,000
	To Q's Current A/c		1,000
	(Interest excessive charged, now rectified)		

Illustration 17 (Rectification of Interest on Capital charged less)

Amar, Akbar and Anthony are partners in a firm sharing profits and losses in the ratio of 2 : 1 : 2. Their fixed capitals were ₹ 30,00,000; ₹ 10,00,000 and ₹ 20,00,000 respectively. Interest on capital for the year 2013 was credited to them @ 9% p.a. instead of 10% p.a. The profit for the year before charging interest was ₹ 25,00,000. Prepare necessary adjustment entry.

Solution :

Table Showing Adjustment

	Amar ₹	*Akbar* ₹	*Anthony* ₹	*Total* ₹
Less interest credited (Cr.)	30,000	10,000	20,000	60,000
Division in 2:1:2 ratio (Dr.)	24,000	12,000	24,000	60,000
Net Effect	(Cr.) 6,000	(Dr.) 2,000	(Dr.) 4,000	

Adjustment

2014		₹	₹
Jan. 1	Akbar's Current A/c Dr.	2,000	
	Anthony's Current A/c Dr.	4,000	
	To Amar's Current A/c		6,000
	(Interest less charged on capital, now rectified)		

Illustration 18

A, B and C are partners in a firm on 1st April 2013 their capital accounts stood at ₹ 3,00,000 ₹ 1,50,000 and ₹ 1,50,000 respectively.

As per the provisions of the deed :

i. C was to be allowed a remuneration of ₹ 30,000 p.a.

ii. Interest at 5% p.a. was to be provided on capital.

iii. Profits were to be divided in the ratio of 2 : 2 : 1.

Ignoring the above terms, net profit of ₹ 1,80,000 for the year ended 31st March 2014 was divided among the three partners equally.

Pass an adjustment entry to rectify the error. Show the workings clearly.

Solution :

Statement of Adjustment

		A ₹	*B* ₹	*C* ₹	*Total* ₹
Remuneration to C	(Cr.)			30,000	30,000
Interest on Capital	(Cr.)	15,000	7,500	7,500	30,000
Profit remaining after allowing remuneration and interest on capital will be ₹ 1,80,000 - ₹ 30,000 - ₹ 30,000 = ₹ 1,20,000. It will be divided in their profit sharing ratio, *i.e.,* 2 : 2 : 1.		48,000	48,000	24,000	1,20,000
Net amount which should have been received	(Cr.)	63,000	55,500	61,500	1,80,000
Less : Profit already distributed equally (Dr.)		60,000	60,000	60,000	1,80,000
Net effect		(Cr.) 3,000	(Dr.) 4,500	(Cr.) 1,500	------

Adjustment Entry

	Particulars		*Dr.* ₹	*Cr.* ₹
	B's Capital A/c	Dr.	4,500	
	To A/s Capital A/c			3,000
	To C's Capital A/c			1,500
	(Adjustment for remuneration, interest on capital and wrong distribution of profit)			

Illustration 19

X, Y and Z have been sharing profits in the ratio of 2 : 2 : 1 respectively. Z wants that he should be given equal share in profits with X and Y and he further wants that the change in the profits sharing ratio should come into effect retrospectively for the last three years. X and Y have no objection to this. The profit for last three years were, ₹ 60,000; ₹ 40,000 and ₹ 50,000.

Show the adjustment of profit for the last three years by means of a Journal entry.

Solution :

Table Showing Adjustments

		X ₹	Y ₹	Z ₹
Total Profits for the three years ₹60,000 + ₹40,000 + ₹50,000 = ₹1,50,000				
This Profit has already been divided in the ratio of 2 : 2 : 1	Dr.	60,000	60,000	30,000
If Profits are shared equally : $\frac{1,50,000}{3} = 50,000$	Cr.	50,000	50,000	50,000
Net Effect		Dr. 10,000	Dr. 10,000	Cr. 20,000

It is clear from the above table that X and Y, both have received ₹ 60,000 each, whereas each one of them should have received only ₹ 50,000 each. Therefore, X and Y will surrender ₹ 10,000 each in favour of Z.

Following adjustment entry will be passed for this purpose :

X's Capital A/c	Dr.	10,000	
Y's Capital A/c	Dr.	10,000	
To Z's Capital A/c			20,000
(Excess amount paid to X and Y now corrected)			

Illustration : 20

Ram, Mohan & Sohan are partners in a firm. They have omitted interest on capital @ 10% p.a. for three years ended 31st March 2014. Their fixed capitals on which interest was to be calculated throughout were :

Ram : ₹ 10,00,000; Mohan : ₹ 8,00,000; Sohan : ₹ 7,00,000

Give the necessary adjusting journal entry with working.

Solution :

Calculation of Interest for 3 years :

		₹
A : 10% on ₹ 10,00,000 for 3 years	=	3,00,000

B : 10% on ₹. 8,00,000 for 3 years	=	2,40,000
C : 10% on ₹ 7,00,000 for 3 years	=	2,10,000
Total		7,50,000

Table Showing Adjustment

		Ram ₹	Mohan ₹	Sohan ₹	Total ₹
Interest on Capital	(Cr.)	3,00,000	2,40,000	2,10,000	7,50,000
Division of Rs. 7,50,000 in profit sharing ratio *i.e.* equally	(Dr.)	2,50,000	2,50,000	2,50,000	7,50,000
Difference		Cr. 50,000	Dr. 10,000	Dr. 40,000	------

Journal Entry

Date 2014	Particulars		Dr. ₹	Cr. ₹
Apr. 1	Mohan's Current A/c	Dr.	10,000	
	Sohan's Current A/c	Dr.	40,000	
	To Ram's Current A/c			50,000
	(Omission of interest on capital for three years rectified)			

Note : Since the capitals are fixed, Current Account will be debited or credited.

WHAT YOU HAVE LEARNT

- Characteristics of partnership are : (i) Agreement; (ii) Number of persons; (iii) Business; (iv) Sharing of Profits; (v) Unlimited liability; (vi) Management; (vii) Mutual Agency; (viii) Transferability of share
- **Partnership Deed :** The written form of the agreement. It is a document in which the terms and conditions regarding the conduct of the business and the relationship between the partners are laid down. If there is no partnership deed or it is silent on certain issues, the Partnership Act becomes applicable. These issues are : (i) Distribution of Profit; (ii) Interest on capital; (iii) Interest on drawings; (iv) Interest on partner's loan; (v) Salary and commission to partners
- **Capital Account :** The contribution made by the partner's in a business is called capital. This capital may be fixed or fluctuating.

(a) Fixed Capital Account- Two separate accounts are kept for each partner i.e. 'capital account' and 'current account'.

(b) Fluctuating Capital Account – Only one account for each partner is kept i.e. capital account,

- **Profit and Loss Appropriation Account :** All adjustments such as partner's salary, partner's commission, interest on capital, interest on drawings etc. are made through this account.

- **Guarantee of Porfit :** In this case a minimum amount of profit is guaranteed to a partner. This amount shall be given to him if his share of profit is lower than the guaranteed amount. The deficit shall be borne either by one of the old partners or by all the old partners in a particular agreed ratio. If nothing has been agreed, then in their old profit sharing ratio of the remaining partners. If his actual share of profit is more than the guaranteed amount, then, he will be given his actual share of profit.

- **Past Adjustments :** If after closing the accounts for the year it is discovered that some errors have been committed or some ommissions have been made then these errors have to be rectified. An adjustment entry has to be passed to rectify the error. The entries are made without disturbing the signed balance sheet only through the capital account. These entries are to rectify the errors committed in past, therefore they are known as 'Past Adjustments'.

TERMINAL EXERCISE

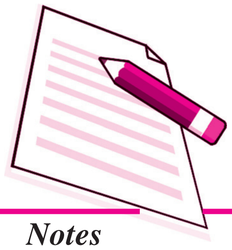
1. Explain the characteristics of a partnership.

2. In the absence of any partnership deed, what are the provisions that become applicable?

3. Distinguish between fixed and fluctuating capital accounts.

4. Why the Profit and Loss Appropriation Account is prepared?

5. A and B are partners in a firm. On January 1, 2013 their capital is ₹ 3,00,000 and ₹ 2,00,000 respectively. Their drawings during the year were ₹ 3,000 per month each. They allowed 6% interest on capital. The profit for the year ₹ 4,00,000. Calculate interest on capital for the year 2013 when capitals are fixed.



Notes

7. X and Y are equal partners. They withdrew ₹ 4,000 each per month. Calculate interest 4% p.a. on drawing in the following cases:

   (i) if they withdrew in the beginning of each month:

   (ii) if they withdrew at the end of each month:

   (iii) if they withdrew in the middle of each month:

8. Naman and Asmeta started business with capital of ₹ 1,00,000 each on January 1,2013. their drawings during the year were ₹ 1,000 and ₹ 500 per month respectively. The interest on drawing was ₹ 200 and ₹ 100 respectively. They are allowed interest on capital at 8% p.a. Naman is allowed a salary of ₹ 2,000 per month. They earned a profit of ₹ 94,000 before interest and salary. They share profit is the ratio of 2.1.

   Prepare Profit and Loss Appropriation Account for the year ended March 31, 2013 and Capital accounts of partners.

9. Rohan and Bhanu were partners in a firm and their balances on March 1, 2013 are as under:

	Rohan (₹)	***Bhanu*** (₹)
Capital accounts	90,000	1,20,000
Current account	8,000 (Cr)	4,000 (Dr.)
Drawings	5,000	6,000

   Net profit for the year 2013 before charging interest on capital and partners salary was ₹ 25,600. They agree on the following:

   (i) Profit and losses to be shared equally.

   (ii) 6% interest is to be allowed on capital.

   (ii) Bhanu will be paid a monthly salary ₹ 9,000.

   Prepare Profit and Loss Appropriation Account for the year ended on March 31, 2013 and partners capital accounts.

10. The partnership agreement of M and R provides that:

   (i) Profit will be shared in the ratio of 3 : 2.

(ii) M will be allowed a salary of ₹ 500 p.m.

(iii) 8% interest will be allowed on partner's fixed capital accounts.

(iv) 6 % interest to be charged on partners drawings.

(v) The fixed capital of M and R is ₹ 2,00,000 and ₹ 1,50,000 respectively. Their drawings were ₹ 10,000 and ₹ 12,000 respectively. The net profit for the year ending December 2013 amounted to ₹ 62,000.

Prepare Profit and Loss Appropriation Account.

11. What do you mean by guarantee of profits? Explain in brief.

12. Explain Past Adjustments.

ANSWERS TO INTEXT QUESTIONS

22.1 I. (i) Two (ii) agreement (iii) written, oral (iv) partnership deed (v) unlimited

II. (i) No (ii) Yes (iii) No (iv) No (v) No

22.2 (i) Credit (ii) Fluctuating (iii) fixed (iv) Credit (v) Debit

22.3 I. (i) credited (ii) Debited (iii) Opening balance (iv)6½ months

II. Interest on capital Reema ₹ 6250 and Anish ₹ 8,000

III. Interest on Drawings ₹ 1100

22.4 (i) Partner's salary, partner's commission, interest on capital, interest on partner's loan.

(ii) Profit and Loss Appropriation A/c Dr.
To Profit and Loss A/c

(iii) Interest on Drawings A/c Dr.
To Profit and Loss Appropriation A/c

ANSWERS TO TERMINAL EXERCISE

5. Interest on Capital to 'A' ₹ 18,000 and 'B' ₹ 12,000.

6. (i) ₹ 1,040, (ii) ₹ 880, (iii) ₹ .960.

Notes

7. Profit distributed to Naman ₹ 36,200 and Asmeta ₹ 18,100
Balance in Capital A/c Naman ₹ 1,56,00 and Asmeta ₹ 1,20,000.

8. Profit distributed to Rohan ₹ 1,100 and Bhanu ₹ 1,100
Balance in current A/c Rohan ₹ 9,500 and Asmeta ₹ 9,100.

9. Profit distributed to M ₹ 17,592 and R ₹ 11,728

ACTIVITY

Make use of your communication skills to obtain Partnership Deed of five firms. Go through partnership deed of such firms. Identify the provisions which are not common. Also find out the important items that you would like to include in one of the partnership deeds.

	Name of the firm	*Items that are exclusive to the firm*	*Items to be included*
1.			
2.			
3.			
4.			
5.			

List of the items you suggest to be included in the partnership deeds

1. ....
2. ....
3. ....
4. ....
5. ....