CHAPTER 8

PARTNERSHIP ACCOUNTS

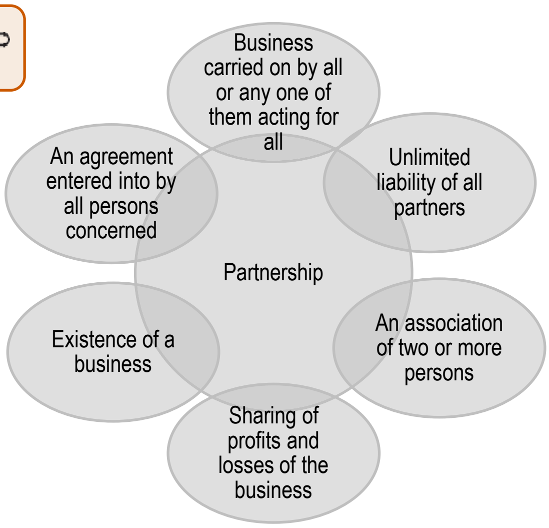
UNIT – 1 INTRODUCTION TO PARTNERSHIP ACCOUNTS

LEARNING OUTCOMES

After studying this unit, you would be able to:

- Understand the provisions of the Indian Partnership Act, 1932 and the Limited Liability Partnership Act, 2008
- Understand the features of a partnership firm and the need for a Partnership Deed.
- Understand the points to be covered in a Partnership Deed regarding accounts.
- Learn the technique of maintaining Profit and Loss Appropriation Account.
- Familiarize with the two methods of maintaining Partners' Capital Accounts, namely Fixed Capital Method and Fluctuating Capital Method.
- Note that Capital Account balance as per Fluctuating Capital method is just equal to the sum of the balances of Capital Account and Current Account as per Fixed Capital Method.
- Learn how to arrive at the corrected net profit figure which is to be taken to be Profit and Loss Appropriation Account after rectification of errors. Rectification of errors may be necessary to arrive at the net profit of the partnership and preparing Profit and loss Appropriation Account.
- Learn that interest on capital and drawings, salaries/commissions are to be shown in the Profit and Loss Appropriation Account and not in the Profit and Loss Account. Also learn that drawings by partners will not appear in the Appropriation Account.

UNIT OVERVIEW



Accounts of Partnership firm		
Trading and Profit and Loss Account and Balance Sheet	Profit and Loss Appropriation Account	Capital accounts of partners (fixed capital method or fluctuating capital method)

1.1 INTRODUCTION: WHY PARTNERSHIP?

An individual i.e., a sole proprietor may not be in a position to cope with the financial and managerial demands of the present day business world. As a result, two or more individuals may decide to pool their financial and non-financial resources to carry on a business. The preparation of final accounts of sole proprietors have already been discussed in chapter 6. The final accounts of partnership firms including basic concepts of accounting for admission of a partner, retirement and death of a partner have been discussed in succeeding units of this chapter.

1.2 DEFINITION AND FEATURES OF PARTNERSHIP

As per **Section 4** of the Partnership Act, 1932:

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

Features of a partnership,

(i) **Existence of an agreement: As per section 5 of the Indian Partnership Act, 1932,** The relation of partnership arises from contract between parties and not from status as it happens in case of HUF (Hindu Undivided Family). **A formal or written agreement is not necessary to create a partnership.**

(ii) **Business:** A partnership can exist only in business. Thus, it is not the agreement alone which creates a partnership. A partnership comes into existence only when partners begin to carry on business in accordance with their agreement. **Section 2 (b)of Indian Partnership Act, 1932 only states that business includes every trade, occupation and profession.**

(iii) **Sharing of profit:** The persons concerned must agree to **share the profits of the business.** Because no person is a partner unless he or she has the right to share the profits of the business. **Section 4 of Indian Partnership Act, 1932** does not insist upon sharing of losses. Thus, a provision for sharing of loss is not necessary.

(iv) **Mutual agency:** It means that the business is to be carried on by all or any of them acting for all. Thus, if the person carrying on the business acts not only for himself but for others also so that they stand in the positions of principals and agents, they are partners.

(v) **Minor as a partner:** A minor can be added in partnership firm. But the condition is that he can be admitted to share profit only. He cannot be made to share losses of the firm. If the partnership firm suffers loss than it will be borne by other major partners is their profit sharing ratio.

Number of Partners: Minimum Partners: Two

Maximum Partners: As per Section 464 of the Companies Act, 2013, no association or partnership consisting of more than 100 number of persons as may be prescribed shall be formed for the purpose of carrying on any business. Rule 10 of Companies (incorporation) Rules 2014 specifies the limit as 50. Thus, maximum number of members in a partnership firm are 50.

1.3 LIMITED LIABILITY PARTNERSHIP

The Indian Partnership Act of 1932 provides for a general form of partnership which has inherent shortcoming of unlimited liability of all partners for business debts and legal consequences, regardless of their holding or profit sharing ratio, as the firm is not a legal entity. General partners are also jointly and severally liable for tortuous acts of co-partners. In case of liquidation personal assets of partners can be liquidated to meet liabilities of the firm.

With the growth of the Indian economy, the role played by its entrepreneurs as well as its technical and professional manpower has been acknowledged internationally. Entrepreneurship, knowledge, risk and capital may be combined to provide a further impetus to India's economic growth. In this background, a need has been felt for a new corporate form that would provide an alternative to the traditional partnership, with unlimited personal liability on the one hand, and, the statute-based governance structure of the limited liability company on the other. This would enable professional expertise and entrepreneurial initiative to combine, organize and operate in flexible, innovative and efficient manner.

The Government felt that with Indian professionals increasingly transacting with or representing multi-nationals in international transactions, the extent of the liability they could potentially be exposed to, is extremely high. Hence, in order to encourage Indian professionals to participate in the international business community without apprehension of being subject to excessive liability, the need for having a legal structure like the LLP is encouraged. Thus in convergence towards global scenario, Limited Liability Partnership Act, 2008 was introduced.

The Limited Liability Partnership (LLP) is viewed as an alternative corporate business proposal that provides the benefits of limited liability but allows its members, the flexibility of organizing their internal structure as a partnership, which is based on a mutually arrived agreement.

The LLP will be a separate legal entity, liable to the full extent of its assets, with the liability of the partners being limited to their agreed contribution in the LLP which may be of tangible or intangible nature or both tangible and intangible in nature. No partner would be liable on account of the independent or un-authorized actions of other partners or their misconduct. The liabilities of the LLP and partners who are found to have acted with intent to defraud Creditors or for any fraudulent purpose shall be unlimited for all or any of the debts or other liabilities of the LLP.

The main benefit in an LLP is that it is taxed as a partnership, but has the benefits of being a corporate, or more significantly, a juristic entity with limited liability. An LLP has the special characteristic of being a separate legal personality distinct from its partners. The LLP is a body corporate in nature.

The Limited Liability Partnerships (LLPs) in India were introduced by Limited Liability Partnership Act, 2008 which lay down the law for the formation and regulation of Limited Liability Partnerships.

1.3.1 Definition of LLP

Section 2 of the Limited Liability Partnership (LLPs) Act, 2008 defines **limited liability partnership"** as a partnership formed and registered under this Act; and **"limited liability partnership agreement"** means any written agreement between the partners of the limited liability partnership or between the limited liability partnership and its partners which determines the mutual rights and duties of the partners and their rights and duties in relation to that limited liability partnership.

1.3.2 Non-applicability of the Indian Partnership Act, 1932

Save as otherwise provided, the provisions of the Indian Partnership Act, 1932 shall not apply to a limited liability partnership.

1.3.3 Minimum number of partners in case of LLP

As per the LLP Act, any individual or body corporate may be a partner in a limited liability partnership; provided that an individual shall not be capable of becoming a partner of a limited liability partnership, if-

(a) he has been found to be of unsound mind by a Court of competent jurisdiction and the finding is in force;

(b) he is an undischarged insolvent; or

(c) he has applied to be adjudicated as an insolvent and his application is pending.

Every limited liability partnership shall have at least two partners.

If at any time the number of partners of a limited liability partnership is reduced below two and the limited liability partnership carries on business for more than six months while the number is so reduced, the person, who is the only partner of the limited liability partnership during the time that it so carries on business after those six months and has the knowledge of the fact that it is carrying on business with him alone, shall be liable personally for the obligations of the limited liability partnership incurred during that period.

1.4 DISTINCTION BETWEEN AN ORDINARY PARTNERSHIP FIRM AND AN LLP

	Key Elements	Partnerships	LLPs
1	Applicable Law	Indian Partnership Act 1932	The Limited Liability Partnerships Act, 2008
2	Registration	Optional	Compulsory with ROC
3	Creation	Created by an Agreement	Created by Law
4	Body Corporate	No	Yes
5	Separate Legal Entity	No	Yes
6	Perpetual Succession	Partnerships do not have perpetual succession	It has perpetual succession and individual partners may come and go
7	Number of Partners	Minimum 2 and Maximum 50	Minimum 2 but no maximum limit
8	Ownership of Assets	Firm cannot own any assets. The partners own the assets of the firm	The LLP as an independent entity can own assets
9	Liability of Partners / Members	Unlimited: Partners are severally and jointly liable for actions of other partners and the firm and their liability extends to personal assets	Limited to the extent of their contribution towards LLP except in case of intentional fraud or wrongful act of omission or commission by a partner.
10	Principal Agent Relationship	Partners are the agents of the firm and of each other	Partners are agents of the firm only and not of other partners

However, in the chapter the scope of discussion has been restricted to Partnership accounts as per the Indian Partnership Act, 1932 only.

1.5 MAIN CLAUSES IN A PARTNERSHIP DEED

The relation between the partners is governed by mutual agreement known as partnership deed. It should be comprehensive to avoid disputes later on. It is usual therefore, to find the following clauses in a Partnership Deed which may or may not be registered.

1. Name of the firm and the partners;
2. Commencement and duration of business;
3. Amount of capital to be contributed by each partner;
4. Amount to be allowed to each partner as drawings and the timings of such drawings;
5. Rate of interest to be allowed to each partner on his capital and on his loan to the firm, and to be charged on his drawings;
6. The ratio in which profits or losses are to be shared;
7. Whether a partner will be allowed to draw any salary;
8. Any variations in the mutual rights and duties of partners;
9. Method of valuing goodwill on the occasions of changes in the constitution of the firm;
10. Procedure by which a partner may retire and the method of payment of his dues;
11. Basis of the determination of the executors of a deceased partner and the method of payment;
12. Treatment of losses arising out of the insolvency of a partner;
13. Procedure to be allowed for settlement of disputes among partners;
14. Preparation of accounts and their audit.

Registration of the firm is not compulsory, but non-registration restricts the partners or the firm from taking any legal action. Often there is no written Partnership Deed or, if there is one, it may be silent on a particular point. In that case the relevant sections of the Partnership Act will apply. If on any point the Partnership Deed contains a clause, it will hold good; otherwise the provisions of the Act relating to the questions will apply.

Rules in the absence of Partnership Deed

In the absence of any agreement to the contrary;

1. No partner has the right to a salary,
2. No interest is to be allowed on capital,
3. No interest is to be charged on the drawings,
4. Interest at the rate of 6%.p.a is to be allowed on a partner's loan to the firm, and
5. Profits and losses are to be shared equally.

Note: In the absence of an agreement, the interest and salary payable to a partner will be paid only if there is profit.

Example

A and B commenced business in partnership on 1 January 2019. No partnership agreement was made either oral or written. They contributed ₹ 40,000 and ₹ 10,000 respectively as capital. In addition, A also advanced ₹ 20,000 on 1 July 2019. A met with an accident on 1 April 2019 and could not attend to the partnership business upto 30 June 2019. The profits for the year ended on 31 December 2019 amounted to ₹ 50,600. Disputes having been arisen between them for sharing the profits.

A claims: (i) He should be given interest at 10% p.a. on capital and loan (ii) Profit should be distributed in proportion of capital.

B claims: (i) Net profit should be shared equally. (ii) He should be allowed remuneration of ₹ 1,000 p.m. during the period of A's illness. (iii) Interest on capital and loan should be given @ 6% p.a. You are required to settle the dispute between them and distribute the profits according to law. State reasons for your answer.

Answer

Since there is no written or oral partnership agreement, allowing rules are applicable as per Indian partnership act 1932

(a) No interest is allowed on capital.

(b) 6% p.a. interest is allowed on the loan advanced.

(c) Profits and losses shall be shared equally.

(d) No remuneration is allowed to any partner for taking part in the conduct of the business.

Thus

a) neither of A nor B will be allowed interest on capital

b) 6% interest will be allowed to both A and B

c) Profit and losses shall be shared equally between A and B

d) No remuneration shall be allowed to B.

Net profit for the year		=	50,600
Less: Int. on A's loan 20,000 × 6% × 6/12		=	600
Net Profit		=	50,000
A's 50%	25,000		
B's 50%	25.000		

Example

A, B and C are partners in a firm sharing profits and losses in the ratio of 2:3:5. Their fixed capitals were ₹ 15,00,000, ₹ 30,00,000 and ₹ 60,00,000 respectively. For the year 2019 interest on capital was credited to them @ 12% instead of 10%. Pass the necessary adjustment entry.

Particulars	A	B	C	Firm
Interest that should have been credited @ 10%	1,50,000	3,00,000	6,00,000	10,50,000

Interest already credited @ 12%	1,80,000	3,60,000	7,20,000	12,60,000
Excess credit in partners account	(30,000)	(60,000)	(1,20,000)	(2,10,000)
By recovering the extra amount paid, the share of profits will increase and it will be credited in the ratio of 2:3:5	42,000	63,000	105,000	2,10,000
Net effect	12,000	3,000	(15,000)	-

The necessary journal entry will be:

Particulars	Debit (₹)	Credit (₹)
C's Capital A/c	15,000	
To A's Capital A/c		12,000
To B's Capital A/c		3,000
(Interest less charged now rectified)		

1.6 POWERS OF PARTNERS

The Partners are supposed to have the power to act in certain matters and not to have such powers in others. In other words, unless a public notice has been given to the contrary, certain contracts entered into by a partner on behalf of the partnership, even without consulting other partners are binding on the firm and the provisions of the Act relating to the question will apply. In case of a trading firm, the implied powers of partners are the following:

(a) Buying and selling of goods;

(b) Receiving payments on behalf of the firm and giving valid receipt;

(c) Drawing cheques and drawing, accepting and endorsing bills of exchange and promissory notes in the name of the firm;

(d) Borrowing money on behalf of the firm with or without pledging the inventories-in-trade;

(e) Engaging servants for the business of the firm.

In certain cases an individual partner has no power to bind the firm. This is to say that third parties cannot bind the firm unless all the partners have agreed. These cases are:

(a) Submitting a dispute relating to the firm arbitration;

(b) Opening a bank account on behalf of the firm in the name of a partner;

(c) Compromise or relinquishment of any claim or portion of claim by the firm;

(d) Withdrawal of a suit or proceeding filed on behalf of the firm;

(e) Admission of any liability in a suit or proceedings against the firm;

(f) Acquisition of immovable property belonging to the firm;

(g) Entering into partnership on behalf of the firm.

The rights, duties and powers of partners can be changed by mutual consent.

1.7 ACCOUNTS

Partnership Act doesn't specify any format for preparation of accounts of Partnership Firm and thus accounts are prepared as per Basic rules of accounts. There is not much difference between the accounts of a partnership firm and that of sole proprietorship (provided there is no change in the firm itself). The only difference to be noted is that instead of one Capital Account there will be as many Capital Accounts as there are partners. If, for instance, there are three partners; A, B, and C, then there will be a Capital Account for each one of the partners; A's Capital Account will be credited by the amount contributed by him as capital and similarly B's and C's Capital Accounts will be credited with the amounts brought in by them respectively as capital.

When a partner takes money out of the firms for his domestic purpose, either his Capital Account can be debited or a separate account, named as Drawings Account, can be opened in his name and the account may be debited. In a Trial Balance of a partnership firm, therefore, one may find Capital Accounts of partners as well as Drawings Accounts. Finally the Drawings Account of a partner may be transferred to his Capital Account so that a net figure is available. But, often the Drawings Account or Current Account (as it is usually called) remains separate.

1.8 PROFIT AND LOSS APPROPRIATION

During the course of business, a partnership firm will prepare Trading Account and a Profit and Loss Account at the end of every year. The final accounts of a sole proprietorship concern will not differ from the accounts of a partnership firm. The Profit and Loss Account will show the profit earned by the firm or loss suffered by it. This profit or loss has to be transferred to the Capital Accounts of partners according to the terms of the Partnership Deed or according to the provisions of the Indian Partnership Act (if there is no Partnership Deed or if the Deed is silent on a particular point). Suppose the Profit and Loss Account reveals a profit of ₹ 90,000. There are two partners, A and B. A devotes all his time to the firm; B does not. A's capital is ₹ 50,000 and B's is ₹ 20,000. There is no Partnership Deed. In such a case the profit will be distributed among A and B equally. This is irrespective of the fact that B does not work as much as A does and B's capital is much less than that of A. But if the Partnership Deed lays down that A is to get a salary and interest is to be allowed on the capital, then first of all, from the profit earned, A's salary must be deducted and interest on the Capital Accounts of both partners will be deducted. The remaining profit will be divided equally between A and B. Further if the Partnership Deed says that profits are to be divided in the ratio of, say, three-fourth to A and one-fourth to B, then this will be the ratio to be adopted.

In a partnership, profit has to be divided between the partners in a certain profit sharing ratio after making necessary adjustments stated in the partnership deed such as interest on capitals, drawings and loans; salaries or/and commission to partners etc. Accordingly, an additional account is prepared and net profit is transferred from the debit side of the profit and loss account to the credit side of this new account which is called Profit and Loss Appropriation Account and before the profit is divided between partners, it is necessary to record the above stated adjustments in this account.

The student can see for himself that if salary is to be allowed to a partner, the Profit and Loss Appropriation Account will be debited and the Partner's Capital Account will be credited. Similarly, if interest is to be allowed on capital, the Profit and Loss Appropriation Account will be debited and the respective Capital Accounts will be credited.

Let us take an illustration to understand how to divide profits among partners.

ILLUSTRATION 1

A and B start business on 1st January, 2019, with capitals of ₹30,000 and ₹20,000. According to the Partnership Deed, B is entitled to a salary of ₹500 per month and interest is to be allowed on capitals at 6% per annum. The remaining profits are to be distributed amongst the partners in the ratio of 5:3. During 2019 the firm earned a profit, before charging salary to B and interest on capital amounting to ₹25,000. During the year A withdrew ₹8,000 and B withdrew ₹10,000 for domestic purposes.

Give journal entries relating to division of profit.

SOLUTION

Journal Entries

2019	Particulars		Dr. (₹)	Cr. (₹)
Dec. 31	Profit and Loss Appropriation Account	Dr.	6,000	
	To B's Capital Account			6,000
	(Salary due to B @ ₹ 500 per month)			
	Profit and Loss Appropriation Account	Dr.	3,000	
	To A's Capital Account			1,800
	To B's Capital Account			1,200
	(Interest due on Capital @ 6% per month)			
	Profit and Loss Appropriation Account	Dr.	16,000	
	To A's Capital Account			10,000
	To B's Capital Account			6,000
	(Remaining profit of ₹ 16,000 divide between A and B in the ratio of 5:3)			

Now, let us learn the preparation of profit and loss appropriation account with the help of same illustration of partnership firm consisting of partners A and B.

ILLUSTRATION 2

Ram, Rahim and Karim are partners in a firm. They have no agreement in respect of profit-sharing ratio, interest on capital, interest on loan advanced by partners and remuneration payable to partners. In the matter of distribution of profits they have put forward the following claims:

(i) Ram, who has contributed maximum capital demands interest on capital at 10% p.a. and share of profit in the capital ratio. But Rahim and Karim do not agree.

(ii) Rahim has devoted full time for running the business and demands salary at the rate of ₹500 p.m. But Ram and Karim do not agree.

(iii) Karim demands interest on loan of ₹ 2,000 advanced by him at the market rate of interest which is 12% p.a.

How shall you settle the dispute and prepare Profit and Loss Appropriation Account after transferring 10% of the divisible profit to Reserve. Net profit before taking into account any of the above claims amounted to ₹45,000 at the end of the first year of their business

SOLUTION

There is no partnership deed. Therefore, the following provisions of the Indian Partnership Act are to be applied for settling the dispute.

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

(ii) No remuneration is payable to any partner. Therefore, Rahim is not entitled to any salary.

(iii) Interest on loan is payable @ 6% p.a. Therefore, Karim is to get interest @ 6% p.a. on ₹ 2,000 instead of 12%.

(iv) The profits should be distributed equally.

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

	Particulars		₹	Particulars	₹
To	Interest on Karim Loan A/c			By Profit and Loss A/c -	45,000
	(₹ 2,000 x 6/100)		120	(Net profit)	
To	Reserve A/c – 10% of				
	₹ (45,000-120)		4,488		
To	Share of Profit A/c :				
	Ram capital A/c	₹ 13,464			
	Rahim capital A/c	₹ 13,464			
	Karim capital A/c	₹ 13,464	40,392		
			45,000		45,000

ILLUSTRATION 3

A and B start business on 1st January, 2019, with capitals of ₹ 30,000 and ₹ 20,000. According to the Partnership Deed, B is entitled to a salary of ₹ 500 per month and interest is to be allowed on opening capitals at 6% per annum. The remaining profits are to be distributed amongst the partners in the ratio of 5:3. During 2019 the firm earned a profit, before charging salary to B and interest on capital amounting to ₹ 25,000. During the year A withdrew ₹ 8,000 and B withdrew ₹ 10,000 for domestic purposes.

Prepare Profit and Loss Appropriation Account.

SOLUTION

Profit and Loss Appropriation Account for the year ended 31-Dec-19

Particulars	₹	Particulars	₹
To B's Capital Account-Salary	6,000	By Net Profit	25,000
To A's Capital Account-interest	1,800		
To B's Capital Account-interest	1,200		
To Profit transferred to :			
A's Capital Account (5/8)	10,000		
B's Capital Account (3/8)	6,000		
	25,000		25,000

NOTE: Since date of drawing & rate of interest on drawing is not given, it is assumed drawings are made on last day of year.

Let us also learn the preparation of capital accounts of partners with the help of same illustration of partnership firm consisting of partners A and B.

ILLUSTRATION 4

A and B start business on 1st January, 2019, with capitals of ₹30,000 and ₹20,000. According to the Partnership Deed, B is entitled to a salary of ₹500 per month and interest is to be allowed on opening capitals at 6% per annum. The remaining profits are to be distributed amongst the partners in the ratio of 5:3. During 2019, the firm earned a profit, before charging salary to B and interest on capital amounting to ₹25,000. During the year A withdrew ₹8,000 and B withdrew ₹10,000 for domestic purposes.

Prepare Capital Accounts of Partners A and B.

SOLUTION

Dr. **A's Capital Account** Cr.

2019	Particulars	₹	2019	Particulars	₹
Dec. 31	To Bank A/c- (Drawings)	8,000	Jan. 1	By Bank A/c	30,000
	To Balance c/d	33,800	Dec. 31	By Profit and Loss appropriation A/c	
				Interest	1,800
				By Profit and Loss appropriation A/c- (5/8 Profit)	10,000
		41,800			41,800
			2020		
			Jan. 1	By Balance b/d	33,800

Dr. **B's Capital Account** Cr.

2019	Particulars	₹	2019	Particulars	₹
Dec. 31	To Bank A/c- (Drawings)	10,000	Jan. 1	By Bank A/c	20,000
Dec. 31	To Balance c/d	23,200	Dec. 31	By Profit and Loss A/c	
				- Salary	6,000
				-Interest	1,200
				By Profit and Loss A/c	6,000
				- (3/8 Profit)	
		33,200			33,200
			2020		
			Jan. 1	By Balance b/d	23,200

1.9 FIXED AND FLUCTUATING CAPITAL

You have seen in the above example that the Capital Account of A has changed from ₹ 30,000 at the beginning to ₹ 33,800 and B's Capital A/c from ₹ 20,000 to ₹ 23,200. This is because we have made entries in respect of interest, salary, profit earned during the year and money taken out by the partners in the Capital Account itself. If the Capital Accounts are prepared on this basis, capitals are said to be fluctuating. Some firms, however, prefer to continue to show the Capital Accounts of the partners at the same old figure. This means that no entry is to be made in the Capital Account in respect of interest, salary, profit and drawings etc. A separate account is to be opened for this purpose. This account is known as the Current Account or even as Drawings Account. Under this system interest on capital if allowed, should be calculated only on the amount of the fixed capital. If the capital Accounts are prepared on this basis, capitals are said to be fixed.

Thus, there are two methods of accounting –

i) **Fixed capital method and**

ii) **Fluctuating capital method.**

In Fixed capital method, generally initial capital contributions by the partners are credited to partners' capital accounts and all subsequent transactions and events are dealt with through current accounts, Unless a decision is taken to change it, initial capital account balance is not changed.

In Fluctuating capital method, no current account is maintained. All such transactions and events are passed through capital accounts. Naturally, capital account balance of the partners fluctuates every time. So in fixed capital method a fixed capital balance is maintained over a period of time while in fluctuating capital method capital account balances fluctuate all the time.

1.9.1 Interest on Capital:

A partner is not entitled to interest on his capital as a matter of right. But if there is an agreement, that partner would receive interest on his capital it is paid at the agreed rate only out of profits. Interest on capital is generally calculated on the opening balance and allowance is made for any additions of capital or withdrawals there from during the accounting period.

- The amount of interest is debited to interest on capital accounts and credited to the capital accounts, if capitals are fluctuating and current accounts, if capitals are fixed. Interest on capital account is then closed by transfer to profit and loss appropriation account.
- Alternatively, credit the capital (or current) account of the partner concerned and debit the profit and loss appropriation account.

For interest on capital

Profit and Loss Appropriation Account Dr.

To (Individual) Capital (or Current) Accounts of Partners

Interest is generally allowed on capitals of the partners. Interest on capital of partners is calculated for the relevant period for which the amount of capital has been used in the business. Normally, it is charged for full year on the balance of capital at the beginning of the year unless some fresh capital is introduced during the year. On the additional capital introduced, interest for the relevant period of utilization is calculated. For example, A has

₹30,000 capital in the beginning of the year and introduces ₹10,000 during the year. If rate of interest on capital is 20 % p.a., interest on A's capital is calculated as follows:

$$\left[30{,}000\times\frac{20}{100}\right]+\left[10{,}000\times\frac{20}{100}\times\frac{6}{12}\right]=₹\ 6{,}000+₹\ 1{,}000=₹\ 7{,}000$$

In case of fixed capital accounts, interest is calculated on the balance of capital accounts only and no interest is payable / chargeable on the balance of current accounts.

Net loss and Interest on Capital: *Subject to contract between the partners, interest on capitals is to be provided out of profits only. Thus in case of loss, no interest is provided. But in case of insufficient profits (i.e., net profit less than the amount of interest on capital), the amount of profit is distributed in the ratio of capital as partners get profit by way of interest on capital only.*

Example

1. Shilpa and Sanju are partners with a capital of ₹1,00,000 and ₹1,60,000 on January 1,2019 respectively. Shilpa introduced additional capital of ₹30,000 on July 1, 2019 and another ₹20,000 on October 31,2019. Calculate interest on capital for the year ending 2019. 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

Interest on capital 14,20,000 × 09/100 × 1/12 = ₹ 10,650

Interest on Capital (Sanju):

On ₹1,60,000 for 12 month @ 9% = 1,60,000 × 9/100 × 12/12 = ₹14,400

By product method: = 1,60,000 × 12 = 19,20,000

$$= 19,20,000 \times \frac{9}{100} \times \frac{1}{12} = 14,400$$

1.9.2 Interest on Drawings

Sometimes interest is not only allowed on the capitals, but is also charged on drawings. In such a case, interest will be charged according to the time that elapses between the taking out of the money and the end of the year.

Method 1: Product Method: When Unequal amount is withdrawn at different time period.

Suppose X, a partner, has drawn the following sum of money –

	₹
On 29th February, 2020	500
On 31st March, 2020	400
On 30th June, 2020	600
On 31st October, 2020	800

Accounts are closed on 31st December every year. Interest is chargeable on drawings at 6% per annum. The interest on X's drawings will be calculated as shown below:

		₹
1.	On ₹ 500 for 10 months, i.e.	25
2.	On ₹ 400 for 9 months, i.e.	18
3.	On ₹ 600 for 6 months, i.e.	18
4.	On ₹ 800 for 2 months, i.e.	8
	Total	69

Alternatively, it can be calculated as follows:

Amount (₹)	Number of months	Product
500	10	5,000
400	9	3,600
600	6	3,600
800	2	1,600
2,300		13,800

Interest on ₹ 13,800 for one month at 6% per annum is ₹ 69.

If the dates on which amounts are drawn are not given, the student will do well to charge interest for six months on the whole of the amount on the assumption that the money was drawn evenly through out the year. In the above example, the total drawings come to ₹ 2,300; and at 6% for 6 months, the interest comes to ₹ 69. The entry to record interest on drawings is- debit the Capital Account of the partner concerned (or his Current Account if the capital is fixed) and credit the Profit and Loss Appropriation Account.

If withdrawals are made evenly in the beginning of each month, interest can be calculated easily for the whole of the amount of 6-1/2 months; if withdrawals are made at the end of each month, interest should be calculated for 5-1/2 months. If withdrawals are mode at the beginning of each quarter, interest can be calculated by Total drawings × Rate × 100 × 7.5/12.

However, if withdrawals are at end of each quarter, the formula : Total drawings × Rate × 100 × 4.5/12 will apply.

1.9.3 Guarantee of Minimum Profit

Sometimes, one partner can enjoy the right to have minimum amount of profit in a year as per the terms of the partnership agreement. In such case, allocation of profit is done in a normal way if the share of partner, who has been guaranteed minimum profit, is more than the amount of guaranteed profit. However, if share of the partner is less than the guaranteed amount, he takes minimum profit and the excess of guaranteed share of profit over the actual share is borne by the remaining partners as per the agreement.

There are three possibilities as far as share of deficiency by other partners is concerned. These are as follows:

- Excess is payable by one of the remaining partners.
- Excess is payable by at least two or all the partners in an agreed ratio.
- Excess is payable by remaining partners in their mutual profit sharing ratio.

If the question is silent about the nature of guarantee, the burden of guarantee is borne by the remaining partners in their mutual profit sharing ratio.

1.9.4 Capital ratio

Partners may agree to share profits and losses in the capital ratio. When capitals are fixed, profits will be shared in the ratio of given capitals. But if capitals are fluctuating and partners introduce or withdraw capitals during the year, the capitals for the purpose of ratio would be determined with reference to time on the basis of weighted average method. Example

A and B formed a partnership with a capital contribution of ₹50,000 and ₹30,000 respectively on 1st January 2019. The profits were to be shared in the capital ratio. Calculate the capital ratio on the basis of following details:

	Capital Introduced		Capital Withdrawn	
	A ₹	B ₹	A ₹	B ₹
31 March	5,000	–	–	2,000
1 July	–	9,000	3,000	–
1 September	5,500	–	–	1,000
1 November	–	4,000	4,500	–

SOLUTION

Total Capital Employed by A for one Month

Capital	Months for which capital has been used in the business	Product
(₹)		(₹)
50,000	3	1,50,000
55,000	3	1,65,000
52,000	2	1,04,000
57,500	2	1,15,000
53,000	2	1,06,000
Total		6,40,000

Total Capital Employed by B for one Month

Capital	Months for which capital has been used in the business	Product
(₹)		(₹)
30,000	3	90,000
28,000	3	84,000
37,000	2	74,000
36,000	2	72,000
40,000	2	80,000
Total		4,00,000

On the basis of products of both the partners, the capital ratio between A and B is 64: 40 or 8 : 5.

ILLUSTRATION 5

A and B are partners sharing profits and losses in the ratio of their effective capital. They had ₹ 1,00,000 and ₹ 60,000 respectively in their Capital Accounts as on 1st January, 2019.

A introduced a further capital of ₹ 10,000 on 1st April, 2019 and another ₹ 5,000 on 1st July, 2019. On 30th September, 2019 A withdrew ₹ 40,000.

On 1st July, 2019, B introduced further capital of ₹ 30,000.

The partners drew the following amounts in anticipation of profit.

A drew ₹ 1,000 per month at the end of each month beginning from January, 2019. B drew ₹ 1,000 on 30th June, and ₹ 5,000 on 30th September, 2019.

12% p.a. interest on capital is allowable and 10% p.a. interest on drawings is chargeable. Date of closing 31.12.2019. Calculate: (a) Profit-sharing ratio; (b) Interest on capital; and (c) Interest on drawings.

SOLUTION

(a) Calculation of Effective Capital

A		B	
₹ 1,00,000 invested for 3 months i.e.,		₹ 60,000 invested for 6 months i.e.,	
₹ 3,00,000 invested for 1 month	3,00,000	₹ 3,60,000 invested for 1 month	3,60,000
₹ 1,10,000 invested for 3 months i.e.,		₹ 90,000 invested for 6 months, i.e.,	
₹ 3,30,000 invested for 1 month.	3,30,000	₹ 5,40,000 invested for 1 month	5,40,000
			9,00,000
₹ 1,15,000 invested for 3 months i.e.,			
₹ 3,45,000 invested for 1 month.	3,45,000		
₹ 75,000 invested for 3 months, i.e.,			
₹ 2,25,000 invested for 1 month.	2,25,000		
	12,00,000		

(b) Calculation of Interest on Capital

A = ₹ 12,00,000 x 12/100 x 1/12 = ₹ 12,000

B = ₹ 9,00,000 x 12/100 x 1/12 = ₹ 9,000

(c) Calculation of Interest on Drawings

A = ₹ 12,000 x 10/100 x 5.5/12 = ₹ 550

B = ₹ 1,000 x 10/100 x 6/12 = ₹ 50
₹ 5,000 x 10/100 x 3/12 = ₹ 125

Efficetive capital is in the ratio 12 : 9 therefore profit sharing ratio is 12 : 9 *i.e.* 4 : 3.

ILLUSTRATION 6

Ram and Rahim start business with capital of ₹ 50,000 and ₹ 30,000 on 1st January, 2019. Rahim is entitled to a salary of ₹ 400 per month. Interest is allowed on capitals and is charged on drawings at 6% per annum. Profits are to be distributed equally after the above noted adjustments. During the year, Ram withdrew ₹ 8,000 and Rahim withdrew ₹ 10,000. The profit for the year before allowing for the terms of the Partnership Deed came to ₹ 30,000. Assuming the capitals to be fixed, prepare the Profit and Loss Appropriation Account and the Capital and Current Accounts relating to the partners.

SOLUTION

Profit & Loss (Appropriation) Account

2019	Particulars	₹	2019	Particulars	₹
Dec. 31	To Rahim's Current A/c		Dec. 31	By Net Profit	30,000
	Salary	4,800		By Sundries-Interest on	
	To Sundries-Interest on			Drawings:	

	Capitals :			Ram's Current A/c	
	Ram's Current A/c	3,000		(6% on ₹ 8,000 for	
	Rahim's Current A/c	1,800		6 months)	240
	To Profit transferred to			Rahim's Current A/c	
	Ram's Current A/c (1/2)	10,470		(6% on ₹ 10,000 for	
	Rahim's Current A/c (1/2)	10,470		6 months)	300
		30,540			30,540

ILLUSTRATION 7

With the help of same information given in illustration 6, let us prepare the Capital and Current Accounts of Ram and Rahim.

SOLUTION

Ram's Capital Account

2019	Particulars	₹	2019	Particulars	₹
Dec. 31	To Balance c/d	50,000	Jan. 1	By Bank A/c	50,000
			2020		
			Jan. 1	By Balance b/d	50,000

Rahim's Capital Account

2019	Particulars	₹	2019	Particulars	₹
Dec. 31	To Balance c/d	30,000	Jan. 1	By Bank A/c	30,000
			2020		
			Jan. 1	By Balance b/d	30,000

Ram's Current Account

2019	Particulars	₹	2019	Particulars	₹
Dec. 31	To Cash Bank A/C (Drawings)	8,000	Dec. 31	By Profit and Loss appropriation A/c - Interest	3,000
	To Profit and Loss appropriation A/c -			By Profit and Loss appropriation A/c -1/2 profit	10,470
	Interest on Drawings	240			
	To Balance c/d	5,230			
		13,470			13,470
			2020		
			Jan. 1	By Balance b/d	5,230

Rahim's Current Account

2019	Particulars	₹	2019	Particulars	₹
	To Cash Bank A/c (Drawings)	10,000	Dec. 31	By Profit and Loss appropriation A/c Salary	4,800
Dec. 31	To Profit and Loss appropriation A/c			Interest	1,800
				By Profit and Loss appropriation	
	Interest on Drawings	300		A/c Profit	10,470
	To Balance c/d	6,770			
		17,070			17,070
			2020		
			Jan. 1	By Balance b/d	6,770

ILLUSTRATION 8

A and B were partners in a firm sharing profits and losses in the ratio of 3:2. They admit C for 1/6th share in profits and guaranteed that his share of profits will not be less than ₹ 250,00,000. Total profits of the firm for the year ended 31st March, 2020 were ₹ 900,00,000. Calculate share of profits for each partner when:

1. *Guarantee is given by firm.*
2. *Guarantee is given by A*
3. *Guarantee is given by A and B equally.*

SOLUTION

Case1. When Guarantee is given by firm.

Profit and Loss Appropriation Account

For the year ending on 31st March, 2020

Particulars	₹	Particulars	₹
To A's Capital A/c (3/5 of ₹ 650,00,000)	3,90,00,000	By Profit and Loss, A/c	9,00,00,000
To B's Capital A/c (2/5 of ₹ 650,00,000)	2,60,00,000		
To C's Capital A/c (1/6 of ₹ 9,00,00,000 or ₹ 25,000,000 which ever is more	2,50,00,000		
	9,00,00,000		9,00,00,000

Case2. When Guarantee is given by A

Profit and Loss Appropriation Account

For the year ending on 31st March, 2020

Particulars	₹	Particulars	₹
To A's Capital A/c (3/6 of ₹ 9,00,00,000) 4,50,00,000		By Profit and Loss, A/c (net profits)	9,00,00,000

Less: Deficiency borne for C (1,00,00,000)	3,50,00,000		
To B's Capital A/c (2/6 of ₹ 9,00,00,000)	3,00,00,000		
To C's Capital A/c (1/6 of ₹ 9,00,00,000) 1,50,00,000 *Add*: Deficiency Recovery from A 1,00,00,000	2,50,00,000		
	9,00,00,000		9,00,00,000

Case3. When Guarantee is given by A and B equally.

Profit and Loss Appropriation Account

For the year ending on 31st March, 2020

Particulars		₹	Particulars	₹
To A's Capital A/c (3/6 of ₹ 9,00,00,000)	4,50,00,000		By Profit and Loss, A/c (net profits)	9,00,00,000
Less: Deficiency borne for C (1/2 of 1,00,00,000)	(50,00,000)	4,00,00,000		
To B's Capital A/c (2/6 of ₹ 9,00,00,000)	3,00,00,000			
Less: Deficiency borne for C (1/2 of 1,00,00,000)	(50,00,000)	2,50,00,000		
To C's Capital A/c (1/6 of ₹ 9,00,00,000)	1,50,00,000			
Add: Deficiency Recovery from A	50,00,000			
Add: Deficiency Recovery from B	50,00,000	2,50,00,000		
		9,00,00,000		9,00,00,000

ILLUSTRATION 9

Aarti, Bharati and Criti were in partnership sharing profits and losses in the ratio 3 : 4 : 3 their capitals as on 1st April 2019 were ₹3,00,000, 5,00,000 and 2,00,000 respectively. According to partnership deed, Criti is entitled to salary of ₹ 15,000 per month., interest on opening capital is to be allowed @ 12% p.a. Aarti was entitled to rent @ .₹ 5,000/- per month for premises belonging to her, used for the partnership business. No interest to be charged on drawings. Rent paid to Aarti and salary paid to Criti were debited to drawings account of respective partners. Bharti had withdrawn ₹ 10,000 per month from the business. The profit of the firm for the year ended 31st March 2020, before charging interest in capital amounted to ₹ 4,60,000. You are required to prepare Profit and Loss appropriation Account and partners' capital Accounts.

SOLUTION

In the Books of Aarti, Bharti and Criti

Profit and Loss Appropriation A/c for the Year ended 31st March 2020

Particulars		₹	Particulars		₹
To salary to Criti		1,80,000	By Net Profit	4,60,000	
To Interest on capital			*Less:* Rent to Aarti	60,000	4,00,000
Aarti	36,000				
Bharti	60,000				
Criti	24,000	1,20,000			
To Net Profit transferred to					
Aarti	30,000				
Bharti	40,000				
Criti	30,000	1,00,000			
		4,00,000			4,00,000

Partners' Capital Accounts

Particulars	Aarti	Bharti	Criti	Particulars	Aarti	Bharti	Criti
				By Balance b/d	3,00,000	5,00,000	2,00,000
				By Interest on Capital	36,000	60,000	24,000
To Drawings		1,20,000		By Salary			1,80,000
				By Rent	60,000		
				By Profit and loss Appropiation A/c	30,000	40,000	30,000
To Balance c/d	4,26,000	4,80,000	4,34,000				
	4,26,000	6,00,000	4,34,000		4,26,000	6,00,000	4,34,000

Working Note:

Partners Drawings Account

Particulars	Aarti	Bharti	Criti	Particulars	Aarti	Bharti	Criti
To bank	60,000	1,20,000	1,80,000	By Profit and loss A/c	60,000		
				By Profit and loss Appro. A/c			1,80,000
				By Capital A/c		1,20,000	
	60,000	1,20,000	1,80,000		60,000	1,20,000	1,80,000

SUMMARY

- The Indian Partnership Act defines partnership as "the relationship between persons who have agreed to share the profit of a business carried on by all or any of them acting for all."
- The LLP will be a separate legal entity, liable to the full extent of its assets, with the liability of the partners being limited to their agreed contribution in the LLP which may be of tangible or intangible nature or both tangible and intangible in nature.
- In the partnership firm relations among the partners will be governed by mutual agreement. The agreement is known as Partnership Deed which is to be properly stamped.
- In the absence of an agreement, the interest and salary payable to a partner will be paid only if there is profit.
- During the course of business, a partnership firm will prepare Trading Account and a Profit and Loss Account at the end of every year.
- There are two methods of accounting –

  i. Fixed capital method and

  ii. Fluctuating capital method.

  In fixed capital method, generally initial capital contributions by the partners are credited to partners' capital accounts and all subsequent transactions and events are dealt with through current accounts, Unless a decision is taken to change it, initial capital account balance is not changed.

  In fluctuating capital method, no current account is maintained. All such transactions and events are passed through capital accounts. Naturally, capital account balance of the partners fluctuates every time. So in fixed capital method a fixed capital balance is maintained over a period of time while in fluctuating capital method capital account balances fluctuate all the time.
- Interest on capital of partners is calculated for the relevant period for which the amount of capital has been used in the business.
- Subject to contract between the partners, interest on capitals is to be provided out of profits only. Thus in case of loss, no interest is provided. But in case of insufficient profits (i.e., net profit less than the amount of interest on capital), the amount of profit is distributed in the ratio of capital as partners get profit by way of interest on capital only.
- Sometimes, one partner can enjoy the right to have minimum amount of profit in a year as per the terms of the partnership agreement. In such case, allocation of profit is done in a normal way if the share of partner, who has been guaranteed minimum profit, is more than the amount of guaranteed profit. However, if share of the partner is less than the guaranteed amount, he takes minimum profit and the excess of guaranteed share of profit over the actual share is borne by the remaining partners as per the agreement.

TEST YOUR KNOWLEDGE

True and False

1. In absence of any agreement partners share profits of the business in the ratio of their capital contribution.
2. Profit sharing ratio and capital contribution ratio need not be same.
3. Every partnership firm must register itself with Registrar of firms.
4. A partner can advance loan to the partnership firm in addition to capital contributed by him.
5. A partner can demand interest on capital even if it is not provided in the partnership deed.
6. If a partner does not take part in day to day business activities of the firm then he is not entitled to any share of profit.
7. Interest should be paid @ 6% p.a. on partners' loan even if it is not provided in the partnership deed.
8. Husband and wife cannot be partners in the same firm.
9. One senior partner is Principal and other partners are his agents.
10. Partners are the agents of the firm and each other.

Multiple Choice Questions

1 If a firm prefers Partners' Capital Accounts to be shown at the amount introduced by the partners as capital in firm then entries for salary, interest, drawings, interest on capital and drawings and profits are made in

(a) Trading Account (b) Profit and Loss Account

(c) Partners' Current Account

2 In the absence of any agreement, partners are liable to receive interest on their Loans @

(a) 12% p.a. (b) 10% p.a.

(c) 6% p.a.

3 The relationship between persons who have agreed to share the profit of a business carried on by all or any of them acting for all is known as ....

(a) Partnership. (b) Joint Venture.

(c) Association of Persons.

4 Firm has earned exceptionally high profits from a contract which will not be renewed. In such a case the profit from this contract will not be included in ....

(a) Profit sharing of the partners. (b) Calculation of the goodwill.

(c) Both.

5 In the absence of an agreement, partners are entitled to

(a) Interest on Loan and Advances. (b) Commission.

(c) Salary.

6 Partners are supposed to pay interest on drawings only when ……… by the ………

(a) Provided, Agreement. (b) Agreed, Partners

(c) Both (a) & (b) above.

7 When a partner is given a guarantee by the other partner, loss on such guarantee will be borne by

(a) Partner who gave the guarantee (b) All the other partners.

(c) Partnership firm.

8. A, B and C had capitals of ₹ 50,000; ₹ 40,000 and ₹ 30,000 respectively for carrying on business in partnership. The firm's reported profit for the year was ₹ 80,000. As per provisions of the Indian Partnership Act, 1932, find out the share of each partner in the above amount after taking into account that no interest has been provided on an advance by A of ₹ 20,000, in addition to his capital contribution.

(a) ₹ 26,267 for Partner B and C & ₹ 27,466 for partner A.

(b) ₹ 26,667 each partner.

(c) ₹ 33,333 for A, ₹ 26,667 for B and ₹ 20,000 for C.

9. X, Y and Z are partners in a firm. At the time of division of profit for the year there was dispute between the partners. Profits before interest on partner's capital was ₹ 6,000 and X wanted interest on capital @ 20% as his capital contributions was ₹ 1,00,000 as compared to that of Y and Z which was ₹ 75,000 and ₹ 50,000 respectively.

(a) Profits of ₹ 6,000 will be distributed equally with no interest on either Capital.

(b) X will get the interest of ₹ 20,000 and the loss of ₹ 14,000 will be shared equally.

(c) All the partners will get interest on capital and the loss of ₹ 39,000 will be shared equally.

10. X, Y and Z are partners in a firm. At the time of division of profit for the year there was dispute between the partners. Profits before interest on partner's capital was ₹ 6,000 and Y determined interest @ 24% p.a. on his loan of ₹ 80,000. There was no agreement on this point.

Calculate the amount payable to X, Y and Z respectively.

(a) ₹ 2,000 to each partner.

(b) Loss of ₹ 4,400 for X and Z & Y will take home ₹ 14,800.

(c) ₹ 400 for X, ₹ 5,200 for Y and ₹ 400 for Z.

11. X, Y and Z are partners in a firm. At the time of division of profit for the year there was dispute between the partners. Profits before interest on partner's capital was ₹ 6,000 and Z demanded minimum profit of ₹ 5,000 as his financial position was not good. However, there was no written agreement. Profits to be distributed to X, Y and Z will be

(a) Other partners will pay Z the minimum profit and will suffer loss equally.

(b) Other partners will pay Z the minimum profit and will suffer loss in capital ratio.

(c) ₹ 2,000 to each of the partners.

Theory questions

1. Write short notes on:

   (a) Features of Partnership

   (b) Powers of Partners

2. Distinguish between

   (i) Fixed capital and fluctuating capital.

   (ii) Partnership and joint venture

Practical questions

1. Weak, Able and Lazy are in partnership sharing profits and losses in the ratio of 2:1:1. It is agreed that interest on capital will be allowed @ 10% per annum and interest on drawings will be charged @ 8 % per annum. (No interest will be charged/allowed on Current Accounts).

   The following are the particulars of the Capital and Drawings Accounts of the partners:

	Weak	**Able**	**Lazy**
	₹	₹	₹
Capital (1.1.2019)	75,000	40,000	30,000
Current Account (1.1.2019)	10,000	5,000	(Dr.) 5,000
Drawings	15,000	10,000	10,000

   The draft accounts for 2019 showed a net profit of ₹ 60,000 before taking into account interest on capitals and drawings and subject to following rectification of errors:

   (a) Life Insurance premium of Weak amounting to ₹ 750 paid by the firm on 30th June, 2019 has been charged to Miscellaneous Expenditure A/c.

   (b) Repairs of Machinery amounting to ₹ 10,000 has been debited to Plant Account and depreciation thereon charged @ 20%.

   (c) Travelling expenses of ₹ 3,000 of Able for a pleasure trip to U.K. paid by the firm on 30th June, 2019 has been debited to Travelling Expenses Account.

   You are required to prepare the Profit and Loss Appropriation Account, Current Accounts of partners Weak, Able and Lazy for the year ended 31st December, 2019.

2. Ram and Rahim are in partnership sharing profits and losses in the ratio of 3:2. As Ram, on account of his advancing years, feels he cannot work as hard as before, the chief clerk of the firm, Ratan, is admitted as a partner with effect from 1st January, 2019, and becomes entitled to 1/10th of the net profits and nothing else, the mutual ratio between Ram and Rahim remaining unaltered.

Before becoming a partner, Ratan was getting a salary of ₹ 500 p.m. together with a commission of 4% on the net profits after deducting his salary and commission.

It is provided in the partnership deed that the share of Ratan's profits as a partner in excess of the amount to which he would have been entitled if he had continued as the chief clerk, should be taken out of Ram's share of profits.

The net profit for the year ended December 31, 2019 is ₹ 1,10,000. Show the distribution of net profit amongst the partners.

3. X and Y are partners. As per terms of agreement interest is allowed on capital at 8% p.a. and charged on drawings at 10% p.a. X withdrew ₹ 40,000 pm at the end of each month and Y withdrew ₹ 120,000 at the end of each quarter. You are required to fill the missing figures in following accounts:

Profit and Loss Appropriation Account for the year ended March 31, 2020

Particulars		₹	Particulars		₹
To ...?			By Profit and Loss A/c (Net profit)		?
To Interest on Capital A/c			By Interest on Drawings A/c		
X	160,000		X	?	?
Y	?	288,000	Y	?	
To profit transferred to Capital A/c					
X (2/3)	?				
Y (1/3)	280,000	?			
		?			?

Partner's Capital Accounts

Particulars	X	Y	Particulars	X	Y
To ...?	?	?	By ...?	?	?
To ...?	?	?	By Salary A/c	3,60,000	?
To ...?	?	?	By ...?	?	
			By ...?	?	?
	?	?		?	?

ANSWERS/HINTS

True and False

1. False: In absence of any agreement partners share profits equally and not in capital contribution ratio.

2. True: Profit sharing can be different from the that of the capital introduced by each of the partner. Not necessary that partner contributing more capital should have a higher profit sharing ratio and vice versa.

3. False: Registration of firms is not compulsory under Indian Partnership Act, 1932.

4. True: Where the partnership deed is absent, then the interest shall be paid at 6% per annum. So the interest on the loan to be paid to the partner.

5. False: Interest on capital can be paid only if it is provided in the partnership deed.

6. False: Every partner need not take part in the business. Even if a partner does not take part in the business he is entitled for his share of profit.

7. True: In absence of Partnership deed, Interest at the rate of 6%.p.a is to be allowed on a partner's loan to the firm.

8. False: Husband and wife can be partners in the same firm.

9. False: There is no senior or junior partner. Every partner is agent/principal of other partners.

10. True: Concept of agency applies to every partner and the firm as well. So each partner is a principal to and agent of every other partner and to the firm.

Multiple Choice Questions

1.	(c)	**2.**	(c)	**3.**	(a)	**4.**	(b)	**5.**	(a)	**6.**	(c)	**7.**	(a)
8.	(a)	**9.**	(a)	**10.**	(c)	**11.**	(c)						

Theoretical Questions

1. **(a)** The following four essential features of a partnership, namely:

   (i) Partnership is the result of an agreement: It means that the relation of partnership arises from contract and not from status.

   (ii) Business: A partnership can exist only in business.

   (iii) Sharing of profit: The persons concerned must agree to share the profits of the business.

   (iv) Mutual agency: It means that the business is to be carried on by all or any of them acting for all. Thus, if the person carrying on the business acts not only for himself but for others also so that they stand in the positions of principals and agents, they are partners.

   (b) Powers of partners are the following:

   (i) Buying and selling of goods;

   (ii) Receiving payments on behalf of the firm and giving valid receipt;

   (iii) Drawing cheques and drawing, accepting and endorsing bills of exchange and promissory notes in the name of the firm;

   (iv) Borrowing money on behalf of the firm with or without pledging the inventories-in-trade;

   (v) Engaging servants for the business of the firm.

2. **(a)** In fixed capital method, generally initial capital contributions by the partners are credited to partners' capital accounts and all subsequent transactions and events are dealt with through current accounts, Unless a decision is taken to change it, initial capital account balance is not changed.

   In fluctuating capital method, no current account is maintained. All such transactions and events are passed through capital accounts. Naturally, capital account balance of the partners fluctuates every time. So in fixed capital method a fixed capital balance is maintained over a period of time while in fluctuating capital method capital account balances fluctuate all the time.

(b) Partnership is a relationship between persons who have agreed to share profits or losses of a business carried on by all or any of them acting for all. Whereas, a joint venture is a contractual agreement whereby two or more parties undertake an economic activity which is subject to joint control. Thus joint venture is a temporary partnership formed for a particular economic activity or venture. The following differences exist between joint venture and other forms of partnership:

The owners of a partnership business are called partners, whereas the owners of a joint venture are called co-ventures.

Accrual basis of accounting is followed in case of partnership and a joint venture generally follows cash basis of accounting.

The financial results of a partnership are obtained at regular intervals. On the other hand, the financial results of a joint venture are obtained generally at the end of the venture.

However, there may be ventures in certain areas which may last for a longer period, for example, joint ventures in key areas like power, petroleum, telecommunication, etc. In these cases, the ventures may even last for ten/fifteen years. For these long term joint ventures, financial statements are prepared periodically by following accrual basis of accounting. Therefore, the line of distinction between long term joint ventures and other forms of partnership is very thin.

Practical Problems

Answer 1

Weak, Able & Lazy

Profit and Loss Appropriation Account for the year ended 31st December, 2019

	₹	₹		₹	₹
To Interest on Capital:			By Net Profit (Adjusted)		55,750
Weak	7,500		By Interest on Drawings:		
Able	4,000		Weak	630	
Lazy	3,000	14,500	Able	520	
			Lazy	400	1,550
To Partner's Current A/cs - Share of profit :					
Weak	21,400				
Able	10,700				
Lazy	10,700	42,800			
		57,300			57,300

Working Notes:

(i) Adjusted Profit

	₹	₹
Net Profit as per Profit & Loss A/c	60,000	
Add : Drawings by Weak : Life Insurance Premium of Weak charged to Miscellaneous Expenditure A/c of the Firm	750	
Drawings by Able : Travelling expenses of Able in connection with pleasure trip to U.K. charged to travelling expenses A/c of the firm	3,000	63,750
Less: Repairs to Machinery wrongly capitalised	10,000	
Less : Depreciation charged @ 20%	(2,000)	(8,000)
		55,750

(ii) Interest on Drawings :

	Weak	Able	Lazy
	₹	₹	₹
Drawings	15,000	10,000	10,000
Add : Rectification adjustments	750	3,000	–
	15,750	13,000	10,000
Interest @ 8% p.a. for 6 months	630	520	400

Partners' Current Accounts

	Weak	Able	Lazy		Weak	Able	Lazy
	₹	₹	₹		₹	₹	₹
To Balance b/d	–	–	5,000	By Balance b/d	10,000	5,000	–
To Drawings	15,000	10,000	10,000	By Profit & Loss App. A/c (Int. on capital)	7,500	4,000	3,000
To Life Insurance Premium	750	–	–	By Profit & Loss App. A/c (Share of profit)	21,400	10,700	10,700
To Travelling Expenses.	–	3,000	–				
To Profit & Loss App. A/c (Int. on drawings)	630	520	400				
To Balance c/d	22,520	6,180	–	By Balance c/d	–	–	1,700
	38,900	19,700	15,400		38,900	19,700	15,400

Answer 2

Amount due to Ratan as a Chief Clerk

	₹
Salary	6,000
Add: Commission 4/104 (₹ 1,10,000 - ₹ 6,000)	4,000
	10,000
Less: Share of Profit as a partner (1/10th of 1,10,000)	(11,000)
Excess chargeable to Ram	(1,000)

Profit and Loss Appropriation Account for the year ended December 31,2019

	Particulars	₹	Particulars	₹
To	Share of Profit A/c		By Profit and Loss A/c	
	Ram [3/5 of (₹ 1,10,000 – ₹ 10,000) – ₹ 1,000]	59,000	(Net profit)	1,10,000
	Rahim [2/5 of (₹ 1,10,000 – ₹ 10,000)]	40,000		
	Ratan [1/10 of ₹ 1,10,000]	11,000		
		1,10,000		1,10,000

Answer 3

Profit and Loss Appropriation Account for the year ended March 31, 2020

Particulars		₹	Particulars		₹
To Salary to X		3,60,000	By Profit and Loss A/c (Net profit)		14,48,000
To Interest on Capital A/c			By Interest on Drawings A/c		40,000
X	1,60,000		X	22,000	
Y	1,28,000	2,88,000	Y	18,000	
To profit transferred to Capital A/c					
X (2/3)	5,60,000				
Y (1/3)	2,80,000	8,40,000			
		14,88,000			14,88,000

Partner's Capital Accounts

Particulars	X	Y	Particulars	X	Y
To Drawing A/c	4,80,000	4,80,000	By Balance b/d	20,00,000	16,00,000
To Interest on Drawings A/c	22,000	18,000	By Salary A/c	3,60,000	1,28,000
To Balance c/d	25,78,000	15,10,000	By Interest on Capital A/c	1,60,000	
			By Profit and Loss App A/c	5,60,000	2,80,000
	30,80,000	20,08,000		30,80,000	2,008,000

Working Notes:

1. **X's Share of Profit** 2,80,000 x 3/1 x 2/3 = 5,60,000

2. **Interest on Drawings**

   X = 4,80,000 x 11/2 x 1/12 x 10/100 = 22,000

   Y = 4,80,000 x 9/2 x 1/12 x 10/100 = 18,000

3. **Y's Interest on Capital** 2,88,000 – 1,60,000 = 128,000