

## **PARTNERSHIP GENERAL**

### **22.1 INTRODUCTION**

You have learnt how to prepare the Profit and Loss account and Balance sheet of a business. These pertain to a business which is owned by a sole proprietor. But, as you know that when a business expands it goes beyond the capacity of one person to manage it. There is a need then, to combine his/her efforts and capital with those of another person or persons. This gives rise to the partnership form of organisation.

The accounting treatment of a few items are slightly different from those of a sole proprietary concern. For example, the profit has to be divided amongst the partners, partners' capitals may remain fixed or fluctuating ; certain adjustments regarding these are required in the partners' capital accounts. Other issues like admission of a new partner, retirement and death of a partner also require special consideration while preparing the accounts of a partnership firm. This lesson focusses on some basic issues of Partnership.

### **22.2 OBJECTIVES**

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

- state the meaning of partnership firm;
- explain the characteristics of partnership;
- explain the meaning of the term partnership deed;
- describe treatment of the following in the absence of Partnership Deed:

— Distribution of Profit

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- Interest on Capital
  - Interest on Drawings
  - Interest on Partner's loan.
  - Salaries and Commission to Partner ;
- distinguish between fluctuating and fixed capital accounts ;
  - calculate the partners' capital balances ;
  - calculate interest on capital and interest on drawings ;
  - calculate commission of partner.

### 22.3 MEANING , CHARACTERISTICS OF PARTNERSHIP AND PARTNERSHIP DEED

Before, you learn accounting for partnership firms, let us be familiar with the meaning and characteristics of partnership firm.

A sole proprietor feels the need to join hands with another person or persons when his/her business expands beyond his/her managerial capacity. As a result, partnership firms are formed.

In a partnership, two or more persons agree to set up a business and share profits and losses. In this manner, they combine their capital and managerial abilities to carry on business. The organisation that comes into existence is the partnership firm and the persons who enter into an agreement are partners. According to the Indian Partnership, Act 1932, "partnership is the relation between persons who have agreed to share profits of a business carried on by all or any of them acting for all."

An agreement is made in which terms and conditions regarding the conduct of the business and the rights and duties of the partners are laid down. Each partner is responsible for his own acts as well as for the acts of the other partners acting in the interest of business.

The characteristics of partnership arising from the above definition are as follows :-

#### (i) Agreement

The agreement forms the basis of the partnership. It defines the relationship between the persons who agree to carry on business. It may be either oral or in writing. It may contain the terms of sharing profits and risks of the business, the capital to be invested by each partner, etc. The agreement is drawn by all the partners mutually. The written agreement is called the **Partnership Deed**.

**(ii) Number of persons**

There must be at least two persons to form a partnership. The Partnership Act is silent about the maximum number of partners in firm. But according to Companies Act, the maximum number of persons in a partnership firm is ten in the case of banking business and twenty in any other business.

**(iii) Business**

The Partnership must be formed for carrying on business with a purpose of earning profits. The business should be lawful activity. If two or more persons agree to carry on smuggling activities and show the illegal earnings it will not be termed as business. If two persons jointly own property and are receiving rent, it will not be termed partnership as it is not a business. Similarly, persons engaged in social services will not be termed partnership as they are not earning profits.

**(iv) Sharing Profits**

A business is set up with an objective of earning profits. The partners who carry on business agree to share profits in a predetermined ratio. This ratio is stated in the partnership agreement. In case of loss, all the partners have to bear it in the same agreed profit sharing ratio.

**(v) 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 the debts, the partners' personal property can be used to satisfy, the claims of the creditors.

**(vi) Management**

All the partners have a right to manage the business. However, they may depute one or more partners to look after the affairs of the business.

**(vii) Implied Agency**

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 also.

**(viii) Utmost Good Faith**

It is the duty of each partner to be fair and open in his/her dealings with outside parties. He/she should honestly disclose all relevant matters of the business to the other partners.

**(ix) Transfer of Interest**

A partner does not have a right to transfer his/her interest i.e. share

of profit in the partnership firm to a third party without the consent of other partners.

## **PARTNERSHIP DEED**

While studying the characteristics of partnership you must have come across the term agreement which forms the basis of partnership. A partnership comes into existence only after an agreement is entered into by the partners. This can be either oral or in writing. The written form of the agreement is a document in which the terms and conditions regarding the conduct of the business and the relationship between the partners are laid down. This document is called a partnership Deed. It can be defined as a document which contains the terms of partnership as agreed to by the partners.

Every firm can frame its own partnership Deed in which the rights, duties and liabilities of the partners are stated in detail. It is an important document and is referred to from time to time. It also helps in settling the disputes arising between the partners in the general conduct of business. The partnership Deed is finalised after all the partners have mutually agreed upon it.

### **Contents of Partnership Deed**

It generally contains the following clauses:-

- (i) Name and address of the partnership firm;
- (ii) Nature and objectives of the business;
- (iii) Name and addresses of each partner;
- (iv) Ratio in which profits are shared and losses are to be borne;
- (v) Capital contribution by each partner;
- (vi) Interest on Capital if allowed;
- (vii) Salary to partners, if allowed;
- (viii) Rate of interest on loan advanced by a partner;
- (ix) Drawings of partners and interest thereon, if any;
- (x) Method of valuation of goodwill and revaluation of assets and liabilities on the admission, retirement or death of partner;
- (xi) Settlement of disputes by arbitration;
- (xii) Settlement of Accounts at the time of retirement or death of 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 PARTNERSHIP DEED

You know the partnership deed lays down the terms and conditions of partnership and the rights, duties and obligations of the partners. But sometimes, there are certain issues which are not dealt with in the partnership deed. The partnership deed may be silent on the profit sharing ratio, interest on capital, interest on drawings and interest on loan and salary of the partners. In such cases, the provisions given in the Partnership Act become applicable, which are:

**(i) Distribution of profit**

If the partnership deed does not mention the ratio in which profits are to be shared, the partners are entitled to share profits equally.

**(ii) Interest on capital**

Partners are not entitled to any interest on the capital in the absence of the partnership deed. But, if there is a clause in the agreement regarding interest to be paid on capital, it will be payable only out of the profits of the business. If profits are insufficient or in the case of losses incurred, interest is not allowed on capital, even though there may be provision in the partnership deed for its payment.

**(iii) Interest on Drawings**

The firm is not allowed to charge any interest on drawings by the partners unless given in the partnership deed.

**(iv) Interest on partners' loan**

The Partnership Act provides that a partner is entitled to interest on any additional amount apart from his capital, which he advances to the firm. If the partnership deed is silent on the rate of interest, partners can charge interest @ 6% per annum on the amount of loan given by them to the firm. This implies that interest on loan has to be paid even if there is a loss.

**(v) Salary and Commission to Partner**

A partner is not entitled to any salary or commission to be paid to him/her for managing the business. It is considered to be his duty to manage the business of the firm.

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## INTEXT QUESTIONS 22.1

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A and B are partners in a firm. If the partnership agreement is silent on certain issues, how are the following to be dealt with :

- (i) A contributes Rs.10,000 and B contributes Rs.20,000 as capital. Should profits be shared equally?

- (ii) B puts in more time in the business. He wants a salary of Rs.5000 to be paid to him. Should B allowed a salary?
- (iii) A has advanced a loan to the firm. He claims interest @ 6% p.a. Is it permissible?
- (iv) B wants interest on capital to be credited @ 8% p.a. Will he get it?
- (v) A gets more contracts for the firm. He wants 5% commission on net profits. Is he entitled to such commission?

## 22.4 TYPES OF PARTNERS' CAPITAL ACCOUNTS AND PROFIT AND LOSS APPROPRIATION ACCOUNT

All partners generally invest certain amount in the business of the firm. This investment by the partners is called capital. Partners mutually agree on the amount of capital to be contributed by each one of them. The capital may be in the form of cash or assets.

In partnership accounts, each partner's capital account is maintained separately. There are certain adjustments regarding interest on capital, drawings, interest on drawing, salaries, profits, etc. to be made.

Partners' capital accounts may be maintained in two ways:

### (i) Fluctuating Capital Accounts

When adjustments regarding these changes are directly made in the capital accounts, it is called fluctuating capital account. Adjustments like interest on capital, commission, salary, profits which increase the capital are recorded on the credit side. Drawings, and interest on drawings which reduce the capital are recorded on the debit side. In this account itself, the capital is adjusted and the balance in the account is the amount of capital left with the partners. Therefore, only one account i.e. Partner's capital A/c is prepared under this method. The format of the partner's fluctuating capital account is as follows :

Dr.		Partner's capital A/c		Cr.	
Particulars	Amount	Particulars	Amount		
To Drawings A/c		By balance b/d			
To Interest on drawings A/c		By Interest on capital A/c			
		By Salary A/c			
		By Commission A/c			
To balance c/d		By Profit share			

**(ii) Fixed Capital Account**

When the original amount contributed by the partners is shown in the capital account as intact, it is called fixed capital account. In such a case, a separate account is maintained which records adjustments like interest on capital, drawings, profits distributed, salary or commission to partners, etc. This account is called partner's current account. Therefore, two accounts have to be maintained for each partner, viz. capital account and current account. But a permanent increase or decrease in capital should be made directly in the capital account and not in the current account. For example, if additional capital is introduced it will be credited to the partner's capital account. The format of the two accounts maintained under this method is as follows :

**Partner's Capital Account**

Dr.		Cr.	
Particulars	Amount Rs.	Particulars	Amount Rs.
To balance c/d		By balance b/d	

**Partner's Current Account**

Dr.		Cr.	
Particulars	Amount Rs.	Particulars	Amount Rs.
To Drawings		By Interest on capital	
To Interest on Drawings		By Commission	
To balance c/d		By Profit - share	

**Illustration - 1**

A and B are partners carrying on business:

	A	B
Capital	Rs.20,000	Rs.10,000
Drawings	Rs.1,600	Rs.900
Interest on capital	Rs.1,000	Rs.500
Salary paid to Partners	Rs.600	Rs.400
Profit share	Rs.4,000	Rs.2,000

Prepare capital accounts of both the partners under the Fixed Capital Method and Fluctuating Capital method.

**Solution**

ANSWER

**Fixed Capital Method****Capital Accounts**

Particulars	A	B	Particulars	A	B
To balance c/d	20,000	10,000	By Cash	20,000	10,000
			By balance b/d	20,000	10,000

**Current Accounts**

Particulars	A	B	Particulars	A	B
To Drawings	1,600	900	By Interest on Capital	1,000	500
To balance c/d	4,000	2,000	By Salary	600	400
			By Profit share	4,000	2,000
	5,600	2,900		5,600	2,900
			By balance b/d	4,000	2,000

**Fluctuating Capital Method****Capital Accounts**

Particulars	A	B	Particulars	A	B
To Drawings	1,600	900	By Cash	20,000	10,000
	/	/	By Interest on Capital	1,000	500
To balance c/d	24,000	12,000	By Salary	600	400
	25,600	12,900	By Profit Share	4,000	2,000
				25,600	12,900
			By balance b/d	24,000	12,000

**PROFIT & LOSS APPROPRIATION ACCOUNT**

Assets and liabilities of a firm should be assessed when a new partner joins it. The increases and decreases in the nature of assets are shown in a separate account, called Profit & Loss Appropriation Account.

This account is prepared to show the appropriation or disposal of profits or losses amongst partners. Specific adjustments relating to partners' entitlement and amount due by them are made in the Profit & Loss Appropriation account.

The partners may be entitled to interest on capital, commission and salary. Similarly, the firm charges interest on drawings from the partners. The following steps are taken while preparing the Profit and Loss Appropriation Account.

- (i) The net profit as ascertained ( from the P & L A/c ) is transferred to the credit side and the net loss to the debit side of the Profit and Loss Appropriation A/c.
- (ii) The Profit & Loss Appropriation A/c will be credited with the interest on drawings charged by the firm.
- (iii) The interest on partners' capitals, salary and commission paid to partners are transferred to the debit side of the Profit and Loss appropriation A/c.
- (iv) The appropriated profit or appropriated loss resulting from these adjustments is distributed to the partners in their profit sharing ratio and ultimately transferred to their capital accounts. The format of Profit & Loss Appropriation A/c is given below :

Profit & Loss Appropriation A/c

Dr.			Cr.
Particulars	Amount Rs.	Particulars	Amount Rs.
To Net Loss (b/d from Profit & Loss A/c) To Commission A/c To Salary A/c To Interest on capital A/c To Partners' Capital A/cs (profit transferred)		By Net Profit (b/d from Profit & Loss A/c) By Interest on drawings By Partners' Capital A/cs (Loss transferred)	

**Illustration - 2**

Mohan and Sohan are partners contributing Rs.50,000 and Rs.40,000 as capitals, respectively. They agree on the following :

- (i) To share profits in the ratio of 2:1
- (ii) Interest to be allowed on capital @ 8% per annum.
- (iii) Interest charged on drawings @ 5% per annum.
- (iv) Salary to be paid to Mohan @ Rs.500 per month.
- (v) Mohan withdrew Rs.8000 and Sohan Rs.5000 during the year. Interest on drawings is charged for full year. Profit for the year dated 31 Dec. 1996 is Rs.20,000. You are required to prepare:

- (i) Profit & Loss Appropriation account;

- (ii) Capital Accounts when they are fluctuating ;  
 (iii) Capital Accounts when they are fixed.

### Solution

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

### Interest on Capital

$$\text{Mohan} - 50,000 \times \frac{8}{100} = 4,000$$

$$\text{Sohan} - 40,000 \times \frac{8}{100} = 3,200$$

### Interest on Drawings

Mohan's drawings - 8,000

$$\text{Interest } 8,000 \times \frac{5}{100} = 400$$

Sohan's drawings - 5,000

$$\text{Interest } 5,000 \times \frac{5}{100} = 250$$

### Profit & Loss Appropriation A/c

Dr.		Cr.	
Particulars	Amount Rs.	Particulars	Amount Rs.
To Mohan's Capital - interest	4,000	By Profit & Loss A/c (Profit for the year)	20,000
To Sohan's capital - interest	3,200	By Mohan's capital (interest on drawings)	400
To Mohan's salary (500 × 12 )	6,000	By Sohan's capital (Interest on drawings)	250
To Mohan's Capital A/c (Share of Profit)	4,967		
To Sohan's Capital A/c (share of Profit )	2,483		
	20,650		20,650

## Fluctuating Capital Accounts

## Mohan's Capital A/c

Dr.		Cr.	
Particulars	Amount Rs.	Particulars	Amount Rs.
To Interest on Drawings	400	By Cash A/c	50,000
To Drawings	8,000	By Interest on capital	4,000
To balance c/d	56,567	By Salary	6,000
		By Profit & Loss Appropriation A/c	4,967
	64,967		64,967
		By balance b/d	56,567

## Sohan's Capital A/c

Dr.		Cr.	
Particulars	Amount Rs.	Particulars	Amount Rs.
To Interest on drawings	250	By Cash A/c	40,000
To Drawings A/c	5,000	By Interest on Capital	3,200
To balance c/d	40,433	By Profit & Loss Appropriation A/c	2,483
	45,683		45,683
		By balance b/d	40,433

## Fixed Capital Accounts

## Mohan's Capital A/c

Dr.		Cr.	
Particulars	Amount Rs.	Particulars	Amount Rs.
To balance c/d	50,000	By Cash A/c	50,000
		By balance b/d	50,000

## Mohan's Current A/c

Dr.		Cr.	
Particulars	Amount Rs.	Particulars	Amount Rs.
To Drawings	8,000	By Interest on capital	4,000
To Interest on drawings	400	By Salaries	6,000
To balance c/d	6,567	By Profit and Loss Appropriation A/c	4967
	14,967		14,967
		By balance b/d	6,567

## Sohan's Capital A/c

Dr.		Cr.	
Particulars	Amount Rs.	Particulars	Amount Rs.
To balance c/d	40,000	By Cash A/c	40,000
		By balance b/d	40,000

## Sohan's Current A/c

Dr.		Cr.	
Particulars	Amount Rs.	Particulars	Amount Rs.
To Drawings	5,000	By Interest on capital	3,200
To Interest on Drawings A/c	250	By Profit and Loss Appropriation A/c	2,483
To balance c/d	433		
	5,683		5,683
		By balance b/d	433

## INTEXT QUESTIONS 22.2

- (i) List the items which usually appear on the debit and credit side of a partners' capital account when the capitals are fluctuating.
- (ii) List the items which appear on the credit side of a partners' capital account when capitals are fixed.
- (iii) Under which account are the changes recorded if the Capital Accounts are to remain fixed?

## 22.5 INTEREST ON CAPITAL, INTEREST ON DRAWINGS, AND PARTNER'S COMMISSION

Let us study some details about interest on capital. As you know, interest is not allowed on capital unless it is specifically provided in the Partnership Deed. If it is provided, the interest rate will be as agreed upon by the partners.

### Fluctuating Capital Accounts

If the firm is maintaining Fluctuating capital accounts for the partners, the interest will be charged on the opening balance of each year.

### Fixed Capital Accounts

In this case, the interest will be charged on the fixed balance in the capital Account. The balance in the current Account will not be considered.

If Fresh capital is introduced or there is reduction in the capital then the fixed balance in the Capital account will change and interest will be charged on the new balance. Interest will be charged on the basis of the period that the capital remains in the business. The Profit and Loss Appropriation Account will be debited with the total amount of interest allowed to the partners on their capitals. It is treated as an expense as it is paid out of the profits of the business. The interest on capital account will be credited. The journal entries (accounting vouchers) will be ;

#### a. Interest is paid on Capital

Interest on Capital A/c                      Dr.

    To Capital A/c.

(Being interest charged on capital)

#### b. Interest on capital is transferred to the Profit & Loss Appropriation

Profit and Loss Appropriation A/c. Dr.

    To Interest on capital A/c.

(Being the amount of interest transferred to  
P & L Appropriation A/c)

*Note* : Transfer Vouchers are also prepared in respect of above transactions.

## INTEREST ON DRAWINGS

When a partner requires cash for his personal use, he can withdraw part of his capital from the firm. This withdrawal of cash is termed as drawings and results in the decrease of the capital balance of the partner. The partnership

Deed may have a provision of charging interest on drawings. If so, then the firm may charge interest on drawings from partners. The period for which interest is charged will depend on the date of withdrawal.

The interest on drawings is charged by the firm. Therefore, it will be credited to the Profit and loss Appropriation Account as it is an income for the firm. At the same time, it reduces the capital balance of the partner, therefore, partner's capital account will be debited and interest on drawings A/c will be credited.

The journal entries (accounting vouchers) for interest on drawing will be :

- i. Interest on Drawings A/c - Dr.  
     To Profit & Loss Appropriation A/c  
     (Being the amount of Interest on drawings  
     transferred to Profit & Loss Appropriation A/c)
- ii. Partner's Capital or Current A/c - Dr.  
     To Interest on Drawings A/c  
     (Being the interest charged on drawings)

**Note :** Transfer vouchers are also prepared in respect of above transactions.

### Calculation of Interest on Drawings

Drawings can be made at regular intervals or in a lumpsum in the beginning or at any time during the year. Interest is charged on the total amount of drawings for the period for which cash is withdrawn. The period for which interest is charged has to be calculated carefully. There are two methods for calculating interest:

- i. Simple Average method
- ii. Product method

#### Simple Average Method

A fixed amount may be withdrawn every month, half yearly or annually. The interest has to be calculated on the period for which the amount has been utilised. The amount withdrawn is added up and the average period for which the amount is utilised is calculated.

The amount can be withdrawn in the beginning, middle or at the end of each month. The calculation of the period will be different in all the three cases.

- i. Suppose a partner withdraws Rs.600 in the beginning of each month and

- i. Suppose a partner withdraws Rs.600 in the beginning of each month and interest is charged at the rate of 10% per annum.

Date of Drawings	Amount withdrawn	Period for which interest is to be calculated (in months)
Jan. 1	600	12 Months
Feb. 1	600	11
March 1	600	10
April 1	600	9
May 1	600	8
June 1	600	7
July 1	600	6
August 1	600	5
September 1	600	4
October 1	600	3
November 1	600	2
December 1	600	1
	7,200	

### Working Notes :

- i. Interest has to be calculated on the total amount withdrawn i.e. Rs.7,200
- ii. The whole amount has not been utilised for 12 months.
- iii. On Jan.1 Rs.600 was withdrawn and was utilised for 12 months, therefore, interest should be calculated for 12 months on Rs.600. On Feb.1, Rs. 600 was withdrawn but utilised for 11 months and so on. Therefore, we calculate interest on the average period for which the amount has been utilised. The average period is calculated as under :-

$$\frac{12+11+10+9+8+7+6+5+4+3+2+1}{12} = 6\frac{1}{2} \text{ months}$$

The annual interest on the total drawings will be :-

$$7,200 \times \frac{10}{100} \times \frac{6\frac{1}{2}}{12} = \text{Rs.390}$$

ii. Suppose the drawings are made at the end of each month then:-

Date of Drawings	Amount withdrawn	Period for which interest (in months)
31 Jan.	600	11 Months
28 Feb.	600	10
31 March	600	9
30 April	600	8
31 May	600	7
30 June	600	6
31 July	600	5
31 August	600	4
30 September	600	3
31 October	600	2
30 November	600	1
31 December	600	0
	<u>7,200</u>	<u>66</u>

By the same reasoning as above, average period is calculated as under:

$$\frac{11+10+9+8+7+6+5+4+3+2+1}{12} = 5\frac{1}{2} \text{ months}$$

Therefore the interest to be calculated will be :-

$$7,200 \times \frac{10}{100} \times \frac{5\frac{1}{2}}{12} = \text{Rs.}330$$

iii. If drawings are made in the middle of the month then the interest will be calculated for a period of 6 months worked out as under :

$$7,200 \times \frac{10}{100} \times \frac{6}{12} = \text{Rs.}360$$

Date of Drawings.	Amount withdrawn	Period for which interest is charged (in months)
Jan. 15	600	11.5
Feb. 14	600	10.5
March 15	600	9.5
April 15	600	8.5
May 15	600	7.5
June 15	600	6.5
July 15	600	5.5
August 15	600	4.5
September 15	600	3.5
October 15	600	2.5
November 15	600	1.5
December 15	600	0.5
	<u>7,200</u>	<u>72.0</u>

The average period is calculated as under :-

$$\frac{11.5 + 10.5 + 9.5 + 8.5 + 7.5 + 6.5 + 5.5 + 4.5 + 3.5 + 2.5 + 1.5 + 0.5}{12}$$

$$= \frac{72}{12} = 6 \text{ months}$$

### Product Method

Under this method, the product is obtained by multiplying the amount of drawings with the period for which that amount is utilised. Then the interest on this amount is calculated for one month. It is not necessary that the amount of drawings are fixed or at regular intervals.

### Calculation of Interest by Product Method

Month	Amount (Rs) 1	×	Period (months) 2	=	Product (1 × 2)
Jan. 1	600		12		7,200
Feb. 1	600		11		6,600
March 1	600		10		6,000
April 1	600		9		5,400
May 1	600		8		4,800
June 1	600		7		4,200
July 1	600		6		3,600
August 1	600		5		3,000
September 1	600		4		2,400
October 1	600		3		1,800
November 1	600		2		1,200
December 1	600		1		600
					46,800

Suppose interest is 10% per annum, then Interest on drawings will be:

$$46,800 \times \frac{10}{100} \times \frac{1}{12} = 440$$

**Note :** Sometimes, total drawings are given and nothing is specified about the period of drawings. In that case, interest is charged for a period of six months.

#### Partner's Salary

This salary is treated as an expense to the firm and therefore, is an appropriation of profits. The partner's capital account is credited with the amount of salary paid by the firm. The salary is finally transferred to the Profit and Loss Appropriation account. The rest of the profits are available for distribution to the partners in their profit sharing ratio.

The following entries are passed when salary is paid to a partner.

Partner's Salary A/c Dr.

To partner's capital a/c

(Being salary credited to partner)

## ii. Profit &amp; Loss Appropriation A/c Dr.

To Partner's Salary a/c

(Being salary transferred to Profit & Loss appropriation A/c)

*Note* : Transfer Vouchers are also prepared in respect of above transactions.

**Partner's Commission**

The Agreement may provide for a certain percentage of profits to be paid to the partner/partners as commission. The accounting treatment and the entries passed will be similar to those of salary. The Commission will have to be calculated on net profits depending upon how it is based on net profits. It may be Charged on net Profit -

- i. Before charging such commission, or
  - ii. After charging such commission.
- i. Commission on net profit before charging such commission. Suppose, net profit of a firm is Rs.40,000. One partner, A, is allowed a 5% commission on net profits before charging such commission.

5% commission is to be calculated on net profit which is Rs.40,000. The formula for calculating commission is :

$$\text{Profit before charging such commission} \times \frac{\text{Rate}}{100}$$

$$\text{Therefore, Commission will be } 40,000 \times \frac{5}{100} = \text{Rs.2,000}$$

- ii. Commission based on net profit after charging such commission.

The formula for calculating commission in the above case will be

$$\frac{\% \text{ rate}}{100 + \% \text{ rate}} \times \text{Net profit before charging such commission}$$

Let profit before commission be Rs.100 commission is 5%

$$\text{Profit after commission will be } 100 + 5 = \text{Rs.105}$$

In the same example above, A's commission will be

$$\frac{5}{100+5} \times 40,000 = \frac{5}{105} \times 40,000 = \text{Rs.1,904.76}$$

The entries passed will be similar to those passed for salaries. Partner'

Commission is also treated as expense to the firm and will be debited to the Profit and Loss appropriation account. Since it is paid to a partner, the partners' capital account is credited. The entries for partner's commission are-

- i. Commission A/c - Dr.  
    To Partner's capital a/c  
    (Being commission credited to partner).
- ii. Profit & Loss Appropriation A/c - Dr.  
    To Commission A/c  
    (Being commission transferred to Profit & Loss Appropriation A/c)
- iii. Commission on net profit after paying salary and charging commission.

In the above example, suppose one partner is paid a salary of Rs.5,000. He is also paid a commission of 5% on net profits which is Rs.40,000. In this case, first salary to be paid will be deducted from the net profits is (Rs.40,000 - Rs.5,000) = Rs.35,000.

5% commission will be charged on Rs.35,000 with the above formula as in (ii) above.

$$\frac{\% \text{ rate}}{100 + \% \text{ rate}} \times \text{Net profit before charging such commission}$$

$$\frac{5}{105} \times 35,000 = \frac{5,000}{3} = \text{Rs.1,667/-}$$

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### INTEXT QUESTIONS 22.3

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Fill in the blanks with suitable word or words:

- (i) Interest on Drawings is \_\_\_\_\_ to Profit & Loss Appropriation Account.
  - (ii) The two methods of calculating interest on drawings are - (i) Simple Average method and (ii) \_\_\_\_\_.
  - (iii) Adjustments are recorded in \_\_\_\_\_, in case of Fixed Capital method.
  - (iv) Profit & Loss Appropriation Account is \_\_\_\_\_ when salary is paid to partner.
-

## 22.6 WHAT YOU HAVE LEARNT

### 1. Definition of Partnership

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

The characteristics of partnership are :-

- |                           |                          |
|---------------------------|--------------------------|
| (i) Agreement             | (ii) Number of persons   |
| (iii) Business            | (iv) Sharing profits     |
| (v) Unlimited liability   | (vi) Management          |
| (vii) Implied Agency      | (viii) Utmost Good Faith |
| (ix) Transfer of Interest |                          |

### 2. Partnership Deed

It is a document which contains the terms of partnership as agreed to by the partners. In the absence of partnership deed or if the partnership deed 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. |                                 |

### 3. Partner's capital accounts

Each partner's capital account is maintained separately. There are two methods viz:-

- (i) Fluctuating capital account method - Only one account is prepared and all adjustments are made in the capital account itself.
- (ii) Fixed capital account method - Two accounts are maintained, a partners' capital account which is kept intact and a current account in which adjustments are made.

Profit & Loss Appropriation account shows the disposal of profits amongst the partners and specific adjustments relating to interest on capital, salary, commission are made in this account.

**4. Interest on Capital**

The journal entries will be :

- (a) Interest on Capital A/c - Dr.  
                     To Partner's Capital A/c  
                     (Being interest charged on capital)
- (b) Profit & Loss Appropriation A/c - Dr.  
                     To Interest on capital A/c

**5. Interest on Drawings**

The journal entries will be

- (a) Interest on Drawings A/c - Dr.  
                     To Profit & Loss Appropriation A/c  
                     (Being the amount transferred to Profit & Loss  
                     Appropriation A/c)
- (b) Partner's Capital or current A/c - Dr  
                     To Interest on Drawing A/c  
                     (Being the interest charged on drawings)

There are two methods of calculating interest on drawings (i) Simple Average method (ii) Product method

**6. Partner's salary**

The following entries are passed:

- (i) Partner's Salary A/c - Dr.  
                     To Partner's Capital A/c  
                     (Being salary paid to partners)
- (ii) Profit & Loss Appropriation - Dr.  
                     To Partner's Salary A/c  
                     (Being salary transferred to Profit & Loss Appropriation A/c)

**Partner's commission**

The entries passed will be :

- (i) Commission A/c - Dr.  
                     To partners' capital a/c  
                     (Being commission paid to partner)
- (ii) Profit & Loss Appropriation A/c Dr.  
                     To Commission A/c  
                     (Being commission transferred to Profit & Loss  
                     Appropriation)

## 22.7 TERMINAL QUESTIONS

1. Define Partnership Deed.
2. Explain the characteristics of a partnership.
3. What are the provisions of the Partnership Act relevant to partnership accounts?
4. Distinguish between fixed and fluctuating methods of preparing capital accounts.
5. What is Profit & Loss Appropriation account? Why is it prepared?
6. What are the steps to be followed for preparing Profit & Loss Appropriation account?
7. A and B are partners in a firm. They share profits and losses in the ratio of 2:3. According to the partnership agreement, interest on drawings is to be charged @ 10% p.a. Their drawings during 1995 were Rs.30,000 and Rs.20,000 respectively. Calculate interest on drawings based on the assumption that the amounts were withdrawn evenly throughout the year.
8. Rita & Gita were partners in a firm contributing capitals of Rs.1,00,000 and Rs.80,000 respectively. They share profits in the ratio of their capitals. According to the partnership agreement, interest on capital and drawing are 12% and 10% p.a. respectively. Rita is to get a monthly salary of Rs.5,000. The profit for the year ended March 31, 1996 was Rs.1,30,000. The drawings of Rita and Gita were Rs.30,000 and Rs.45,000 respectively. The interest was Rs.1,500 for Rita and Rs.2,000 for Gita. Prepare Profit & Loss Appropriation A/c and partners' capital accounts according to fluctuating capital method.
9. The partnership agreement of Krishan and Arjun states –:
  - i. Krishna will be allowed a salary of Rs.1,000 p.m.
  - ii. Arjun will be allowed a commission of 10% of the net profit after allowing Krishna's salary.
  - iii. Partners are entitled to 7% interest on their fixed capitals.
  - iv. 5% interest will be charged on partner's annual drawings.
  - v. They will share profits equally.

The fixed capital of Krishna and Arjun were Rs.1,20,000 and Rs.90,000 respectively. Their annual drawings were Rs.20,000 and Rs.15,000 respectively. On March 31, 1995 the net profit was Rs.55,000. Prepare Profit & Loss Appropriation account.

10. A and B are partners, sharing profits and Losses equally. Their monthly drawings are Rs.3000 each. Interest on drawings is to be charged @ 10% p.a. Calculate interest on A's drawings for the year 1995, if :
- Drawings are made in the beginning of each month.
  - In the middle of every month.
  - At the end of every month.
11. Abdul and Rahim were partners in a firm and their balances on March 31, 1995 were :

	Abdul Rs.	Rahim Rs.
Capital accounts	50,000	60,000
Current accounts	8,200	3,800
Drawings	10,850	8,150

Net profit before charging interest on capital and partner's salary was Rs.12,000.

They agree on the following:

- Profits & Losses to be shared by Abdul and Rahim in the ratio of 3:2.
- 5% interest is to be allowed on capital.
- Rahim should be paid a monthly salary Rs.5000. Prepare Profit & Loss Appropriation account and the Partners' current accounts.

## 22.8 ANSWERS TO INTEXT QUESTIONS

22.1 (i) Yes. (ii) No. (iii) Yes.

(iv) No. (v) No.

22.2 (i) Debit Side - Drawings A/c, Interest on Drawings A/c.  
Credit Side - Interest on Capital A/c, Salary A/c,  
Commission A/c, Share of Partner's Profit.

(ii) Credit Side - Capital introduced/Balance of Capital A/c.

(iii) Current A/c.

22.3 (i) Credited (ii) Product method

(iii) Current A/c (iv) Debited