Chapter 9

# Accounting for Partnership Firms

## 1. BASICS, APPROPRIATION OF PROFIT TO PARTNERS

### 1.1 Definitions

1. **Partnership:** Partnership is the relationship between persons who have agreed to share the profit or loss of a business carried on by all or any one of them acting for all.
2. **Partners:** Persons who have entered into Partnership with one another are individually called Partners.
3. **Firm:** Persons who have entered into Partnership with one another are **collectively** called **Firm**.
4. **Firm Name:** The name under which their business is carried on is called the Firm Name.

### 1.2 Features of Partnership

1. **Persons:** It requires atleast two persons to form a Partnership. Persons for this persons includes natural persons i.e. individuals and artificial persons having legal entity e.g. a Limited Company.
2. **Relationship:** A relationship exists between / among two or more persons who join together to form the Partnership.
3. **Agreement:** An agreement is entered by all the persons concerned, setting out the terms and conditions under which the Partnership is based. When this agreement is set out in writing, it is called the "Partnership Deed".
4. **Managing of Business:** The activities of the business will be carried on / managed by all or any one of them acting for all. This principle of **mutuality** is the essence of Partnership agreement.
5. **Sharing of Profit / Loss:** The Partners share the profits and losses of the business in the agreed ratio.

### 1.3 Partnership Deed and its Contents

1. **Meaning:** Partnership Deed is the written agreement containing the terms and conditions under which the Partnership will sustain or exist.

2. **Contents of Partnership Deed:**

(a) Name of the Firm and the nature of the Partnership Business.

(b) Commencement and Tenure of the Business (e.g. Partnership at Will, etc.).

(c) Amount of Capital to be contributed by each Partner.

(d) Ratio for sharing the Profit / Loss of the Partnership business amongst the Partners.

(e) Arrangement in respect of Drawings by Partners and limits thereon.

(f) Interest to be credited on the Capital Account of Partners.

(g) Interest to be charged on Drawings of Partners.

(h) Remuneration to Partners and the basis of determining such remuneration e.g. Commission as a percentage of the Firm's Turnover, other conditions for eligibility of remuneration etc.

(i) Process of settling disputes that may arise among the Partners.

(j) Procedure for maintenance of Books of Accounts.

(k) Audit of Books of Accounts.

(l) Manner of valuation of Goodwill in case of admission of new partners, retirement of existing partners and death of a Partner.

(m) Procedure for settlement of Partners' claims in case of retirement / death.

(n) Procedure for dissolution of Partnership.

(o) Such other conditions which the Partners' may decide.

**Note:** It is not mandatory to have a written agreement in all cases. Further, even in cases where there is a written Partnership Deed, it is not compulsory to have it registered.

## 1.4 Powers of Partners

The rights, duties and powers of Partners can be changed by mutual consent. The following principles apply in this regard –

| 1. **Instances where acts of Individual Partners will bind Other Partners** | 2. **Instances where acts of Individual Partners will NOT bind Other Partners** |
|---|---|
| In a trading Firm, the following acts are considered to be within the Partner's implied authority –<br>(a) Purchase, on behalf of the Firm, goods dealt by the Firm or used by the Firm in its business,<br>(b) Sale of the goods of the Firm,<br>(c) Receiving payments of debts due to the Firm and issuing receipt for it,<br>(d) Settlement of accounts with third parties who deal with the Firm,<br>(e) Appointment of employees as may be required to carry on the Firm's business,<br>(f) Borrowing money on behalf of the Firm,<br>(g) Pledging as security, goods of the Firm for loans obtained,<br>(h) Drawing, accepting and endorsing negotiable instruments on behalf of the Firm,<br>(i) Hiring solicitor to defend actions against the Firm. | In the absence of any usage or custom of trade to the contrary, implied authority of a Partner does not enable him to –<br>(a) Submit to arbitration, a dispute relating to the business of the Firm,<br>(b) Open a bank account on behalf of the Firm in Partner's own name,<br>(c) Compromise or relinquish any claim or portion of claim by the Firm,<br>(d) Withdraw any suit or proceeding filed on behalf of the Firm,<br>(e) Admit any liability in a suit or proceeding against the Firm,<br>(f) Acquire immovable property on behalf of the Firm,<br>(g) Transfer immovable property belonging to the Firm, and<br>(h) Enter into Partnership on behalf of the Firm. |

## 1.5 Remuneration, Interest on Capital Profit Sharing Ratio

1. **Governing Statute:** The law governing Partnership in India is the Partnership Act, 1932.

2. **Conditions not covered by Partnership Deed:** Where any situation or circumstance is not covered by the Partnership Deed or is not adequately provided for in the Partnership Deed, the provisions of the Partnership Act, 1932 will apply.

| If the Deed is silent on – | Provisions of the Partnership Act |
|---|---|
| Partners' Remuneration / Salary / Commission | No Remuneration will be allowed to any Partner. |
| Interest on Partners' Capital | No Interest on Capital will be allowed to any Partner. |
| Interest on Loan given by Partner to the Firm | Maximum 6% p.a. can be allowed on Loan. |
| Interest on Partners' Drawings | No interest will be charged on Partners' Drawings. |
| Profit Sharing Ratio | Profits and Losses will be shared equally. |

**Note:** In the absence of agreement, Interest and Remuneration payable to a Partner will be paid only if there is profit.

## 1.6 Transactions that affect the Capital Accounts of Partners

1. **Transactions:** The following transactions affect the Capital Accounts of Partners –
   (a) Capital Contribution in the form of Cash / other Asset introduced into business (Both Initial Capital Contribution & Additional Capital Contribution, to the extent not treated as Loan, will be considered.)
   (b) Interest on Capital at the rate agreed in the Partnership Deed,
   (c) Amounts withdrawn by Partners during the period,
   (d) Interest, if any, chargeable on Drawings of Partners,
   (e) Salary / Remuneration to Partners for managing the affairs of the business,
   (f) Share of Profit / Loss of the business as per agreed Profit Sharing Ratio (PSR),
   (g) Share of Goodwill / Revaluation Profit, etc.

2. **Methods of Accounting:** The transactions affecting the Partners' Capital Accounts may be accounted under any of the following methods –

| Aspect | Fluctuating Capital Method | Fixed Capital Method |
|---|---|---|
| Ledger Accounts prepared | Partner's Capital Account. | 1. Partner's Capital Account, and<br>2. Partner's Current Account. |
| Initial Capital Contribution | Amount brought in or contributed is credited to the Partner's Capital A/c. | Amount brought in or contributed is credited to the Partner's Capital A/c. |
| Subsequent transactions | Subsequent transactions are also routed through Partner's Capital Account. | Subsequent transactions are accounted in Partner's Current Account. |

**FORMAT OF PARTNERS' CAPITAL ACCOUNT**

| Particulars | A | B | C | Particulars | A | B | C |
|---|---|---|---|---|---|---|---|
| To Cash / Bank<br>(withdrawal of Capital, if any)<br>To balance c/d | | | | By Cash / Bank / Assets<br>(i.e. Capital Contribution) | | | |
| **Total** | | | | **Total** | | | |

**FORMAT OF PARTNERS' CURRENT ACCOUNT**

| Particulars | A | B | C | Particulars | A | B | C |
|---|---|---|---|---|---|---|---|
| To Drawings A/c<br>To Profit & Loss Appropriation<br>– Interest on Drawings, if any<br>– Share of Loss, if any<br><br>To balance c/d | | | | By Cash / Bank / Assets<br>(i.e. Additional Capital, if any)<br>By Profit & Loss Appropriation<br>– Remuneration / Salary / Commn<br>– Interest on Capital<br>– Share of Profit | | | |
| **Total** | | | | **Total** | | | |

**Note:** If Capital Accounts are maintained on Fluctuating basis, all the above entries will be made in one single Capital Account only. There will not be any Current Account.

## 1.7 Profit and Loss Appropriation Account

1. **Purpose:** The Profit and Loss A/c of the Firm will show the profit earned or loss suffered by the Firm. To distribute the above Profit properly to the Partners, the **Profit and Loss Appropriation A/c** is used.

2. **Features:**
   (a) It is an extension of P&L Account.
   (b) It is applicable only for Partnership Firms, and not Sole Proprietary Concerns.
   (c) It provides details of how the Net Profit for the period has been distributed to the Partners.
   (d) The entries in P&L Appropriation A/c are governed by the Partnership Deed or Partnership Act.

3. **Journal Entries:**

| Item | Journal Entry |
|---|---|
| (a) Profit brought forward from P&L A/c to Profit and Loss Appropriation A/c (**See Note below**) | Profit & Loss A/c Dr.<br>To Profit & Loss Appropriation A/c |
| (b) Remuneration / Salary / Commission to Partners, as per Partnership Deed<br>(c) Interest on Partners' Capital, if any.<br>(d) Profit distributed to Partners in agreed ratio. | Profit & Loss Appropriation A/c Dr.<br>To Partners' Capital (individually) |
| (e) Transfer to Reserves, if any. | Profit & Loss Appropriation A/c Dr.<br>To Specific Reserve A/c |
| (f) Interest on Partners' Drawings, if any.<br>(g) Loss distributed to Partners in agreed ratio. | Partners' Capital A/c (individually) Dr.<br>To Profit & Loss Appropriation A/c |

**Note:** Interest on Partners' Loan, Rent for use of Partners' premises, if any, etc. are all debited to P&L A/c itself. Net Profit **after** charging and debiting these items, is only transferred to P&L Appropriation A/c.

4. **Format:** **Profit and Loss Appropriation Account**

| Particulars | Amt | Particulars | Amt |
|---|---|---|---|
| To Remuneration / Salary / Commission to Partners, as per Partnership Deed<br>To Interest on Partners' Capital<br>To Transfer to Reserves, if any<br>To Profit distributed to Partners in PSR | | By Profit and Loss A/c<br>(Profit for the year brought forward)<br>By Interest on Partners' Drawings, if any<br><br>By Loss distributed to Partners in PSR | |
| (PSR = Profit Sharing Ratio) **Total** | | **Total** | |

## 1.8 Calculation of Remuneration / Salary / Commission to Partners

Remuneration / Salary / Commission to Partners, can be provided to Partners, only if the Partnership Deed so provides. The calculations are as under –

| Type of Capital | Computation |
|---|---|
| 1. Remuneration / Salary | Remuneration / Salary p.a. = Monthly Amount × No. of months |
| 2. Commission as a % of Turnover | Commission p.a. = Sales Turnover of the Firm × Rate of Commission |
| 3. Commission as % of Net Profit<br>(a) before Commission<br>(b) after Commission | <br>Net Profit before Commission × Rate of Commission/100<br>$\text{Net Profit before Commission} \times \dfrac{\text{Rate of Commission}}{(100 + \text{Rate of Commission})}$ |

## 1.9 Interest on Partners' Capital

| Type of Capital | Computation of Interest on Capital (IOC) |
|---|---|
| 1. Opening Capital | IOC = Opening Capital × Rate of Interest |
| 2. Additional Capital introduced | IOC = Additional Capital × Rate of Interest × Period of use |

**Example:** On $1^{st}$ January, Ram brought in ₹ 5,00,000 into the Firm's business. He introduced a further ₹ 2,00,000 on $30^{th}$ September as his Capital. He is entitled to 12% Interest on Capital. The Firm closes its books on $31^{st}$ December every year. Here, IOC on Ram's Capital will be [(₹ 5,00,000 × 12%) + (₹ 2,00,000 × 12% × 3/12)] = ₹ 66,000.

## 1.10 Interest on Capital in case of insufficient Profits or Loss

Interest on Partners' Capital is provided out of **profits only**. The treatment in different situations is as under –

<table>
<tr><th>Situation</th><th colspan="2">Treatment of Interest on Capital (IOC)</th></tr>
<tr><td>1. When Partnership Deed is silent, or when there is no Deed</td><td colspan="2">IOC is not allowed.</td></tr>
<tr><td rowspan="4">2. When Partnership Deed provides for Interest on Capital</td><td>Profit Situation</td><td>IOC</td></tr>
<tr><td>(a) In case of Loss</td><td>IOC is not allowed.</td></tr>
<tr><td>(b) In case of Insufficient Profits</td><td>IOC is restricted to the amount of Net Profit. Each Partner's IOC is proportionately reduced. (See Note)</td></tr>
<tr><td>(c) In case of sufficient Profits</td><td>IOC is fully allowed to each Partner.</td></tr>
</table>

**Note:** This treatment is effectively the same as distribution of Net Profit in the **Capital Contribution ratio** of the Partners.

**Illustration 1: Interest on Capital in various situations**

**X and Y are Partners sharing profits and losses in the ratio of 2:3 with a capital of ₹ 2,00,000 and ₹ 1,00,000 respectively. Show the distribution of profits / losses for the year ended 31st March, in each of the following cases –**

**Case 1: If the Partnership Deed is silent as to Interest on Capital and the profits for the year is ₹ 20,000.**

**Case 2: If the Partnership Deed provides for Interest on Capital at 6% p.a. and Loss for the year is ₹ 15,000.**

**Case 3: If the Partnership Deed provides for Interest on Capital at 6% p.a. and the profits for the year is ₹ 21,000.**

**Case 4: If the Partnership Deed provides for Interest on Capital at 6% p.a. and the profits for the year is ₹ 15,000.**

**Solution:**

| Situation | Profit before IOC | IOC | Share of Profit |
|---|---|---|---|
| **Case 1:** If P'ship Deed is silent as to IOC, and Profits =₹ 20,000. | Profit ₹ 20,000 | IOC is **not** allowed in this case. | X: ₹ 20,000 × 2/5 = ₹ 8,000 Profit<br>Y: ₹ 20,000 × 3/5 = ₹ 12,000 Profit |
| **Case 2:** If P'ship Deed provides for 6% IOC, and there is a loss | Loss ₹ 15,000 (See **Note 1**) | IOC is **not** allowed in this case. | X: ₹ 15,000 × 2/5 = ₹ 6,000 Loss<br>Y: ₹ 15,000 × 3/5 = ₹ 9,000 Loss |
| **Case 3:** If P'ship Deed provides for 6% IOC, and Profits = ₹ 21,000 | Profit ₹ 21,000 | IOC at 6% on Cap is<br>X: ₹ 12,000<br>Y: ₹ 6,000 | Pft after IOC = 21,000 – 18,000 = 3,000<br>X: ₹ 3,000 × 2/5 = ₹ 1,200 Profit<br>Y: ₹ 3,000 × 3/5 = ₹ 1,800 Profit |
| **Case 4:** If P'ship Deed provides for 6% IOC, and Profits = ₹ 15,000 | Profit ₹ 15,000 (See **Note 2**) | IOC **restricted** to the amt of Pft ₹ 15,000<br>X: ₹ 10,000<br>Y: ₹ 5,000 | Profit as such is not transferred to Partners' Capital A/c. IOC is restricted to the amount of profit available. |

**Note:**

1. In **Case 2** above, the transfer of Loss to Partner' Capital A/c is made directly from P&L A/c. There is no need to prepare P&L Appropriation A/c in this case.
2. In **Case 4** above, IOC is computed as = (IOC Due to each Partner× Profit Avlble ÷ Total IOC Due)
   - X: (₹ 12,000 × ₹ 15,000) ÷ ₹18,000 = ₹ 10,000
   - Y: (₹6,000 × ₹ 15,000) ÷ ₹ 18,000 = ₹ 5,000

**Illustration 2: Interest on Capital with additional Capital**

**A and B started business on 1st January with a Capital of ₹ 60,000 and ₹ 40,000 respectively. During the year, A introduced ₹ 10,000 to the Firm as Additional Capital on 1st July. They withdrew ₹ 5,000 per month for household expenses in lieu of profits. Interest on capital is to be allowed at 10%. Calculate the interest payable to A and B for the year ended 31st December.**

**Solution:**

| **Interest on A's Capital:** | ₹ |
|---|---|
| Interest on ₹ 60,000 for one year: ₹ 60,000 × 10% | 6,000 |
| Interest on ₹ 10,000 for 6 months: ₹ 10,000 × 10% ×6/12 (from 1st July to 31st Dec) | 500 |
| | **6,500** |
| **Interest on B's Capital:** Interest on ₹ 40,000 for one year: ₹ 40,000 × 10% | **4,000** |

**Note:** No interest has been charged on Drawings in the absence of any provision to that effect.

**Illustration 3: Interest on Capital with additional Capital**

**Ramesh and Naresh are Partners in a Firm. Their capitals as on 1st April of a financial year were ₹ 2,50,000 and ₹ 1,50,000 respectively. They share profits equally. On 1st July, they decided that their Capitals should be ₹ 2,00,000 each. The necessary adjustment in the capitals was made by introducing or withdrawing cash. Interest on Capital is allowed at 8% p.a. Compute the interest on capital for both Partners for the year ending 31st March.**

**Solution:**

| Period | IOC for Ramesh | IOC for Naresh |
|---|---|---|
| 3 months (1st April to 30th June) | 2,50,000 × 8% ×3/12 = ₹ 5,000 | 1,50,000 × 8% ×3/12 = ₹ 3,000 |
| 9 months (1st July to 31st Mar) | 2,00,000 × 8% ×9/12 = ₹ 12,000 | 2,00,000 × 8% ×9/12 = ₹ 12,000 |
| **Total** | **₹ 17,000** | **₹ 15,000** |

## 1.11 Interest on Partners' Drawings

Drawings refer to the amount withdrawn by the Partners, in cash or in kind, for their personal use. **If the Partnership Deed so provides,** Interest on Drawings shall be calculated as below –

| Situation | Interest on Drawings = |
|---|---|
| 1. Fixed Amount drawn at the **beginning of every month,** throughout the year | Total Drawings × Rate of Interest× $\frac{6.5}{12}$ |
| 2. Fixed Amount drawn at the **middle of every month,** throughout the year | Total Drawings × Rate of Interest× $\frac{6}{12}$ |
| 3. Fixed Amount drawn at the **end of every month,** throughout the year | Total Drawings × Rate of Interest× $\frac{5.5}{12}$ |
| 4. Fixed Amount drawn at the **beginning of every quarter,** throughout the year | Total Drawings × Rate of Interest× $\frac{7.5}{12}$ |
| 5. Fixed Amount drawn at the **middle of every quarter,** throughout the year | Total Drawings × Rate of Interest× $\frac{6}{12}$ |
| 6. Fixed Amount drawn at the **end of every quarter,** throughout the year | Total Drawings × Rate of Interest× $\frac{4.5}{12}$ |
| 7. Fixed Amount drawn at the **beginning of every month,** for a 6–months period | Total Drawings × Rate of Interest× $\frac{3.5}{12}$ |
| 8. Fixed Amount drawn at the **middle of every month,** for a 6–months period | Total Drawings × Rate of Interest× $\frac{3}{12}$ |
| 9. Fixed Amount drawn at the **end of every month,** for a six months period | Total Drawings × Rate of Interest× $\frac{2.5}{12}$ |
| 10. Annual Amount of Drawings is given, but **date of withdrawal is not given.** | Total Drawings × Rate of Interest× $\frac{6}{12}$ |
| 11. Annual Drawings is given, but Interest is to be calculated without reference to Time Factor, i.e. without "p.a." | Total Drawings × Rate of Interest |
| 12. **Unequal** Amounts withdrawn on different dates | Use – (a) **Direct Method**, or (b) **Product Method,** to calculate Interest. |

**Illustration 4: Interest on Drawings in various situations**

**Compute Interest on Partners' Drawings in the following situations, if interest rate is 10% p.a. –**

- **₹ 10,000 withdrawn per month, throughout the year, at – (a) beginning of each month, (b) middle of each month, and (c) end of each month.**
- **₹ 24,000 withdrawn per quarter, throughout the year, at – (a) beginning of each quarter, (b) middle of each quarter, and (c) end of each quarter.**
- **₹ 15,000 withdrawn per month, for a six months period, at – (a) beginning of each month, (b) middle of each month, and (c) end of each month.**
- **Drawings during the entire year ₹ 2,50,000 (details of withdrawal not available)**

- **Drawings during the entire year ₹ 2,50,000 (details of withdrawal not available), and interest is to be calculated without reference to time factor. (i.e. Interest on Drawings at 10%, and not 10% p.a.)**

**Solution:**

| Situation | Computation of Interest on Drawings |
|---|---|
| 1. ₹ 10,000 p.m. at **beginning** of each month | = Total Drawings × Rate of Interest× 6.5/12<br>= ₹ 1,20,000 × 10% × 6.5/12 = ₹ **6,500** |
| 2. ₹ 10,000 p.m. at **middle** of each month | = Total Drawings × Rate of Interest× 6/12<br>= ₹ 1,20,000 × 10% × 6/12 = ₹ **6,000** |
| 3. ₹ 10,000 p.m. at **end** of each month | = Total Drawings × Rate of Interest× 5.5/12<br>= ₹ 1,20,000 × 10% × 5.5/12 = ₹ **5,500** |
| 4. ₹ 24,000 per quarter, at **beginning** of each quarter | = Total Drawings × Rate of Interest× 7.5/12<br>= ₹ 96,000 × 10% × 7.5/12 = ₹ **6,000** |
| 5. ₹ 24,000 per quarter, at **middle** of each quarter | = Total Drawings × Rate of Interest× 6/12<br>= ₹ 96,000 × 10% × 6/12 = ₹ **4,800** |
| 6. ₹ 24,000 per quarter, at **end** of each quarter | = Total Drawings × Rate of Interest× 4.5/12<br>= ₹ 96,000 × 10% × 4.5/12 = ₹ **3,600** |
| 7. ₹ 10,000 p.m. for 6 months, at **beginning** of each month | = Total Drawings × Rate of Interest× 3.5/12<br>= ₹ 60,000 × 10% × 3.5/12 = ₹ **1,750** |
| 8. ₹ 10,000 p.m. for 6 months, at **middle** of each month | = Total Drawings × Rate of Interest× 3/12<br>= ₹ 60,000 × 10% × 3/12 = ₹ **1,500** |
| 9. ₹ 10,000 p.m. for 6 months, at **end** of each month | = Total Drawings × Rate of Interest× 2.5/12<br>= ₹ 60,000 × 10% × 2.5/12 = ₹ **1,250** |
| 10. ₹ 2,50,000 during the year | = Total Drawings × Rate of Interest× 6/12<br>= ₹ 2,50,000 × 10% × 6/12 = ₹ **12,500** |
| 11. ₹ 2,50,000 during the year, interest calculated without reference to Time Factor | = Total Drawings × Rate of Interest<br>= ₹ 2,50,000 × 10% = ₹ **25,000** |

**Illustration 5: Interest on Drawings using Direct Method and Product Method**

**Compute Interest on Partners' Drawings, at 15% p.a. (Financial Year of the Firm ends on 31st December)**

| Date of withdrawal | Feb 1 | May 1 | June 30 | Oct 31 | Dec 31 |
|---|---|---|---|---|---|
| Amount withdrawn (₹) | 20,000 | 50,000 | 20,000 | 60,000 | 20,000 |

**Solution:**

**Interest on Drawings under Direct Method and Product Method**

| Drawings Date | Amount ₹ | Months from Drawings Date to Yr–end, i.e. Dec.31 | Interest on Drawings under Direct Method | Product |
|---|---|---|---|---|
| (1) | (2) | (3) | (4) | (5=2×3) |
| Feb 1 | 20,000 | 11 | ₹ 20,000 × 15% × 11/12 = ₹ 2,750 | 2,20,000 |
| May 1 | 50,000 | 8 | ₹ 50,000 × 15% × 8/12 = ₹ 5,000 | 4,00,000 |
| June 30 | 20,000 | 6 | ₹ 20,000 × 15% × 6/12 = ₹ 1,500 | 1,20,000 |
| Oct 31 | 60,000 | 2 | ₹ 60,000 × 15% × 2/12 = ₹ 1,500 | 1,20,000 |
| Dec 31 | 20,000 | | Nil | Nil |
| | **1,70,000** | | ₹ **10,750** | **8,60,000** |

Interest on Drawings under Product Method = Total Products × Rate of Interest× 1/12
= ₹ 8,60,000 × 15% × 1/12 = ₹ **10,750.**

## 1.12 Guarantee of Minimum Profit to a Partner

1. **Meaning:** Sometimes, the Partners may mutually agree that certain Partner(s) has the right to have **minimum amount** of profit. Such profit is called Guaranteed Profit or Guaranteed Minimum Profit.

2. **Treatment:**

| Situation | Steps in Computation / Treatment |
|---|---|
| (a) If Profit Share > Guaranteed Profit | Distribute the Total Available Profit in the agreed profit sharing ratio, in the usual manner. |
| (b) If Profit Share < Guaranteed Profit | • Distribute the Total Available Profit in the agreed profit sharing ratio, in the usual manner. • Compute the **shortfall** in Guaranteed Profit, and add that to the share of the Partner entitled to the same. • Deduct the shortfall from the Profit Shares of the Other Partners, as described below. |

3. **Burden of Shortfall:** The shortfall in respect of Guaranteed Profit has to be reduced from the Profit Shares of the Other Partners, in the following manner –

| Guarantee given by | Shortfall to be reduced from |
|---|---|
| (a) One of the remaining Partners | That Remaining Partners Share of Profit. |
| (b) Remaining two or all Partners in an agreed ratio | Two or all Partners, in agreed ratio. |
| (c) Remaining Partners in their mutual PSR | All Remaining Partners in mutual PSR. |

**Note:** If the question is silent about the nature of guarantee, situation (c) given above is assumed.

**Illustration 6: P&L Appropriation A/c and Partners' Capital A/c**

**Abhijit and Bhairav are Partners in a Firm sharing profits and losses equally. At the beginning of a year, the Capitals of the Partners were Abhijit – ₹ 2,00,000 and Bhairav – ₹ 1,60,000. The P&L Account of the Firm for the year ended 31st March, showed a Net Profit of ₹ 3,75,000 (before interest on Bhairav's Loan). With the following information, prepare the Profit and Loss Appropriation Account of the Firm and the Partners' Capital Accounts.**

- **Interest on Capital to be allowed at 6% p.a.**
- **Interest on Bhairav's Loan Amount of ₹ 1,00,000 for the whole year.**
- **Interest on Drawings of Partners at 6% p.a. Drawings being Abhijit – ₹ 40,000 and Bhairav – ₹ 30,000**
- **Transfer of 10% of the Distributable Profits to the Reserve Fund.**

**Solution:**

1. **Net Profit for appropriation:** Interest on Partner's Loan is taken at 6% p.a. as there has been no agreement. This is a charge against profit, and will be shown on the Debit Side of the Profit and Loss Account. So, NP for appropriation is ₹ 3,69,000, being ₹ 3,75,000 (given) **less** Interest on Loan ₹ 1,00,000 at 6% p.a, i.e. ₹ 6,000.

2. **Profit and Loss Appropriation Account for the year ended 31st March**

| Particulars | | ₹ | Particulars | ₹ |
|---|---|---|---|---|
| To Interest on Capitals: | | | By Profit and Loss A/c | 3,69,000 |
| Abhijit (₹ 2,00,000 × 6%) | 12,000 | | By Interest on Drawings – | |
| Bhairav (₹ 1,60,000 × 6%) | 9,600 | 21,600 | Abhijit (₹ 40,000 × 6% × 6/12) | 1,200 |
| To Reserve Fund (See **Note**) | | 34,950 | Bhairav(₹ 30,000 × 6% × 6/12) | 900 |
| To Share of Profit transferred to: | | | | |
| Abhijit's Capital A/c | 1,57,275 | | | |
| Bhairav's Capital A/c | 1,57,275 | 3,14,550 | | |
| **Total** | | **3,71,100** | **Total** | **3,71,100** |

**Note:**

- As the date of Drawings is not mentioned, interest is calculated for the average period, i.e. 6 months.
- Reserve Fund is taken at 10% of ₹ 3,49,500, i.e. (₹ 3,69,000 + ₹ 1,200 + ₹ 900 – ₹ 21,600)

3. **Partners' Capital Accounts**

| Particulars | Abhijit | Bhairav | Particulars | Abhijit | Bhairav |
|---|---|---|---|---|---|
| To Drawings A/c | 40,000 | 30,000 | By balance b/d | 2,00,000 | 1,60,000 |
| To Interest on Drawings A/c | 1,200 | 900 | By Interest on Capital | 12,000 | 9,600 |
| To balance c/d | 3,28,075 | 2,95,975 | By P & L Approp. A/c (Profit) | 1,57,275 | 1,57,275 |
| **Total** | **3,69,275** | **3,26,875** | **Total** | **3,69,275** | **3,26,875** |

**Illustration 7: P&L Appropriation A/c and Partners' Capital A/c – Comprehensive**

**A, B and C are Partners in a Firm. According to the Partnership Deed, the Partners are entitled to draw ₹ 7,000, ₹ 6,000 and ₹ 5,000 respectively. Interest on Capitals and Interest on Drawings is fixed at 8% and 10% respectively. Profit during the year ended 31st March was ₹ 7,55,000 out of which ₹ 2,00,000 are to be transferred to General Reserve. B and C are entitled to receive a salary of ₹ 30,000 & ₹ 45,000 respectively. A is entitled to a commission of 10% on Net Distributable Profits after charging such Commission. The balances of Capital Accounts at the beginning of the year were ₹ 5,00,000, ₹ 4,00,000 and ₹ 3,50,000 respectively. Show the Profit and Loss Appropriation Account for the year ended 31st March and the Capital Accounts of Partners in the books of the Firm.**

**Solution:** **Profit & Loss Appropriation A/c for the year ended 31st March**

| Particulars | | ₹ | Particulars | | ₹ |
|---|---|---|---|---|---|
| To Interest on Capitals: | | | By Profit as per Profit and Loss A/c | | 7,55,000 |
| A's Capital (5,00,000× 8%) | 40,000 | | By Interest on Drawings **Note 1** | | |
| B's Capital (4,00,000× 8%) | 32,000 | | A's Capital (84,000 × 10%) | 8,400 | |
| C's Capital (3,50,000×8%) | 28,000 | 1,00,000 | B's Capital (72,000 × 10%) | 7,200 | |
| To Partners' Salaries: | | | C's Capital (60,000 × 10%) | 6,000 | 21,600 |
| B's Capital A/c | 30,000 | | | | |
| C's Capital A/c | 45,000 | 75,000 | | | |
| To General Reserve (given) | | 2,00,000 | | | |
| To A's (Commission) **Note 2** | | 36,510 | | | |
| To Profit trfd to: **Note 3** | | | | | |
| A's Capital A/c (1/3rd) | 1,21,697 | | | | |
| B's Capital A/c (1/3rd) | 1,21,697 | | | | |
| C's Capital A/c (1/3rd) | 1,21,696 | 3,65,090 | | | |
| **Total** | | **7,76,600** | **Total** | | **7,76,600** |

**Note:**

1. Interest on Capital and Interest on Drawings are fixed at 8% and 10% (and not 8% and 10% p.a.) respectively. So, the time factor is ignored.
2. Commission Payable to A is calculated as under –
   10/110 × (₹ 7,55,000 + ₹ 21,600 – ₹ 1,00,000 – ₹ 75,000 – ₹ 2,00,000) = ₹ 36,510.
3. If the Partnership Deed is silent, all Partners are **equal partners**. So, profits of the year are divided among the Partners equally.

**Partners' Capital Accounts**

| Particulars | A | B | C | Particulars | A | B | C |
|---|---|---|---|---|---|---|---|
| To Drawings A/c | 84,000 | 72,000 | 60,000 | By balance b/d | 5,00,000 | 4,00,000 | 3,50,000 |
| To P & L App. A/c | 8,400 | 7,200 | 6,000 | By P & L App. A/c | | | |
| (Int. on Drawings) | | | | –Interest on Capital | 40,000 | 32,000 | 28,000 |
| | | | | –Partners' Salaries | – | 30,000 | 45,000 |
| | | | | –Commission | 36,510 | – | – |
| To balance c/d | 6,05,807 | 5,04,497 | 4,78,696 | –Share of Profit | 1,21,697 | 1,21,697 | 1,21,696 |
| **Total** | **6,98,207** | **5,83,697** | **5,44,696** | **Total** | **6,98,207** | **5,83,697** | **5,44,696** |

**Illustration 8: Guarantee of Profits to Manager as Partner**

**Arun and Bhanu were in Partnership sharing profits and losses in the ratio of 3:2. In appreciation of the services of their Manager Chandru who was in receipt of a Salary of ₹ 24,000 p.a. and a Commission of 5% of the Net Profit after charging such Salary and Commission, they took him to Partnership as from 1st April 2008, giving him 1/8th of the share of profits. The agreement provided that any excess over his former remuneration to which Chandru becomes entitled will be borne by Arun and Bhanu in the ratio of 2:3. Profits for the year ended 31st March 2009 amounted to ₹ 4,44,000. Ascertain how the profits will be shared by the parties.**

**Solution: 1. Computation of Guaranteed Profit and bearing of Deficiency by Other Partners**

| Particulars | ₹ | ₹ |
|---|---|---|
| 1. Chandru's Share as Partner($1/8^{th}$ of Profits ₹ 4,44,000) | | 55,500 |
| 2. Amount payable to Chandru as Manager: Salary | 24,000 | |
| Commission (₹ 4,44,000 − ₹ 24,000) × 5 / 105 | 20,000 | 44,000 |
| 3. Deficiency to be borne by Arun and Bhanu in the ratio 2 : 3 (1 − 2) | | 11,500 |
| 4. Sharing of Deficiency: Arun (₹ 11,500 × 2/5) | | 4,600 |
| Bhanu (₹ 11,500 × 3/5) | | 6,900 |

**2. Statement of Profit sharing by Partners**

| Particulars | Arun | Bhanu | Chandru | Total |
|---|---|---|---|---|
| 1. Basic Share of Profit (See **Note** below) | 4,00,000× 3/5 = 2,40,000 | 4,00,000× 2/5 = 1,60,000 | Share as Manager = 44,000 | 4,44,000 |
| 2. Deficiency of Chandru adjusted | (4,600) | (6,900) | + 11,500 | – |
| 3. Adjusted Share of Profits | **2,35,400** | **1,53,100** | **55,500** | **4,44,000** |

**Note:** Profits available to Arun & Bhanu = 4,44,000 – Chandru's Share as Manager 44,000 = ₹ 4,00,000

**3. Profit and Loss Appropriation A/c**

| Particulars | ₹ | Particulars | ₹ |
|---|---|---|---|
| To Share of Profit transferred to: | | By P&L A/c (Profit for the year) | 4,44,000 |
| Arun Capital A/c | 2,35,400 | | |
| Bhanu Capital A/c | 1,53,100 | | |
| Chandru Capital A/c | 55,500 | | |
| **Total** | **4,44,000** | **Total** | **4,44,000** |