CHAPTER-1 ACCOUNTING FOR PARTNERSHIP FIRMS— FUNDAMENTALS

concept no.



Calculation of Interest on Partner's Capitals

concept no.5A

Calculation of Interest on Partners'Capitals

Interest on Capital is allowed to compensate a partner for contributing capital to the firm in excess of the profit-sharing ratio

PROVISIONS RELATING TO INTEREST ON CAPITAL

Case	Provision
1) When the Partnership Deed does not exist or Partnership Deed does not provide for interest on capital.	**1).**Interest on capital is not allowed.
2) When the Partnership Deed provides for interest on capital but is silent on whether interest is a charge or appropriation.	**2)** Interest on capital is accounted as appropriation of profit Interest on capital is allowed only if there is profit. There are three possible situations as follows: **(i)Situation 1**: Loss – Interest on capital is incurred is not allowed. **(ii) Situation 2**: Profit – Interest on capital is before interest is allowed at the agreed equal to or more rate. than the interest. **(iii) Situation 3**: Profit – Interest is allowed only before interest is to the extent of profit less than the in the ratio of interest on interest. capital of each partner.
3). When the Partnership Deed provides for interest on capital as a charge(i.e., to be allowed whether there are profits or losses).	**3).**Interest on capital is allowed whether the firm has earned profit or has incurred loss.

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Journal entries to record interest on capital are:

If Partners' Capital Accounts are fixed.		If Partners' Capital Accounts are fluctuating.	
(i) nterest on Capital A/c To Partners'Current A/cs (Interest on capital allowed to partners)	...Dr.	(i) Interest on Capital A/c To Partners'Capital A/cs (Interest allowed on partners'capitals)	...Dr.
(ii) Profit & Loss Appropriation A/c To Interest on Capital A/cs (Interest on capital transferred to Profit & Loss Appropriation Account)	...Dr.	(ii) Profit & Loss Appropriation A/c To Interest on Capital A/cs (Interest on capital transferred to Profit & Loss Appropriation Account)	...Dr.

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Questions

Q.1) X and Y are partners sharing profits and losses in the ratio of 2 : 3 with capitals of ₹ 2,00,000 and ₹ 1,00,000 respectively. Pass the necessary Journal entry or entries for distribution of profit/loss for the year ended 31st March, 2024 in each of the alternative cases:

Case 1. If Partnership Deed does not provide for interest on capital and the profit for the year is ₹ 20,000.

Case 2. If Partnership Deed provides for interest on capital @ 6% p.a. and loss for the year is ₹ 15,000.

Case 3. If Partnership Deed provides for interest on capital @ 6% p.a. and the profit for the year is ₹ 21,000.

Case 4 If Partnership Deed provides for interest on capital @ 6% p.a. as a charge on profit and the profit for the year is ₹ 20,000.

Case 5. If Partnership Deed provides for interest on capital @ 6% p.a. as a charge on profit and the profit for the year is ₹ 2,000.

Case 6. If Partnership Deed provides for interest on capital @ 6% p.a. as a charge on profit and the profit for the year is ₹ 18,000.

[ANS: CASE-1 Net profit transferred to Profit & Loss Appropriation Account, and Profit distributed between X and / in the ratio of 2:3, 8,000 & 12,000

CASE-2 Loss transferred to Profit & Loss Appropriation A/c, and (Loss distributed between X and Y in the ratio of 2:3,6,000 and 9,000)

Note: Due to loss, interest on capital is not allowed.

CASE-3 Net profit transferred to Profit & Loss Appropriation Account, Interest on capital allowed to Partners @ 6% p.a,12,000 & 6000 ,Profit distributed between X and Y in the ratio of 2 :3 1200 & 1800

CASE-4 Interest on capital allowed @ 6% p.a.,12,000 & 6,000, Interest on capital transferred to Profit & Loss Account 18,000 ,Net profit transferred to Profit & Loss Appropriation Account Rs.2000, Profit distributed between X and Y in the ratio of 2 :3 800 & 1200

CASE-5 Interest on capital allowed @ 6% p.a.,12,000 & 6,000, Interest on capital transferred to Profit & Loss Account 18,000 ,Loss transferred to Profit & Loss Appropriation A/c Rs.16,000, Net loss transferred to Capital Accounts of X and Y in their profit-sharing ratio,6400 & 9600

CASE-6 (Interest on capital allowed as a charge on profit @ 6% p.a.12,000 & 6,000,Interest on capital transferred to Profit & Loss Account Note: Case 6: Profit & Loss Appropriation Account will not be prepared because interest on capital is a charge against profit and hence is debited to Profit & Loss Account. After allowing interest on capital, it results in neither profit nor loss.

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Case 1: No interest on capital, profit ₹ 20,000
Profit and Loss A/c Dr. ₹ 20,000
To X's Capital A/c ₹ 8,000
To Y's Capital A/c ₹ 12,000
Profits shared in 2:3 ratio

Case 2: Interest on capital @ 6% p.a., loss ₹ 15,000
X's Capital A/c Dr. ₹ 6,000
Y's Capital A/c Dr. ₹ 9,000
To Profit and Loss A/c ₹ 15,000
Interest not provided, only loss distributed in 2:3 ratio

Case 3: Interest on capital @ 6% p.a., profit ₹ 21,000
Profit and Loss A/c Dr. ₹ 21,000
To Interest on Capital A/c ₹ 18,000
To X's Capital A/c ₹ 1,200
To Y's Capital A/c ₹ 1,800
₹ 12,000 and ₹ 6,000 interest given first,
balance profit shared

Case 4: Interest on capital @ 6% p.a. as a charge, profit ₹ 20,000
Profit and Loss A/c Dr. ₹ 20,000
To Interest on Capital A/c ₹ 18,000
To X's Capital A/c ₹ 8,00
To Y's Capital A/c ₹ 12,00
Interest treated as charge, balance ₹ 2,000 shared in 2:3 ratio

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Case 5: Interest on capital @ 6% p.a. as a charge, profit ₹ 2,000

Profit and Loss A/c Dr. ₹ 18,000
To Interest on X'Capital A/c ₹ 12,000
To Interest on Y'Capital A/c ₹ 6,000

X'Capital A/c ₹ 64,00
Y'Capital A/c ₹ 96,00
To Profit and Loss A/c Dr. ₹ 16,000

Case 6: Interest on capital @ 6% p.a. as a charge, profit ₹ 18,000

Profit and Loss A/c Dr. ₹ 18,000
To Interest on Capital A/c ₹ 18,000
Entire profit is used for interest payments, no remaining profit

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Q.2) Ramesh and Naresh are partners in a firm. Their capitals as on 1st April, 2023 were ₹ 2,50,000 and ₹ 1,50,000 respectively. They share profits equally. On 1st July, 2023, they decided that their capitals should be ₹ 2,00,000 each. The necessary adjustment in the capitals were made by introducing or withdrawing capital. Interest on capital is allowed @ 8% p.a.
Calculate interest on capital for both the partners for the year ended 31st March, 2024 **[ANS: (i) Interest on Ramesh's Capital:₹17,000 (ii) Interest on Naresh's Capital:₹15,000]**

Q.3) A and B have capitals of ₹ 4,00,000 and ₹ 2,00,000 respectively and interest on capital is to be allowed @ 6% p.a. Their profit-sharing ratio is 2:3 and net profit for the year is ₹ 30,000. Prepare Profit & Loss Appropriation Account to distribute the profit
[ANS: The interest on As Capital and B's Capital is ₹ 24,000 and ₹ 12,000 respectively. Thus, total interest on capital is ₹ 36,000. Profit before interest is ₹ 30,000. The interest on capital will be allowed as follows:
A = = ₹ 20,000; B. = = ₹ 10,000
Remember: Interest on capital is allowed to the extent of available profit only, since interest on capital is an appropriation of profit.]

Q.4) Atul and Bhaskar are partners sharing profits in the ratio of 2 : 3. Their capitals are ₹ 4,00,000 and ₹ 2,00,000 respectively. Interest is to be allowed on capitals @ 6% p.a., whether the firm earns profit or incurs loss. Profit before allowing interest on capitals is ₹ 30,000.
Prepare Profit & Loss Appropriation Account
[ANS: Loss transferred to Capital A/cs:Atul ₹ 2,400,Bhaskar ₹ 3,600]

Q.5 . Moli and Bholi contribute₹ 20,000 and ₹ 10,000 respectively towards capital. They decide to allow interest on capital @ 6% p.a. Their respective share of profits is 2 : 3 and profit for the year is ₹ 1,500. Show distribution of profits:
(i) When there is no agreement except for interest on capitals; and
(ii) When there is an agreement that the interest on capital is a charge.
[Ans.: (i) Interest on Capital: Moli—₹ 1,000; Bholi—₹ 500; (ii) Loss: Moli—₹ 120; Bholi—₹ 180.]