

### INTEREST ON CAPITAL

Interest on partners' capital will be allowed only when it has been specifically mentioned in the partnership deed. Interest on Capital can be treated as either an Appropriation of profit or a charge against profits.

Charge	Appropriation
<ul style="list-style-type: none"><li>➤ Charge is compulsory in nature. Whether there is profit or loss, all charge items will be met.</li><li>➤ Example of Charge: Office Rent Salary to Employees Manager's Commission etc.</li></ul>	<ul style="list-style-type: none"><li>➤ Appropriation is not compulsory in nature. Appropriation is that amount of profit which is paid to the partners in the form of interest on capital, salary, commission/bonus etc.</li><li>➤ The concept of appropriation is applicable only when there is some profit.</li><li>➤ In case of loss no appropriations.</li><li>➤ Example of Appropriation: Interest on capital, salary or remuneration to partners, bonus or commission to partners etc.</li></ul>

### A. Interest on Capital : An Appropriation of Profits:

<i>When there is loss</i>	<i>Interest on Capital is not allowed because it is an appropriation and will be paid only when there is some profit</i>
<i>In Case of Sufficient Profits</i>	<i>Interest on Capital is allowed in full. All partners are entitled for the interest on capital at the agreed rate or rate of interest on capital already mentioned in the partnership deed.</i>
<i>In case of Insufficient Profits</i>	<i>Interest on Capital is allowed only to the extent of profits in the ratio of interest on capital of each partner. In this case partners do not get full amount of interest.</i>

### B. Interest on Capital: As a Charge against Profits:

Interest on Capital is always allowed in full irrespective of amount of profits or losses

#### Journal Entries

#### a. In case of sufficient profits

Profit and Loss Appropriation A/c      Dr.  
    To Interest on Capital A/c

(Being interest on capital transferred to P & L Appropriation A/c)

#### b. In case of Insufficient Profits or Losses

Profit and Loss / Profit and Loss Adjustment A/c      Dr.  
    To Interest on Capital A/c

(Being interest on capital transferred to P&L Adjustment A/c)

#### Note :

Interest on Capital is always calculated on the opening capital. If Opening Capital is not given in the question, it should be ascertained as follows :

### Calculation of Opening Capital

Capital at the end (closing capital)	XXXX
ADD : Drawings made during the year	XXXX
ADD : Share of Loss During the year (if any)	XXXX
	XXXX
Less : Additional Capital introduced (if any)	XXXX
Less : Share of Profit during the year (if any)	XXXX
<b>Capital in the beginning</b>	<b>XXXX</b>

For additional capital interest is calculated for period for which capital is utilised e.g if additional capital is introduced on 1<sup>st</sup> October in firm where accounts are closed on 31<sup>st</sup> March.

Interest = Amount introduced x Rate/100 x 6/12 as money is utilised for 6 months

### Interest on Drawings

Drawings means cash or goods withdrawn from the business by the proprietor for personal use. It reduces the capital of the proprietor. Interest on drawings will be charged from the partner's capital account, only if it is mentioned in the partnership deed. If partnership deed is silent, no interest on drawings will be charged. According to the business entity concept interest on drawings will be treated as income for the business and loss for the partners.

### Distinction between drawings against profit and drawings against capital

Drawings against profit	Drawings against capital
<ol style="list-style-type: none"> <li>1. This is the amount withdrawn from profits.</li> <li>2. It is shown in the debit side of drawings account</li> <li>3. It is made out of profit, so does not affect the capital</li> <li>4. It is ignored at the time of calculation of interest on drawings</li> </ol>	<ol style="list-style-type: none"> <li>1. This is the amount withdrawn from capital</li> <li>2. It is shown on the debit side of capital account</li> <li>3. It is made out of capital, it reduces the capital</li> <li>4. It is considered for the calculation of interest</li> </ol>



## Methods for Calculation of interest on drawings

1. When a fixed amount is withdrawn by the partners after regular intervals and rate of interest is given in the question with the word per annum

Step 1. Calculate average period :

$$\text{average period} = \frac{\text{Time after first drawing} + \text{time after last drawing}}{2}$$

Step 2. Calculate interest on drawings :

$$\text{interest on drawings} = \text{Total drawings} \times \text{Rate}/100 \times \text{Average period}$$

2. When rate of interest is given without the word per annum

In such a case, Interest on Drawings is calculated with a flat rate irrespective of date of drawings.

3. When Different amounts are withdrawn at different time intervals

We have the following two methods to calculate the amount of Interest on Drawing :

1. **Simple Interest Method**

In this method, interest on drawing is calculated for each amount of drawing individually on the basis of periods for which

2. **Product Method**

In this method, the amounts of drawings are multiplied by the period for which it remained withdrawn during the period, Interest for 1 month is calculated on the sum of these products.

4. **Half Yearly Drawings**

**Half yearly Drawings for year when:**

(a) Drawings are made in the beginning of each period (half-year) Interest on drawing =  
Amount  $\times$  Rate/100  $\times$  9/12

(b) Drawings are made in the middle of each period (half year) Interest on drawing =  
Amount  $\times$  Rate/100  $\times$  6/12

(c) Drawings are made at the end of each period (half year)

Interest on drawing = Amount x Rate/100 x 3/12

**For monthly drawings for 6 months**

(a) Drawings are made in beginning of each month

Interest = Amount x Rate/100 x 3.5/12

(b) When drawings are made in the middle of each month

Interest = Amount x Rate/100 x 3/12

**When date of withdrawal is not specified**

Sometimes date of withdrawal is not given in the question; amount withdrawn by the partners as drawings is given only. In such a case it is assumed that the amount is withdrawn at average basis or withdrawn evenly throughout the year and interest will be charged for the average period which will be assumed to be 6 months. It is assumed that amount is withdrawn in the middle of every month. The following formula will be used.

Interest on Drawings = Total Drawings x Rate/100 x 6/12

**Important Points**

1. If amount is withdrawn in the beginning of each month, interest is calculated for 6 ½ months.
2. If amount is withdrawn in the middle of each month, interest is calculated for 6 months.
3. If amount is withdrawn at the end of each month, interest is calculated for 5 ½ months.
4. If amount is withdrawn in the beginning of each quarter, interest is calculated for 7 ½ months.
5. If amount is withdrawn at the middle of each quarter, interest is calculated for 6 months.
6. If amount is withdrawn at the end of each quarter, interest is calculated for 4 ½ months.
7. When date of withdrawal is not given, it is mainly assumed to be in the middle of month.
8. When different amounts are withdrawn at different intervals, product method is used for the calculation of interest.
9. In the absence of partnership deed or if partnership deed is there but silent about interest, No interest will be charged on drawings.
10. Interest will be credited to P/L Appropriation Account and Debited to partners' capital/current Account.