ACCOUNTING FOR PARTNERSHIP - BASIC CONCEPTS

Nature and Definition of Partnership – In order to overcome the limitations of sole proprietorship such as limited capital, limited managerial ability, limited risk bearing capacity, it will be better to think about a new form of business organization, ie; the Partnership when a business wants to expand or to invest a large amount of capital two or more persons join hands to run it. They agree to share the capital, the management, the risk and the profit and such a mutual relationship based on the agreement among these persons is termed as partnership.

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

Nature of Partnership

1. Two or more persons – **(2 to 50).** Minimum number of members is 2. According to Section 464 of Companies Act 2013 maximum number of partners can be 100, subject to the number prescribed by the government. At present it is limited to 50 by Govt. of India.
2. Agreement Between the Partners – There should be an agreement between the partners either in written or oral regarding the sharing of profit, capital investment etc.
3. Business – The agreement should be for carrying on a business whereas joint ownership of some property does not constitute partnership.
4. Sharing of profits – There must be the sharing of profits among the partners either equally or on the agreed ratio. If there is loss the same treatment should be made as in the case of profit.
5. Business is carried on by all or any of them acting for all – The business can be conducted either by all the partners or any of them can act as agents for the other partners and they carry out the business. Here the partner becomes act as a principal as well as an agent.
6. Unlimited Liability – The liability of each partner is unlimited and they are jointly and severally liable for the debts of the firm.
7. No Separate legal existence – Although the business may be carried on in the firm's name, the firm has no separate existence apart from the partners. It cannot own property or enter into contract in its own name. Whenever a change takes place like retirement, admission, death, insolvency etc. it will also lead to change in the constitution of the firm.
8. Utmost good faith – All the partners should disclose all material facts and present true account to one another. No one should make a secret profit out of the business.
9. Restriction on Transfer of Interest – A partner is not entitled to transfer his interest in the partnership to an outsider without the consent of the other partners.

Partnership Deed / Articles of Partnership

It is the document which contains the terms of partnership as agreed by the partners. It can be either oral or in writing but it is desirable to have it in writing to avoid any misunderstanding in future.

<u>Contents of the Deed</u>

1. Name of the firm
2. Names and addresses of all partners
3. Nature and place of business
4. Date of Commencement of partnership
5. Duration of partnership, if any
6. Capital contribution by the partners
7. The amount which can be withdrawn by each partner
8. Rules regarding operation of bank accounts
9. Division of profits or losses
10. Interest on capital or drawings, if any
11. Interest on partner's loan to the firm
12. Salaries, commission, etc. if payable to any partner
13. Details of division of work among the partners
14. The ascertainment of goodwill on admission, retirement and death of a partner.
15. Settlement of accounts in the event of retirement or death of partners.
16. Settlement of accounts on dissolution of the firm
17. Provisions relating to the maintenance and audit of accounts
18. Provisions for arbitration in the event of disputes
19. Provision regarding borrowings of the firm
20. Rights, duties and liabilities of partners

Rules applicable in the absence of Partnership Deed / Provisions Relevant for Accounting

In the absence of the partnership deed or if the deed is silent on any matter, the Partnership Act 1932 provides the following:-

1. **Profit Sharing** – The profit or loss should be shared equally among the partners irrespective of their capital contribution.
2. **Interest on Capital** – No interest is payable to the partners. If the deed provides for interest on capital, it should be paid only out of profit and if there is loss, no interest can be allowed.
3. **Interest on loan to the firm** – Partners is entitled to get interest at **6%** p.a. on loans advanced by the partners. It should be paid even if there is loss.
4. **Interest on Drawings** – No interest will be charged on drawings made by the partners.
5. **Remuneration to Partners** – No one is entitled to get salary or commission.

PARTNERS' CAPITAL ACCOUNTS

The transactions relating to partners should be recorded in their capital accounts. Normally each partner's capital account is prepared separately.

(*Proforma of Capital account under Fluctuating Capital Method – refer the text book)*

Note: All the items which are entitled to the partner is entered in the credit side and all the items which are bound to pay to the firm is entered in the debit side of the capital account)

There are two methods by which capital accounts of partners can be maintained:-

1. **FLUCTUATING CAPITAL METHOD**

Under this method only one account is maintained ie, the partner's capital account. In this account all the items affecting partner's capital account is recorded such as interest on capital, interest on drawings, drawings, salary, commissions, share of profit or loss etc. as a result the balance in the capital accounts keeps on fluctuating year after year.

2. **FIXED CAPITAL METHOD**

In this case two accounts are maintained for each partner, ie; capital account and current account. In capital account the balance remains the same unless some additional capital is introduced or some amount of capital is withdrawn by an agreement among the partners. While all the items such as interest on capital, drawings, interest on drawings, salary, commission, share of profit or loss etc. are recorded in partner's current account and hence the balance of current account is always changing.

(*Proforma of Capital a/c and Current a/c under fixed capital method – refer the text book)*

Difference between Fixed Capital and Fluctuating Capital Methods

FIXED CAPTIAL METHOD	FLUCTUATING CAPITAL METHOD
1. Two accounts are maintained, ie, capital a/c and current a/c	1. Only one account ie, capital a/c is prepared.
2. Usually, the amount of capital remains the same year after year.	2. The amount of capital is fluctuating
3. Adjustments like interest on capital, drawings, interest on drawings, etc. are made in the current a/c	3. Adjustments are made in the capital a/c itself.
4. Both the current a/c and the capital a/c are appeared in the Balance Sheet	4. Only the capital a/c appears in the Balance Sheet.
5. It should be specifically mentioned in the deed.	6. It is not necessary.

Drawings Account – Withdrawal by a partner in the form of money or money's worth from the firm is called drawings. Drawings account is a personal account. When cash or goods are withdrawn by a partner, drawings account is debited and cash or purchase account is credited. At the end of the period, drawings account is closed by transfer to capital account or current account of the partner concerned.

If some amount is withdrawn out of capital, it is recorded in capital account and not in drawings account.

Journal entries:

1. When cash or goods withdrawn by a partner

    Partner's Drawings A/c Dr

        To Cash / Purchase A/c

2. To close drawings account by transfer to capital account

    Partner's Capital / Current A/c Dr

        To Partner's Drawings A/c

3. When some amount is withdrawn by a partner out capital

Partner's capital A/c Dr

To Cash A/c

Distribution of Profit / Loss among Partners

Profit and Loss Appropriation Account

The net profit reflected by the profit and loss account of the partnership firm needs certain adjustments for items like interest on capital, interest on drawings, salary, commission to the partners etc. All these items are incorporated in the Profit and Loss Appropriation Account.

This is an extension of profit and loss account and is prepared to show how the net profit has been distributed among the partners. This account should begin with the net profit or net loss brought forward from the profit and loss account (profit on the credit side and if loss on the debit side) as the gross profit transferred from the trading account to the profit and loss account.

Further this account should be debited with all the interest on capital, salary, commission to the partner (incomes to the partner i.e., expense to the firm) and credited with interest on drawings, (expense to the partner, i.e., incomes to the firm). The net profit or loss after making the above adjustments will be divided among the partners in the agreed profit sharing ratio and transferred to their capital accounts or current accounts.

Note: Interest payable on the partner's loan is debited to the Profit and Loss Account but not debited to the Profit and Loss Appropriation Account. If such an item is given, it may be ignored while preparing the P&L Appropriation A/c.

(Proforma of Profit and Loss Appropriation Account – refer the text book)

Note: While solving problems, try to reveal the journal entries from the P/L Appn. Account.

Interest on Capital – If the Partnership Deed allows to pay the interest on capital, it should be calculated on the opening balance in the capital account. However, if some additional capital is introduced during the year, the interest on this additional amount should be calculated based on the time for which the amount remains in the business. It is to be noted that no interest is calculated on the Current A/c balances.

In case the opening balance of capital a/c is not given, it may be found out by subtracting those items which have been added to the capital (incomes to the partner) and by adding those items which have been subtracted (expenses to the partner) as detailed below:

Capital at the end of the year			xxxx
Add:	Drawings		xxx
	Interest on Drawings		xxx
	Share of loss if any		xxx
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			xxxx
Less:	Partner's Salary	xxx	
	Partner's Commission	xxx	
	Share of profit if any	xxx	
	Additional Capital if any	xxxx	xxxx
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Opening Capital			xxxx
			======

In case there are withdrawals out of capital as per agreement, during the year, interest on capital is calculated in the following manner:

i. Calculate the interest on the opening capital up to the date of withdrawal out of capital.

ii. Then calculate interest for the remaining period on the amount left after the withdrawal out of capital. These two together constitute the total interest on capital.

Interest on Drawings – Interest on drawings is to be charged from partners if it is specified in the deed. The interest is calculated by considering the time period involved.

Different methods of computing interest on drawings:

1. Amount of withdrawal, rate of interest and the date of withdrawal given,
2. Date of withdrawal not given but the amount and rate of interest given:

   In this situation, it is assumed that the drawings were made evenly throughout the year. In such a case interest should be charged for 6 months on the whole amount.
3. Different amounts withdrawn at different Intervals:

   In case the dates of drawings and the amounts of drawings are clearly stated, the interest may be calculated with the help of Product Method.

   Steps-

   i. Calculate the time period between the date of withdrawal and the date of closing the accounts.

   ii. Multiply the period so calculated by the respective amount of drawings, this is called the Product.

   iii. Add up the various products.

   iv. Calculate the interest for one month on the sum of products at the rate of percentage.
4. Fixed amount withdrawn every month:

   It is to be noted that if a fixed amount is withdrawn at regular intervals, the interest on drawings can be calculated on the basis of average period, as follows:

   a. If the amount is withdrawn on the first day of very month:

$$\text{Average Period} = \frac{\text{Total period in months} + 1}{2}$$

$$= \frac{12 + 1}{2} = 6.5 \text{ months}$$

:. Interest on Drawings = Total Amount x Average Period x 1/12 x Rate of Interest / 100

   b. If the amount is withdrawn on the last day of every month:

$$\text{Average Period} = \frac{\text{Total period in months} - 1}{2}$$

$$= \frac{12 - 1}{2} = 5.5 \text{ months}$$

:. Interest on Drawings = Total Amount x Average Period x 1/12 x Rate of Interest / 100

Interest on Drawings

Also we can interpret the average period as follows:

(Months left after 1st withdrawal + Months left after last withdrawal) / 2

1. 1st day of every month; months left after 1st withdrawal is 12 months and months left after the last withdrawal is 1 month. (= $\frac{12+1}{2}$ = 6.5 months)
2. Middle of every month; (11.5 + 0.5)/2 = 6 months
3. Last day of every month; (11+0)/2 = 5.5 months
4. 1st day of every quarter; (12+3)/2 = 7.5 months
5. Middle of every quarter; (10.5+1.5)/2 = 6 months
6. Last day of every quarter; (9+0)/2 = 4.5 months
7. 1st day of every 6 months; (12+6)/2 = 9 months
8. Middle of every 6 months; (9+3)/2 = 6 months
9. Last day of every 6 months; (6+0)/2 = 3 months

c. If the amount is withdrawn on the middle of every month:

Average Period = $\frac{\text{Total period in months}}{2}$

= 12 /2 = 6 months

:. Interest on Drawings = Total Amount x Average Period x 1/12 x Rate of Interest / 100

5. If the amount is withdrawn at each quarter:
   a. If the amount is withdrawn in the beginning of each quarter (3 months), the average period is 7.5 months. (12+3)/2 = 15/2 = 7.5 months - here 3 indicates number of months in a quarter.
   b. If the amount is withdrawn at the end of each quarter, the average period is 4.5 months. (12-3)/2 = 9/2 = 4.5 months.
   c. If the amount is withdrawn in the middle of each quarter, the average period is 6 months. (12/2 = 6)

GUARANTEE OF PROFIT TO A PARTNER

In certain exceptional cases a partner is guaranteed a minimum amount as share in the profits of the firm. It may be given to an existing partner or a new partner at the time of his admission. This guaranteed profit is to be paid only if his profit as per the ratio is less than the guaranteed amount.

For example, Abin and Sibin are partners, they admit Mohanlal , profit sharing ratio is 3:2:1 with a guaranteed amount of Rs.5000 to Mohanlal.

Current year's profit is Rs.24000/-

:. Mohanlal's share of profit will be Rs.4000/- ie; $24000x\frac{1}{6}$

This is Rs.1000 less than the guaranteed amount.

This deficiency amount of Rs.1000 should be given to Mohanlal by Abin and Sibin in their profit sharing ratio, ie; 3:2

:. Sacrifice by Abin = 1000 x 3/5 = 600

Sacrifice by Sibin = 1000 x 2/5 = 400

In this case, Abin's share of profit = 24000 x 3/6 – 600 = 12000 – 600 = 11400

Sibin's share of profit = 24000 x 2/6 – 400 = 8000 – 400 = 7600

Sometimes any one of the old partners may give guarantee to the incoming partner, say for example Mr.Abin, then he should pay the entire amount of deficiency. In that such a case his share of profit will be :

24000 x 3/6 – 1000 = 12000 – 1000 = 11000/-

Past Adjustments – Sometimes, after closing the books of accounts it is found that certain items are left out by mistake or have been wrongly treated. In such a case necessary adjustments are carried out either in partners' capital accounts or through "Profit and Loss Adjustments Account".

Final Accounts – The Trading and Profit and Loss Accounts and Balance Sheet are prepared in the same manner as in the case of a sole trading concern. The only difference is in the division of profit among the partners at the end. After preparing the trading and profit and loss account, the net profit or net loss should be transferred to Profit and Loss Appropriation Account. All adjustments like interest on capital, interest on drawings, interest on partner's loan, partner's salary, share of profit or loss, etc. are entered in the profit and loss appropriation account. This is to distinguish between the results of operations of business and the distribution of profit among the partners.

Note: **Interest on partner's loan** (loan taken from a partner) is a charge against profit; hence it is debited to Profit and Loss Account. In case, if interest on partner's loan is not debited in the P/L Account then it will be adjusted through Profit and Loss Appropriation Account. Usually this item is shown on the credit side of P/L Appropriation A/c by way of deduction from Net Profit and the remaining profit will be considered for appropriation among the partners.

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