ACCOUNTING FOR PARTNERSHIP FIRMS – FUNDAMENTALS

According to Section -4 of the Indian Partnership Act, 1932:

"Partnership is the relations between two or more persons who have agreed to share the profits of a business carried on by all or any one of them acting for all"

Features of Partnership

1. Two or more persons: There must be at least two persons to form a valid partnership. The maximum number of partners cannot exceed the number of partners prescribed by Companies Act, 2013 which is 50 in any business whether banking or non- banking.

2. Agreement: Partnership comes into existence by an agreement (either written or oral among the partners. The written agreement among the partners is called Partnership Deed.

3. Existence of business and profit motive: A partnership can be formed for the purpose of carrying on legal business with the intention of earning profits. A joint ownership of some property by itself cannot be called a partnership.

4. Sharing of Profits: An agreement between the partners must be aimed at sharing the profits. If some persons join hands to run some charitable activity, it will not be called partnership. Further, if a partner is deprived of his right to share the profits of the business, he cannot be called as partner.

5. Business carried on by all or any of them acting for all: It means that each partner can participate in the conduct of business and each partner is bound by the acts of other partners in respect to the business of the firm.

6. Relationship of Principal and Agent: Each partner is an agent ad well as a partner of the firm. An agent, because he can bind the other partners by his acts and principal, because he himself can be bound by the acts of the other partners.

Partnership Deed

Since partnership is the outcome of an agreement, it is essential that there must be some terms and conditions agreed upon by all the partners. Such terms and conditions may be either written or oral. The law does not make it compulsory to have a written agreement. However, in order to avoid all misunderstandings and disputes, it is always the best course to have a written agreement duly signed and registered under the Act.

The partnership deed is a written agreement among the partners which contains the terms of agreement. It is also called ' ***Articles of Partnership'.*** **A partnership deed should contain the following points:**

1. Name and address of the firm as well as partners.
2. Name and addresses of the partners.
3. Nature and place of the business.
4. Duration, if any of partnership.
5. Capital contribution by each partner.
6. Interest on capital.

7. Drawings and interest on drawings.
8. Profit sharing ratio.
9. Interest on loan.
10. Partner's Salary/commission etc.
11. Method for valuation of goodwill and assets.
12. Accounting period of the firm and duration of partnership
13. Rights and duties of partners how disputes will be settled.
14. Decisions taken if some partner becomes insolvent.
15. Opening of Bank Account – whereas it will be in the name of firm or partners.
16. Rules to be followed in case of admission & Settlement of accounts or retirement or death of partner.
17. Revaluation of assets & liabilities, if any to be done.
18. Method of recording of firm's accounts
19. Auditing
20. Date of commencement of partnership

<u>Benefits of Partnership Deed</u>

(1) It regulates the rights, duties and liabilities of each partner.
(2) It helps to avoid any misunderstanding amongst the partners because all the terms and conditions of partnership have been laid down before hand in the deed.
(3) Any dispute amongst the partners may be settled easily as the partnership deed may be readily referred to.
Hence, it is always best course to have a written partnership deed duly signed by all the partners and registered under the Act.

<u>Rules applicable in the absence of partnership deed</u>

- ✓ Profit sharing Ratio Equal, irrespective of capital contribution.
- ✓ No Interest on Capital is to be allowed to any Partner.
- ✓ No interest on Drawings is to be charged to any partner.
- ✓ No Salary or Commission to a Partner allowed to any partner.
- ✓ Interest @ 6% per annum on loan by a Partner to the firm.

<u>Charge against Profit and Appropriation of Profit</u>

Payment made or due to a partner may be a charge against profit or an appropriation of profit.
Charge against Profit means that it is an expense for the firm and is paid whether the firm earns profit or incurs loss. On the other hand, appropriation of profit means that they are allowed, if the firm earns profit during the year.
Interest on Loan by Partner, Rent Payable to a partner and Manager's Commission, etc., are charge against profit and are payable whether the firm earns profit or incurs loss.
On the other hand, **Salary/Commission to partners, interest on capitals and transfer of profit to Reserves** are appropriations.

Difference between Charge Against Profit and Appropriation of Profit

Basis	**Charge Against Profit**	**Appropriation of Profit**
1. Nature	It is an expense hence deducted from revenue to determine net profit or loss for the year.	It means distribution of net profit for the year among partners under different heads as per the Partnership Deed.
2. Recording	It is debited to Profit and Loss Account.	It is debited to Profit and Loss Appropriation Account.
3. Priority	It is allowed before Appropriation of Profit.	It is appropriated after accounting of all charges.
4. Examples	Rent paid to a partner, interest on loan by partner, etc	Salary to partners, interest on capital, transfer of profit to General Reserve, etc.

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Special Aspects of Partnership Accounts

In Partnership Accounts, there are some aspects that require discussion. They are:

1. Partners' Capital Accounts;
2. Interest on Partners' Capitals;
3. Interest on Partners' Drawings;
4. Adjustments for Incorrect Appropriations of Profits in the Past (Past Adjustments); and
5. Guarantee of Profit.

Distribution of Profits among Partners

The Journal Entries regarding Profit and Loss Appropriation Account are as follows:

1.) For transfer of balance of Profit and Loss Account

Profit and Loss A/c Dr.
To Profit and Loss Appropriation A/c
(Being profit transferred to Profit and Loss Appropriation A/c)

2.) For Interest on Capital

For allowing Interest on capital
a) Interest on Capital A/c Dr.
To Partner's Capital/Current A/cs
(Being interest on capital allowed @ % p.a.)

b) For transferring Interest on Capital to P&L Appropriation A/c.
Profit and Loss Appropriation A/c Dr.
To Interest on Capital A/c.
(Being interest on capital transferred to P&L Appropriation A/c)

3.) For Salary or Commission payable to a partner

i.) For allowing Salary or Commission to a partner:
Partners Salary/Commission A/c Dr.
To Partner's Capital/Current A/cs
(Being salary/commission payable to a partner)

ii.) For transferring Partner's Salary/Commission A/c to Profit and Loss Appropriation A/c:
Profit and Loss Appropriation A/c Dr.
To Partner's Salary/Commission A/c

4.) For transfer of Reserves:

Profit and Loss Appropriation A/c Dr.
To Reserve A/c
(Being reserve created)

5.) For Interest on Drawings:

1.) For charging interest on a partner's drawings:
Partner's Capital/Current A/c. Dr.
To Interest on Drawings A/c
(Being interest on drawings charged @ % p.a.)

2.) For transferring interest on drawings to Profit and Loss Appropriation A/c
Interest on Drawings A/c Dr.
To Profit and Loss Appropriation A/c
(Being interest on drawings transferred to P&L appropriation A/c)

6.) For transfer to Profit (i.e. Credit Balance of Profit and Loss Appropriation Account
Profit and Loss Appropriation A/c Dr.
To Partners Capital/Current A/cs
(Being profits distributed among partners)

SPECIMEN OF PROFIT AND LOSS APPROPRIATION ACCOUNT

Profit and Loss Appropriation Account
Dr. for the year ending on ____________________ **Cr.**

Particulars	Rs.	Particulars	Rs.
To Interest on Capital: A B To Partner's Salary/Commission To Reserves To Profits transferred to capital A/cs of: A B		By Profit and Loss A/c (Net Profits transferred from P & L A/c) By Interest on drawings: A B	

Partner's Capital Accounts

Partner's Capital Accounts: It is an account which represents the partners interest in the business. In case of partnership business, a separate capital account is maintained for each partner. The capital accounts of partners may be maintained by any of the following two methods.

1. Fixed Capital Accounts
2. Fluctuating Capital Accounts

1. Fixed Capital Accounts

Under this method the original capitals invested by the partners remain constant, unless additional capital is introduced by an agreement. All entries relating to drawings, interest on capitals, interest on drawings, salary to partner, share of profits/losses are made in separate account which is called as Current Account. Thus, the following two accounts are maintained:

(i) When capitals are fixed - Capital Account

This account will always show a credit balance. Balance of Capital account remains fixed, it does not change every year that is why it is called fixed capital method and only the following two transactions are recorded in the Fixed Capital Accounts:

-Permanent Additional Capital Introduced
-Permanent Capital Withdrawn or Drawings out of Capital only

Dr. **Partner's Capital A/Cs** **Cr.**

Particulars	X (Rs.)	Y (Rs.)	Particulars	X (Rs.)	Y (Rs.)
To Cash/Bank A/c (Capital Withdrawn) To Balance c/d			By Balance b/d (Opening Cr. Balance) By Cash/Bank A/c		

(Closing balance)			(Additional Capital Introduced)		

(ii) Current Account

The Current account may show a debit or credit balance. All the usual adjustments such as interest on Capital, partner's salary/commission, drawings (out of profits), interest on drawings and share in profits or losses etc. are recorded in this account. All the Current Year's adjustments are recorded in this account, that is why it is called Current account.

Dr. **Partner's Current A/Cs** **Cr.**

Particulars	X (Rs.)	Y (Rs.)	Particulars	X (Rs.)	Y (Rs.)
To Balance b/d (Opening Dr. Balance) To Drawings (out of Profits)			By Balance b/d (Opening Cr. Balance) By Interest on Capital By Partner's Salary or Commission By Profit and Loss Appropriation A/c		

Note:

1. Debit balance of Current Account is shown in Assets side of Balance Sheet.

2. Credits balance of Current Account A/c is shown in Liabilities side of balance Sheet.

3. Balance of Fixed Capital Accounts are always shown in Liabilities side of Balance Sheet as it will be always be credit balance.

2. Fluctuating Capital Accounts

In this method only one account i.e., Capital Account of each and every partner is prepared and all the adjustment such as interest on capital interest on drawings etc, are recorded in this account under this method, Capital account may show a debit or credit balance and the balance of this account changes frequently from time to time therefore it is called fluctuating Capital Account. In this method the capitals are not fixed.

In the absence of information, the Capital Accounts should be prepared by this method.

Dr. **Partner's Capital A/cs** **Cr.**

Particulars	X (Rs.)	Y (Rs.)	Particulars	X (Rs.)	Y (Rs.)
To Balance b/d (Opening Dr. Balance) To Cash/Bank A/c (Capital Withdrawn) To Drawings (out of profits) To Interest on Drawings To Profit and Loss A/c (Share in losses) To Balance c/d			By Balance b/d (Opening Cr. Balance) By Cash/Bank A/c (Additional Capital Introduced) By Interest on Capital By Partner's Salary or Commission By Profit and Loss Appropriation A/c (Share in Profits)		

(Closing credit Balance)			By Balance c/d (Closing Dr. Balance)		

INTEREST ON CAPITAL

Interest on partners' capital will be allowed only when it has been specifically mentioned in the partnership deed. If interest on capital is to be allowed as per the agreement, it should be calculated with respect to the time, rate of interest and the amount of capital.

INTEREST ON DRAWINGS

Interest on drawing is charged by the firm only when it is clearly mentioned in Partnership Deed. It is calculated with reference to the time period for which the money was withdrawn.

INTEREST ON PARTNER'S LOAN

If a partner has given loan to the firm, he is entitled to receive interest on such loan at an agreed rate.
It is a charge against profits. It is always Debited to Profit and Loss A/c.
It is provided irrespective of profits or loss. It will also be provided in the absence of Partnership Deed @ 6% per annum.

The following entries are passed to record the interest on partner's loan

1.) For allowing Interest on loan:
Interest on Partner's Loan A/c Dr.
To Partner's Loan A/c
(Being interest on loan allowed @ % p.a.)
2.) For transferring Interest on Loan to Profit and Loss A/c:
Profit and Loss A/c Dr.
To Interest on Loan A/c
(Being Interest on loan transferred to P & L A/c)

Rent Paid to Partner.

Rent paid to a partner is also a charge against profits and it will also be **Debited to Profit and Loss A/c.**

Manager's Commission

Like Rent paid to a partner, Manager's Commission is also a charge against profits and it will also be **Debited to Profit and Loss A/c.** It is calculated in following two ways:

1.) As % profit before charging commission

Commission= Profit before commission x $\frac{\text{Rate}}{100}$

2.) As % profit after charging commission

Commission= Profit before commission x $\frac{\text{Rate}}{100 + \text{Rate}}$

PAST ADJUSTMENTS

Sometimes after closing the accounts of a partnership firm, *i.e.*, preparing the financial statements, some errors or omissions in the accounts of the earlier years are noticed. For example, interest on capital or drawings is omitted, allowed or charged at higher or lower rate, profits or losses are distributed among the partners in a wrong ratio and so on. These errors and omissions are rectified by adjusting the Capital Accounts of the affected partners by passing (a) an adjustment entry, or (b) adjustment entries.

(A) When an Adjustment Entry (Single Adjustment Entry) is passed: In this case, net effect of the errors is determined and an adjustment entry is passed by debiting and crediting the Partners' Capital/Current Accounts.

Let us take an example to understand it better. Following is the Profit and Loss Appropriation Account of a firm in which *A*, *B* and *C* are equal partners:

PROFIT AND LOSS APPROPRIATION ACCOUNT

Dr. *for the year ended 31st March, 2020* Cr.

Particulars	Rs.	Particulars	Rs.
To Profit transferred to: *A*'s Capital A/c 1,00,000 *B*'s Capital A/c 1,00,000 *C*'s Capital A/c 1,00,000	3,00,000	By Profit and Loss A/c— Net Profit	3,00,000
	3,00,000		3,00,000

After preparing the financial statements, it was noticed that interest on capital was not allowed to *A*— Rs. 12,000, *B* — Rs. 9,600 and *C*— Rs. 10,500 and also interest was not charged on drawings of *A* and *B*
amounting to Rs. 1,200 and Rs. 900 respectively.

Correct Profit and Loss Appropriation Account giving effect to the above omissions would have been as follows:

PROFIT AND LOSS APPROPRIATION ACCOUNT

Dr. *for the year ended 31st March, 2020* *Cr.*

Particulars	Rs.	Particulars	Rs.
To Interest on Capital A/cs: *A* 12,000 *B* 9,600 *C* 10,500	32,100	By Profit and Loss A/c—Net Profit	3,00,000
To Profit transferred to: *A*'s Capital A/c 90,000 *B*'s Capital A/c 90,000 *C*'s Capital A/c 90,000	2,70,000	By Interest on Drawings A/cs: *A* 1,200 *B* 900	2,100
	3,02,100		3,02,100

From the corrected Profit and Loss Appropriation Account, following is observed:

	A's Capital A/c (Rs.)	*B*'s Capital A/c (Rs.)	*C*'s Capital A/c (Rs.)
I. Credited Short for Interest on Capitals	12,000	9,600	10,500

II. Debited Short for Interest on Drawings	(1,200)	(900)	---
III. Credited Excess as Share of Profit [32,100 (Interest on Capital) – 2,100 (Interest on Drawings) Equally]	(10,000)	(10,000)	(10,000)
Net Effect	800 Short Credited	(1,300) Excess Credited	500 Short Credited

An adjustment entry rectifying the above errors can be passed as follows:

Date	Particulars	L.F.	Dr.	Cr.
2020 March31	*B*'s Capital A/c Dr. To *A*'s Capital A/c To *C*'s Capital A/c (Interest on capital not allowed and Interest on drawings not charged, now adjusted)		1,300	 800 500

<u>(B) When Adjustment Journal Entries (in Place of one Adjustment Entry) are passed:</u> In this situation, analytical table to determine the net effect of all the adjustments is not prepared instead Journal entries are passed for each error or omission by debiting or crediting Profit and Loss Adjustment Account. After passing the entries for adjustment of errors and omissions, Profit and Loss Adjustment Account is closed by debiting or crediting (as the situation is) with the corresponding credit or debit to the Partners' Current Accounts, if Fixed Capital Accounts Method is followed or Partners' Capital Accounts, if Fluctuating Capital Accounts Method is followed.

Accounting Entries

Following Journal entries shall be passed through Profit and Loss Adjustment Account:

(i) Adjustment entries for the items which are to be credited to the Partners' Capital/Current Accounts:

Profit and Loss Adjustment A/c Dr.
To Partners' Capital/Current A/cs
(Adjustment made for previously omitted, now recorded)

(ii) Adjustment entries for the items which are to be debited to the Partners' Capital/Current Accounts:

Partners' Capital/Current A/cs Dr.
To Profit and Loss Adjustment A/c
(Adjustment made for previously omitted, now recorded)

(iii) For Net Profit/Loss due to above adjustments:

(a) For Profit

Profit and Loss Adjustment A/c Dr.
To Partners' Capital/Current A/cs
(Profit on adjustment credited to Partners' Capital/Current Accounts)

(b) For Loss

Partners' Capital/Current A/cs Dr.
To Profit and Loss Adjustment A/c
(Loss on adjustment transferred to Partners' Capital/Current Accounts)

Note: If capitals of the partners are fixed, adjustment entries are passed through Partners' Current Accounts.

GUARANTEE OF PROFITS TO A PARTNER

Guarantee is an assurance given to the partner of the firm that at least a fixed amount shall be given to him/her irrespective of his/her actual share in profits of the firm. If actual share in profits is less than the guaranteed amount in that case the deficit amount shall be borne either by the firm or by any partner as the case may be or as may have been decided by an agreement.
Note: Guarantee to a partner is given for minimum share in profits. If the actual share in profits is more than the minimum share in profits, then the actual profits will be allowed to the partner.

Case: 1. When guarantee is given by FIRM (i.e. by all the Partners of the firm)
1. If share in actual profits is less than the guaranteed amount then. Guaranteed amount to a partner is first written off against the profits and then,
2. Remaining profits are distributed among the remaining partners in the remaining ratio.

Case: 2. When guarantee is given by a partner or partners to another partner.
1. Calculate the share in profits for the partner to whom guarantee is given.
2. If share in profits is more than the guaranteed amount, distribute the profit as per the profit and loss sharing ratio in usual manner.
3. If share in profits is less than the guaranteed amount, find the difference between the share in profits and the guaranteed amount and the difference known as deficiency.
Deficiency is contributed by the partner or partners who guaranteed in certain ratio and subtracted from his or their respective shares.

Accounting Entries:
1.) On Distributing the Profit as if there is no Guarantee Agreement:
Profit and Loss Appropriation A/c Dr.
To All Partners' Capital A/cs
2.) On Charging Deficiency to Guaranteeing Partner(s):
Guaranteeing Partners' Capital A/cs Dr.
To Guaranteed Partner's Capital A/c