

Ch-01: Accounting for Partnership Firms-Fundamental

Meaning and Definition of Partnership

According to Section 4 of the Partnership Act 1932 “Partnership is 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”

Features of partnership Firm

- 1) Association of two or more persons:- Minimum-2 & maximum-50 members
- 2) Partnership Agreement or Deed
- 3) Legal Business
- 4) Sharing of Profits or Losses in a certain ratio.
- 5) Mutual Agency
- 6) Unlimited Liability: Partners' liability to the third parties is unlimited.

Partnership Deed: The document, which contains terms of the agreement, is called '*Partnership Deed*'. It generally contains the details about all the aspects affecting the relationship between the partners including the objective of business, contribution of capital by each partner, ratio in which the profits and the losses will be shared by the partners and entitlement of partners to interest on capital, interest on loan, etc.

Provisions of Partnership Act, 1932 in the absence of Partnership Deed:

- a) *Profit Sharing Ratio*:- If the partnership deed is silent about the profit sharing ratio, the profits and losses of the firm are to be shared equally by partners
- b) *Interest on Capital*: - No interest on capital is payable if the partnership deed is silent on the issue.
- c) *Interest on Drawings*: - No interest is to be charged on the drawings made by the partners, if there is no mention in the Deed.
- d) *Interest on Advances*: - If any partner has advanced some money to the firm beyond the amount of his capital for the purpose of business, he shall be entitled to get an interest on the amount @ 6% p.a.
- e) *Remuneration for Firm's Work*: - No partner is entitled to get salary or other remuneration for taking part in the conduct of the business of the firm.

Maintenance of Partners Capital A/c

Partners Capital A/c can be maintained by two methods

1. Fixed capital method
2. Fluctuating capital method

In fixed capital method two accounts are prepared partners capital account and partners current account while in fluctuation method only one account is prepared i.e. partners capital account

Final Accounts of Partnership firm

Following accounts are prepared by a firm

1. Trading ,Profit and loss A/c
2. P/L appropriation A/c
3. Partners capital A/c

4. Balance sheet

FIXED CAPITAL METHOD.

(1) In this method Partners Capitals shall remain fixed unless additional Capital is introduced apart of capital is withdrawn permanently.

(2) All adjustments like interest on Cap. or salary etc. are shown in a separate A/c named as Partners Current a/c

(3) Partners Capital will always show Credit balance while partners Current Alc may have Dr. or Cr. balance.

Dr.		Partners Capital A/c		Cr.	
Particulars	A (₹)	B (₹)	Particulars	A (₹)	B (₹)
To Bank(permanent withdrawal)	xxx	xxx	By bal·b/d	xxx	xxx
To bal cld	xxx	xxx	By Bank (additional Cap)	xxx	xxx
	xxxx	xxxx		xxxx	xxxx

Dr.		Partners Current A/c		Cr.	
Particulars	A (₹)	B (₹)	Particulars	A (₹)	B(₹)
To bal b/d (if Dr bal)	xxx	xxx	By bal. b/d (if cr bal)	xxx	xxx
To Drawings	xxx	xxx	By Int on capital	xxx	xxx
To Int on drawings	xxx	xxx	By Salary	xxx	xxx
To P/L APP(share of loss)	xxx	xxx	By Commission	xxx	xxx
To bal c/d (in case of cr.bal.	xxx	xxx	By P/L App (Share of Profit)	xxx	xxx
			By bal c/d (incase of dr. bal.	xxx	xxx
	xxxx	xxxx		xxxx	xxxx

Fluctuating Capital Method: In this method Partners Capital doesn't remain fixed. It Keeps on changing. Only one A/c is prepared by Partners i.e. Partners capital A/c. All adjustments are recorded in capital A/c only. It may have Dr. or Cr. balance.

Partners Capital A/c

Dr.

Cr.

Particulars	A (₹)	B (₹)	Particulars	A (₹)	B (₹)
To bal b/d (if Dr bal)	xxx	xxx	By bal. bld (if cr bal)	xxx	xxx
To Bank(permanent withdrawal)	xxx	xxx	By Bank (additional Cap)	xxx	xxx
To Drawings	xxx	xxx	By Int on capital	xxx	xxx
To Int on drawings	xxx	xxx	By Salary	xxx	xxx
To P/LAPP(share of loss)	xxx	xxx	By Commission	xxx	xxx
To bal c/d (incase of cr. bal.	xxx	xxx	By P/L App (Share of Profit)	xxx	xxx
			By bal c/d (incase of dr. bal.	xxx	xxx
	xxxx	xxxx		xxxx	xxxx

Difference between fixed and fluctuating Capital method

BASIS	FIXED CAPITAL	FLUCTUATING CAPITAL
Number of Accounts	2 Separate A/c are prepared.	Only 1 A/c is prepared.
Adjustment	All adjustments a are made in Current A/c	All adjustments are made in Capital A/c
Fixed Balance	The capital remains unchanged unless there is addition or withdrawal of Cap.	The balance of capital fluctuates from year to year
Credit Balance	Capital A/c always shows Cr balance.	Capital A/c may Show Dr or Cr. bal.

Distribution of profits among Partners

- ❖ Profit /Loss appropriation Alc
- ❖ P/L Appropriation A/c is an extension of P/L A/c of the firm.
- ❖ All adjustments regard to in Is salary Partners Commission, Interest on Capital, Interest on a drawings etc are made through this account
- ❖ It shows the appropriation of profits among partners.

S.No.	Particulars	Dr. (₹)	Cr. (₹)
1	For transfer of profit from P/L A/C P/L A/c Dr. To P/L Appropriation A/c In case of loss P/L App. A/c Dr. To P/L A/c		
2	Interest on capital Interest on Capital A/c Dr. To Partners Capital/Current A/c For transferring to P/L appropriation A/C P/L App. A/c Dr. To Interest on capital A/c		
3	Salary Salary A/c (individually) Dr. To Partners Capital/Current A/c For transferring to P/L appropriation A/C P/L App. A/c Dr. To Salary A/c (individually)		
4	Commission to partners Commission A/c (individually) Dr. To Partners Capital/Current A/c		
	For transferring to P/L appropriation A/C P/L App. A/c Dr. To Commission A/c (individually)		
5	Interest on drawings Partners Capital/Current A/c Dr. To Interest on Drawings For transferring to P/L appropriation A/C Interest on Drawings A/c Dr. To P/L Appropriation A/c		
6	Sharing of profit or loss after appropriations In case of Profits P/L App. A/c Dr. To Partners Capital/Current A/c (individually) In case of losses Partners Capital/Current A/c Dr. To P/L App. A/c		

Profit and Loss Appropriation A/c for the year ended ____

Particulars	(₹)	Particulars	(₹)
To P/L A/c (in case of loss)	xxx	By P/L A/c (in case of profits)	xxx
To Interest on capital	xxx	By Interest on drawings	xxx
To salary	xxx	To Partners Cap/Current A/c (share of losses)	xxx
To commission	xxx		
To Partners Cap/Current A/c (share of profit)	xxx		
	xxxxx		xxxxx

★ Interest on loan is a charge against profits.

Calculation of Interest on Drawings

S.No	Situation	Formula
1	When varying amounts are withdrawn at different intervals	Interest is calculated through Product method and given for 1 month Total product X R/100 X 1/12
2	When fixed amount is withdrawn a) At the beginning of each month b) At the end of each month c) During the month or mid of each month	a) Total drawings X R/100 X 6.5/12 b) Total drawings X R/100 X 5.5/12 c) Total drawings X R/100 X 6/12
3	When fixed amount is withdrawn	a) Total drawings X R/100 X 7.5/12

	a) In the beginning of each quarter b) In the end of each quarter	b) Total drawings X R/100 X 4.5/12
4	When fixed amount is withdrawn a) In the beginning of each half year b) In the end of each half year	a) Total drawings X R/100 X 9/12 b) Total drawings X R/100 X 3/12

Past Adjustment:

Sometimes after closing the accounts, i.e., preparing the financial statement, some errors or omission 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) Adjusting entries.

Particulars	A(₹)	B(₹)	C(₹)	Firm(₹)
+ Interest on Capital	+	+	+	-
+ Partner's Salary/Commission	+	+	+	-
- Interest on Drawings	-	-	-	+
	+	+	+	-
Excess profit taken back in their P & L Sharing Ratio	-	-	-	
	+	-	+	

+ means Cr. the Partner's Capital A/c

- means Dr. the Partner's Capital A/c.

Guarantee of Profit to a Partner

Guarantee of profit means a minimum amount of profit to be paid to a partner. This amount shall be given to him if his share of profit is lower than the guaranteed amount. The deficit shall be borne either by one of the old partners or by all the old partners in a particular agreed ratio. If there is no agreement, then in their old profit sharing ratio, if his actual share of profit is more than the guaranteed amount, then, he will be given his actual share of profit. He gets the guaranteed amount or the actual share of profit, **whichever is higher**.

(a) Guarantee given by all partners

The deficiency shall be shared by other partners in their profit sharing ratio.

(b) Guarantee given by One Partner only:-

First calculate his share of profit. Compare it with the guaranteed amount. The amount of deficiency is to be charged from the partner who gave guarantee.

(c) Guarantee given to a partner by other partners in a ratio different from their profit sharing ratio:-

Distribute profit among all the partners in the profit sharing ratio. Work out the amount of deficiency by comparing it with the guaranteed amount and his actual share of profit. The other partners will bear the deficiency in an agreed new ratio.

Q. X, Y and Z share profit in the ratio of 2:3:5. They earned a profit of ₹ 1,50,000 for the year ended 31/12/2022. The profit was by mistake distributed among X, Y and Z in the ratio of 3:2:1, respectively. This error was noted in the beginning of the new year.

Pass necessary adjustment entry.

Particulars	X (₹)	Y (₹)	Z (₹)	Firm (₹)
1. Profit distributed in wrong ratio taken back Dr.	(-)75,000	(-)50,00	(-)25,000	+1,50,000
2. The same profit now correctly distributed in correct ratio Cr.	+30,000	+45,000	+75,000	1,50,000

Adjustment required	Dr.	-45,000	-5,000	+50,000	
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Pass necessary adjustment entry

X's capital A/c Dr 45,000
 Y's capital A/c Dr 5,000
 To Z's capital A/c 50,000
 (Being adjustment entry made)

Practical Problems:

Partnership Deed

1. Mohan and Shyam are partners in a firm. State whether the claim is valid if the partnership agreement is silent in the following matters:

- (i) Mohan is an active partner. He wants a salary of ₹10,000 per year.
- (ii) Shyam had advanced a loan to the firm. He claims interest @10% p.a.
- (ii) Mohan has contributed ₹ 20,000 and Shyam ₹ 50,000 as capital.
- (iv) Mohan wants equal share in profits.
- (v) Shyam wants interest on capital to be credited @ 6% per annum.

2. State whether the following statements are true or false:

- (i) Valid partnership can be formulated even without a written agreement between the partners.
- (ii) Each partner carrying on the business is the principal as well as the agent.
- (iii) Methods of settlement of dispute among the partners can't be part of the partnership deed.
- (iv) If the deed is silent, interest at the rate of 6% p.a. would be charged on the drawings made by the partner.

Interest on Capital & Interest on Drawings:-

3. A and B are partners sharing profits and losses in the ratio of 3:2. Their capital accounts showed balances of ₹1,50,000 and ₹ 2,00,000 respectively on Jan 01, 2003. Show the treatment of interest on capital for the year ending December 31, 2006 in each of the following alternatives:

- (a) If the partnership deed is silent as to the payment of interest on capital and the profit for the year is ₹ 50,000;
- (b) If partnership deed provides for interest on capital @ 8% p.a. and the firm incurred a loss of ₹ 10,000 during the year;
- (c) If partnership deed provides for interest on capital @ 8% p.a. and the firm earned a profit of ₹ 50,000 during the year;
- (d) If the partnership deed provides for interest on capital @ 8% p.a. and the firm earned a profit of ₹ 14,000 during the year.

Hint: In the absence of any information interest on capitals will be appropriation of profit.

Guarantee of Profit

4. Ram, Mohan and Sohan are partners with capitals of ₹ 5, 00,000, ₹ 2, 50,000 and ₹ 2, 00,000 respectively. After providing interest on capital @10% p.a. the profits are divisible as follows: Ram 1/2, Mohan 1/3 and Sohan 1/6. Ram and Mohan have guaranteed that Sohan's share in the profit

shall not be less than ₹ 25, 000, in any year. The net profit for the year ended March 31, 2016 is ₹ 2, 00,000, before charging interest on capital.

You are required to show distribution of profit.

(Ans: Profit to Ram ₹ 48,000, Mohan ₹ 32,000 and Sohan ₹ 25,000).

Past Adjustment

5. The net profit of X, Y and Z for the year ended 31st March, 2021 was ₹ 60, 000 and the same was distributed among them in their agreed ratio of 3:1:1. It was subsequently discovered that the under mentioned transactions were not recorded in the books:

(i) Interest on Capital @ 5% p.a.

(ii) Interest on drawings amounting to X ₹ 700, Y ₹ 500 and Z ₹ 300.

(iii) Partner's Salary: X ₹1, 000, Y ₹1,500 p.a.

The capital accounts of partners were fixed as: X ₹ 1, 00,000, Y ₹ 80, 000 and Z ₹ 60, 000.

Record the adjustment entry.

(Ans: X Dr. ₹ 2,700, Y Cr. ₹ 2,600 and Z Cr. ₹ 100]

MULTIPLE CHOICE QUESTION:-

1. Rani and Shyam is partner in a firm. They are entitled to interest on their capital but the net profit was not sufficient for paying his interest, then the net profit will be disturbed among partner in

(a) 1 : 2

(b) Profit Sharing Ratio

(c) Capital Ratio

(d) Equally

[c]

2. Which one of the following items is recorded in the Profit and Loss Appropriation account:-

(a) Interest on Loan

(b) Partner salary

(c) Rent paid to Partner's

(d) Managers Commission

[b]

3. A, B and C were partner in a firm sharing Profit in the ratio of 3:2:1 during the year the firm earned profit of ₹ 84,000. Calculate the amount of Profit or Loss transferred to the Capital A/c of B.

(a) Loss ₹ 87,000

(b) Profit ₹ 87,000

(c) Profit ₹ 28,000

(d) Profit ₹ 14,000

[c]

4. Closing entry for interest on loan allowed to partners

(a) Interest on Partner's loan ... Dr.
To Profit and Loss A/c

(b) Interest on loan ... Dr.
To Profit and Loss Appropriation A/c

(c) Profit and Loss Appropriation A/c ... Dr.

To Interest on Partners loan A/c

(d) Profit and Loss Appropriation A/c ...Dr.
To Interest on loan A/c [c]

5. Salary to a partner under fixed capital account is credited to

- (a) Partner's Capital A/c
- (b) Partners current A/C
- (c) Profit & Loss A/c
- (d) Partner's Loan A/c [b]

6. In the absence of partnership deed partner share profit and loss in

- (a) Ratio of capital Employed (b) Equal Ratio
- (c) 2 : 1 (d) 1 : 2 [b]

7. As per section a minor may be admitted for the benefit of the partnership if:-

- (a) One partner agree
- (b) More than one agree
- (c) All Partners agree
- (d) Both (a) or (b) [c]

8. If the partner carries on the business that is similar to firm competition with the firm and profit earned from it, the profit

- (a) Shall be retained by the partner
- (b) Shall be paid to firm
- (c) Can be retained or gained to the firm
- (d) Both (a) or (b) [b]

9. The relation of the partner with the firm is that of

- (a) An owner
- (b) An agent and a Principal
- (c) An agent
- (d) Manager [b]

10. A, B, and C are partner's sharing profits in the ratio of 5:3:2 According to the partnership agreement C is to get a minimum amount of ₹ 10,000 as his share of profits every year. The net profit for the year ended 31st March, 2021 amounted to ₹ 40,000. How much amount contributed by A?

- (a) ₹ 1,350 (b) ₹ 1,250
- (c) ₹ 750 (d) ₹ 1,225 [b]

11. Goodwill is

- (a) Tangible asset
- (b) Intangible asset
- (c) Fictitious asset
- (d) Both (b) & (c) [b]

TRUE / FALSE :

- 1. The nature of Profit and Loss Account is real. [F]
- 2. Registration of partnership is optional. [T]

3. A body corporate can be a partner in partnership firm. [F]
4. Sleeping partner are those who do not take part in conduct of the business. [F]
5. When the Partnership agreement is silent about the treatment of interest on capital then it will be treated as charge on profit. [F]
6. Fixed capital always shows Dr. balance. [F]
7. When a partnership firm gives loan to its partner then interest on loan will be debited in profit and loss account. [T]
8. In case of fixed capital account method drawing out of capital is shown in partner current account. [F]
9. Manager's commission is shown in Profit and Loss Appropriation A/c. [F]
10. Interest as a charge means interest on capital is to be allowed whether the firm has earned profit or incurred loss. [T]
11. In the absence of partnership deed mutual relations are governed by the Indian partnership act 2013. [T]
12. Capital in the beginning is calculated by subtracting drawing and adding profit distributed. [F]