CHAPTER – 2

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."

Features 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 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.

Contents of the Deed

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

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.

(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	
		--------	xxxx

Less: Partner's Salary xxx Partner's Commission
xxx
Share of profit if any xxx xxxx

Opening Capital xxxx
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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.