

CHAPTER 1

INTRODUCTION OF PARTNERSHIP FIRM

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 as 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:

- Name and address of the firm as well as partners.
- Name and addresses of the partners.
- Nature and place of the business.
- Duration, if any of partnership.
- Capital contribution by each partner.
- Interest on capital.
- Drawings and interest on drawings.
- Profit sharing ratio.
- Interest on loan.
- Partner's Salary/commission etc.
- Method for valuation of goodwill and assets.
- Accounting period of the firm and duration of partnership

Rules applicable in the absence of partnership deed

Profit sharing Ratio	Equal, Irrespective of capital contribution.
Interest on Capital	No Interest on Capital is to be allowed to any Partner
Interest on Drawings	No interest on Drawings is to be charged to any partner
Salary or Commission to a Partner	Not allowed to any partner
Interest on loan by a Partner	Interest is allowed @ 6% per annum.

Profit and loss appropriation account

A Profit and Loss Appropriation Account is prepared to show the distribution of profits among partners as per the provision of Partnership Deed (or as per the provision of Indian Partnership Act, 1932 in the absence of Partnership Deed). It is an extension of profit and Loss Account. It is nominal account. It records entries for interest on capital, Interest on Drawings, Salary to the partner, and division of profits among the partners.

SPECIMEN OF PROFIT AND LOSS APPROPRIATION ACCOUNT

Profit and Loss Appropriation Account

For the year ending on _____

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

(i) Capital Account

This account will always show a credit balance: Balance of Capital account remains fixed, it does not change every year, it is called fixed capital method.

Partner's Capital A/Cs

Particulars	X	Y	Particulars	X	Y
To Cash/Bank A/c (Capital Withdrawn)			By Balance b/d (Opening Cr. Balance)		
To Balance c/d (Closing balance)			By Cash/Bank A/c (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, it is called Current account.

Partner's Current A/Cs

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

Partner's Capital

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

A. Interest on Capital: An Appropriation of Profits:

In case of Losses	Interest on Capital is NOT ALLOWED
In cases of Sufficient Profits	Interest on Capital is ALLOWED IN FULL
In case of Insufficient Profits	Interest will be restricted to the amount of profit. Hence, profit will be distributed in the ratio of interest on capital of each partner.

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

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

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:

Particulars	(Rs.)
Capital at the End	_____
Add: 1. Drawing	
2. Interest on Drawings	
3. Losses during the year	
Less: 1. Additional Capital Introduced	
2. Profits during the year
3. Any salary/commission received	
Opening 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. There are two cases in which calculation of interest on drawings may arise:

Case 1: When Rate of Interest on Drawings is given in %

Interest on Drawings is calculated on flat rate irrespective of period.

Case 2: When Rate of Interest on Drawings is given in % p.a.

1. When date of Drawing is not given

$$\text{Interest on Drawing} = \text{Total Drawings} \times \frac{\text{Rate}}{100} \times \frac{6}{12}$$

Note: Interest is calculated for a period of 6 months, we assume drawings have been done evenly during the year, that is why we take average six months tenure.

2. When date of Drawings is given

$$\text{Interest on Drawing} = \text{Total Drawings} \times \frac{\text{Rate}}{100} \times \frac{\text{Time left after drawings (in months)}}{12}$$

Case 3: When different amount are withdrawn on different dates:

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 it remained withdrawn till the close of accounting period.

2. Product Method

In this method, the amounts of drawings are multiplied by the period for which it remained withdrawn during the period; Thereafter the products are added and interest is calculated on the total of products so arrived at for one month. The advantage of this system is that separate calculations are not required each time.

Case 4: When an equal amount is withdrawn regularly

Interest on Drawing can be calculated using either Product Method or Direct Method (i.e. Short Cut Method)

$$\text{Interest on Drawing} = \frac{\text{Total Drawings} \times \text{Rate}}{100} \times \frac{T}{12}$$

T = Time (in months) for which interest is to be

$$\text{charged } T = \frac{\text{Time left after first drawing} + \text{Time left after last drawing}}{2}$$

Value of T under Different circumstances will be as under:

Monthly Drawings for 12 Months	Quarterly Drawings for 12 Months	Half yearly Drawings for 12 Months	Monthly Drawings for 06 Months (last 6 months)
6.5(beginning of the month)	7.5 (beginning of every quarter)	9 (beginning of every month for six month in the beginning of 6 months)	3.5(beginning of the month for last six month)
6(middle of very month)	6(middle of every quarter)	6 middle of every month for six month in the beginning of 6 months)	3(middle of the month for last six month)
5.5(end of every month)	4.5(end of every quarter)	3 (end of every month for six month in the beginning of 6 months)	2.5(end of the month for last six month)

INTEREST ON PARTNERS 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 provided irrespective of profits or loss. It will also be provided in the absence of Partnership Deed @ 6% per annum.

PAST ADJUSTMENTS

If, after preparation of Final Accounts of firm, it is found that some errors or commission in accounts has occurred than such errors or omissions are rectified in the next year by passing an adjustment entry.

A statement is prepared to ascertain the net effect of such errors or omissions on partner's capital/current accounts in the following manner.

Statement showing adjustment

Particulars	A	B	C
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A Amount to be given credited Interest on Capital (Not allowed or provided at a lower rate) Partner's Salary or Commission etc. (Omitted to be recorded) Actual Profits (To be distributed in correct ratio)			
Total A			
B. Amount already given to be taken back now debited * Interest on Capital (If given at a higher rate) * Interest on Drawings (If not charged) * Profits already distributed in wrong ratio (debited now)			
Total B			
Net Effect (A-B)	+/-	+/-	+/-

+ Indicates Amount to be Credited to Partner's Capital Account – Indicates Amount to be Debited to Partners Capital Account
Journal

Date	Particulars	LF.	Debit(Rs.)	Debit(Rs.)
	Partners Capital A/C Dr. (Amount to be Debited) To Partners' Capital A/c (Amount to be Credited) (Being adjustment entry passed)			

During Past Adjustment it is not compulsory that capital accounts of all partners are affected. More than one partners Capital Account may be debited or credited but amount of debit & credit should be equal.