

Accounting of Partnership: Basic Concepts

❖ Meaning/Definition of Partnership

As per the Partnership Act of 1932, “Partnership is a relationship between two or more persons who have agreed to share profits and losses from the partnership business carried by all or any one of them acting for all”.

❖ Features or Characteristics of Partnership- Minimum two persons are required to form a partnership.

- As per Rule (10) of Companies (Miscellaneous) Rules Act 2014, the maximum number of partners permissible is 50.
- Agreement between the partners of a partnership business can be either written or oral.
- Partnership is formed to carry out business.
- Each partner carrying out business is a principle as well as an agent for all other partners.
- Liability of partners is not limited to the extent of their capital. Each partner is liable jointly with all the other partners and also severally to the third party for all the acts of the firm.

❖ Partnership Deed

It is a document containing the details about partners and agreement among all the partners of a partnership firm. It includes agreement on profit sharing ratio, salaries, commission of partners, interest provided on partner's capital and drawings and interest on loan given or taken by the partners, etc.

❖ Content of a Partnership Deed

A partnership deed provides the following information and agreements: Objective of business of the firm

- Name and address of the firm
- Name and address of all partners
- Profit and loss sharing ratio
- Contribution to capital by each partner
- Rights, types of roles and duties of partners

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- Duration of partnership
- Rate of interest on capital, drawings and loans
- Salaries, commission, if payable to partners.
- Settlement of disputes amongst partners
- Rights and Duties of partners
- Rules regarding admission, retirement, death and dissolution of the firm, etc.

❖ Importance of Partnership Deed

- It provides information about rights, duties and obligations determined among the partners.
- It can be produced as evidence in the court of law to settle disputes among the partners.
- It provides information regarding distribution of profit and regarding the presentation of Partners' Capital Accounts.

❖ Provision in Absence of Partnership Deed

In absence of partnership deed, the following rules are applied. If profit sharing ratio is not mentioned in the deed, then profit and loss are shared equally among the partners.

- If interest on capitals is not mentioned in the deed, then no interest shall be allowed on partners' capital.
- If interest of drawings is not mentioned in the deed, then no interest shall be charged on partners' drawings.
- If interest on the partners' loans and advances to firm is not mentioned in the deed, then interest shall be paid at 6% p.a. even, if the firm incurred loss.
- If salary and commission to partners are not mentioned in the deed, then no salary or commission will be allowed to any partner.

❖ Profit and Loss Appropriation Account

- It is an extension of Profit and Loss Account.
- It is prepared to show how the profit available for appropriation has been appropriated among different items such as, interest on capitals, partners'

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remunerations in the form of salary, commissions, etc. It is nominal account in nature.

- In case of partnership the items of profit due partners such as, interest on capitals, partners' remunerations in the form of salary, commissions, are debited and the items due from partners such as interest on partners' drawings, Net Profit are credited to the Profit and Loss Appropriation Account.

❖ Specimen of the Profit and Loss Appropriation Account

Profit and Loss Appropriation Account

Particulars	Amount Rs	Particulars	Amount Rs
Interest on Capitals: X Y Partner's Salary: X Y Partner's Commission: X Y Reserve Profit transferred to (Balancing Figure) X's Capital/Current A/c Y's Capital/Current A/c		Profit and Loss (Net Profit for appropriation after adjusting the items of charge against profit e.g. <i>interest on partners loan, manager's commission, etc.</i>) Interest on Drawings: X Y	

Note: If in the question interest on loan, managers' commission, outstanding expenses, accrued income, etc. are mentioned and Profit before charging these items is given, then there are following two ways of treatment.

- By preparing Profit and Loss Adjustment Account, followed by Profit and Loss Appropriation Account, or
- By showing profit net of these items on the credit side of the Profit and Loss Appropriation Account (deducting these items from the Profit).

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Example

A and B are equal partners in a partnership business with their capital balances as on January 01, 2011 are Rs 1,20,000 and Rs 80,000 respectively. Interest on their capitals amounted to Rs 6,000 and Rs 4,000, Salary to A and B amounted to Rs 2,000 p.a. and Rs 1,500 p.a., interest on the loan forwarded by A to the firm amounted to Rs 5,000 and the profit earned during the year amounted to Rs 90,000. Prepare Profit and Loss Appropriation Account to show the appropriation of the profit.

Solution:

This question can be solved by either of the following two ways.

First Way

Profit and Loss Adjustment Account

Particulars	Amount Rs	Particulars	Amount Rs
Interest on A's Loan	5,000	Profit	90,000
Profit transferred to Profit and Loss Appropriation Account (Balancing Figure)	85,000		
	90,000		90,000

Profit and Loss Appropriation Account

Particulars		Amount Rs	Particulars	Amount Rs
Interest on Capitals:		10,000	Profit and Loss (Net Profit for appropriation after adjusting interest on A's loan)	85,000
A	6,000			
B	4,000			
Partner's Salary:		3,500		
A	2,000			
B	1,500			
Profit transferred to:				
<i>(Balancing Figure)</i>				
A's Capital/Current A/c	35,750			
B's Capital/Current A/c	35,750	71,500		
		85,000		

Particulars		Amount Rs	Particulars	Amount Rs
Interest on Capitals:			Profit and Loss (90,000 – 5,000)	85,000
A	6,000			
B	4,000	10,000		
Partner's Salary:				
A	2,000			
B	1,500	3,500		
Profit transferred to:				
(Balancing Figure)				
A's Capital/Current A/c	35,750			
B's Capital/Current A/c	35,750	71,500		
		85,000		85,000

Points of Difference	Profit and Loss Account	Profit and Loss Appropriation Account
Objective	It is prepared to ascertain profit earned and expenses and loss incurred from the main course of business.	It is prepared to show the appropriation of profit.
Partnership Agreement	Items in this account may or may not be related to the partnership agreement.	Items in this account are shown as per the partnership agreement.
Matching concept	It prepared by following the matching concept	It is prepared by following partnership agreement.
Started with	It begins with Gross Profit or Gross Loss.	It begins with Net Profit (Net Loss) or the opening balance that is available for appropriation.

- Fixed Capital Account
- Fluctuating Capital Account

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❖ **Fixed Capital Account:** It is prepared to show the capital contribution and drawings made (withdrawal of capital) by the partners during an accounting period. The fixed capital balances remain unaffected by the items of appropriation such as, interest on capital, share of profit, etc. The following are the two accounts that are prepared when the Partner's Capital Accounts are presented by Fixed Capital Account Method.

- **Partners' Capital Account-** This account records the opening capital balances and closing capital balances. If any fresh capital is introduced during the accounting period, then it is credited to this account and if any withdrawal of capital is made then it is debited to this account.

Partner's Capital Account

Dr.			Cr.		
Particulars	A	B	Particulars	A	B
Cash/Bank (Withdrawal of capital)			Balance b/d (Opening Balance)		
Balance c/d (Closing Balance)			Cash/Bank (Additional capital)		

- **Partners' Current Account-** Under Fixed Capital Account Method, besides the Partners' Capital Account, a separate account, i.e. Partners' Current Account is prepared to show the items of appropriation received by the partners and charged from the partners.

Partners' Current Account

Dr.			Cr.		
Particulars	A	B	Particulars	A	B
Balance b/d (In case of debit balance)			Balance b/d (In case of credit balance)		
Drawings			Interest on Capital		
Interest on Drawings			Partners Salary		
Profit and Loss (<i>Loss- if any</i>)			Commission		
			Profit and Loss Appropriation (<i>Profit</i>)		
Balance c/d (If credit is more than debit)			Balance c/d (If debit is more than credit)		

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❖ **Fluctuating Capital Accounts Method:**

Under this method, no separate account is prepared to show the items of appropriation and drawings etc. In this method, only one account is prepared, i.e. Partners' Capital Account.

❖ **Format of Fluctuating Partners Capital Account**

Partners Capital Account					
Dr.			Cr.		
Particulars	A	B	Particulars	A	B
Balance b/d (In case of debit balance)			Balance b/d (Opening balance)		
Drawings			Cash/Bank (Additional capital)		
Interest on Drawings			Interest on Capital		
Profit and Loss (Loss- if any)			Partners Salary		
			Commission		
			Profit and Loss Appropriation (Profit)		
Balance c/d (If credit is more than debit)			Balance c/d (If debit is more than credit)		

❖ **Drawings:** The amount withdrawn in cash or in form other asset by the partners.

❖ **Interest on Drawings:** Interest on Drawings will be charged at the rate prescribed partnership or orally decided (agreed) by the partners at the time of formation of partnership.

Treatment of Interest on Drawings

Partners' Capital A/c Dr.

OR

Partners' Current A/c Dr. (If capital is fixed)

To Interest on Drawings A/c
(Interest charged on partners' drawings)

Interest on Drawings A/c Dr.

To Profit and Loss Appropriation A/c
(Interest on drawings transferred to Profit and Loss Appropriation A/c)

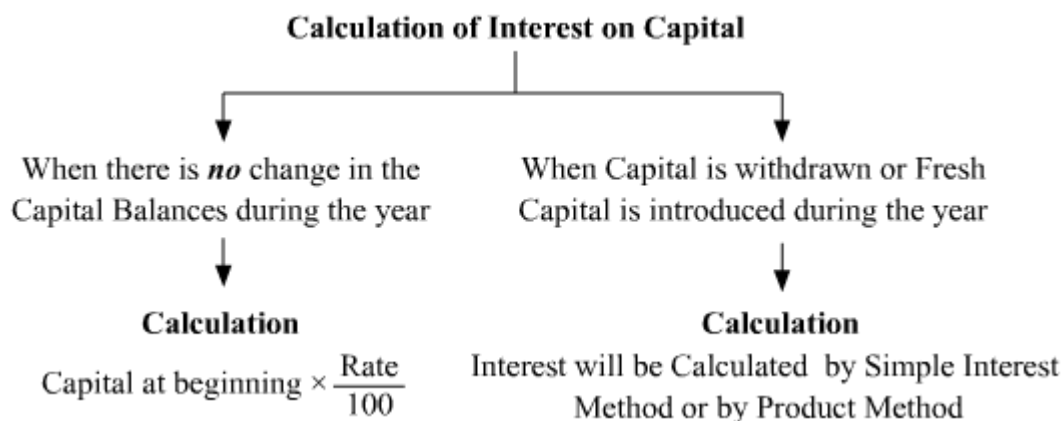
Partners' Capital A/c Dr.
OR
Partners' Current A/c Dr.
To Profit and Loss Appropriation A/c
(Interest charged on partners' drawings)

Where will be allowed on capital where rate of interest is given in partnership deed agreed among the partners at the time of formation of partnership.

Interest on Capital A/c Dr.
To Partners' Capital A/c
OR
To Partners' Current A/c (*If capital are fixed*)
(Interest on capital allowed to partners)

Profit and Loss Appropriation A/c	Dr.
To Partner on Capital A/c	

Profit and Loss Appropriation A/c Dr.
To Partners' Capital A/c
OR
To Partners' Current A/c (*If Capital are fixed*)
(Interest allowed on partners' capital)



When there is no change in the capital balances

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Example:

A and B are the partners in a business their capital as on January 01, 2012 were Rs 1,00,000 and Rs 80,000 respectively.

	A	B
Capital	1,00,000	80,000

Interest on Capital:

$$A = 1,00,000 \times \frac{6}{100} = \text{Rs } 6,000$$

$$B = 80,000 \times \frac{6}{100} = \text{Rs } 4,800$$

When capital is withdrawn or fresh capital is introduced during the year

Example:

	A	B
Opening Balances (January 01, 2012)	Rs 1,00,000	Rs 80,000
Drawings (July 01, 2012)	Rs 20,000	–
Additional Capital Introduced (July 01, 2012)	–	Rs 20,000
Additional Capital Introduced (October 01, 2012)	Rs 30,000	–

Solution:

Simple Interest Method

Interest on A's Capital

During 2012	Capital Balances	Months	Product
From Jan. 01 to June 30	1,00,000	6	$1,00,000 \times \frac{6}{100} \times \frac{6}{12} = \text{Rs } 3,000$
From July 01 to Sep. 30	80,000	3	$80,000 \times \frac{6}{100} \times \frac{3}{12} = \text{Rs } 1,200$
From Oct. 01 to Dec. 31	1,10,000	3	$1,10,000 \times \frac{6}{100} \times \frac{3}{12} = \text{Rs } 1,650$
Total Interest			Rs 5,850

Interest on B's Capital

During 2012	Capital Balances	Months	Product
From Jan. 01 to June 30	80,000	6	$80,000 \times \frac{6}{100} \times \frac{6}{12} = \text{Rs } 2,400$
From July 01 to Dec. 31	1,00,000	6	$1,00,000 \times \frac{6}{100} \times \frac{6}{12} = \text{Rs } 3,000$
Total Interest			Rs 5,400

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Product Method

Interest on A's Capital

During 2012	Capital Balances	Weights	Product
From Jan. 01 to June 30	1,00,000	6	Rs 1,00,000 × 6 = Rs 6,00,000
From July 01 to Sep. 30	80,000	3	Rs 80,000 × 3 = Rs 2,40,000
From Oct. 01 to Dec. 31	1,10,000	3	Rs 1,10,000 × 3 = Rs 3,30,000
Sum of Product			Rs 11,70,000

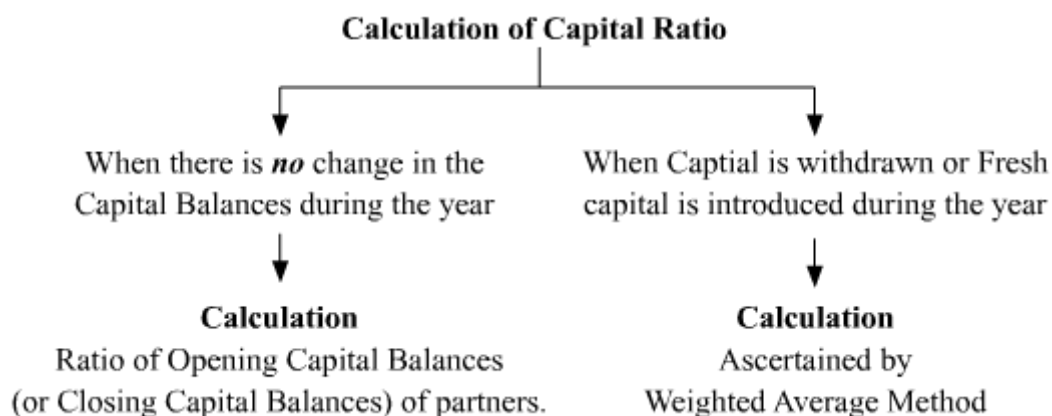
$$\text{Interest on A's Capital} = 11,70,000 \times \frac{6}{100} \times \frac{1}{12} = \text{Rs } 5,850$$

Interest on B's Capital

During 2012	Capital Balances	Weights	Product
From Jan. 01 to June 30	80,000	6	Rs 80,000 × 6 = Rs 4,80,000
From July 01 to Dec. 31	1,00,000	6	Rs 1,00,000 × 6 = Rs 6,00,000
Sum of Product			Rs 10,80,000

$$\text{Interest on B's Capital} = 10,80,000 \times \frac{6}{100} \times \frac{1}{12} = \text{Rs } 5,400$$

- ❖ In case the question specifies that the profit is to be distributed among the partners in the ratio of their capital balances, then we need to determine the **capital ratio**.



Example: When there is no change in the capital balances during the year

A and B are the partners in a business with capitals of Rs 1,00,000 and Rs 80,000 as on January 01, 2012.

	A	B
Capital	1,00,000	80,000
Capital Ratio	5 : 4	

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Example: When capital is withdrawn or fresh capital is introduced during the year

	A	B
Opening Balances (January 01, 2012)	Rs 1,00,000	Rs 80,000
Drawings (July 01, 2012)	Rs 20,000	—
Additional Capital Introduced (July 01, 2012)	—	Rs 20,000
Additional Capital Introduced (October 01, 2012)	Rs 30,000	—

Solution: Calculation of Capital Ratio

During 2012	A's Capital Balances	Weights	Product
From Jan. 01 to June 30	1,00,000	6	Rs 1,00,000 × 6 = Rs 6,00,000
From July 01 to Sep. 30	80,000	3	Rs 80,000 × 3 = Rs 2,40,000
From Oct. 01 to Dec. 31	1,10,000	3	Rs 1,10,000 × 3 = Rs 3,30,000
Total		12	Rs 11,70,000

During 2012	B's Capital Balances	Weights	Product
From Jan. 01 to June 30	80,000	6	Rs 80,000 × 6 = Rs 4,80,000
From July 01 to Dec. 31	1,00,000	6	Rs 1,00,000 × 6 = Rs 6,00,000
Total		12	Rs 10,80,000

	A	B
Total Weights	11,70,000	10,80,000
Capital Ratio	117	108

- ❖ **Partner's Salary and Commission:** Salary and commission will be allowed to the partners only if it is mentioned in the partnership deed.

Accounting Treatment:

Partners' Salary A/c	Dr.
Partners' Commission A/c	Dr.
To Partners' Capital A/c	
OR	
To Partners' Current A/c	(If capital are fixed)

(Salary and Commission allowed to partners)

Profit and Loss Appropriation A/c	Dr.
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capitals of A and B of Rs 2,000 and Rs 1,500 and without charging interest on drawings of Rs 200 and Rs 150.

Adjust the omitted items by passing adjusting Journal entries.

Solution:

Journal Entry

Particulars	L.F.	Debit Amount Rs	Credit Amount Rs
B's Capital A/c Dr. To A's Capital A/c (Interest on capital and drawings adjusted)		225	225

Working Note:

	A	B		Total
Interest on capital	2,000	1,500	=	3,500
Less: Interest on Drawings	(200)	(150)	=	(350)
Profit should have been distributed	1,800	1,350		3,150
Less: Profit wrongly distributed	(1,575)	(1,575)		(3,150)
	225	(225)		NIL

Example

Saint and Kabir are partners sharing profits and losses in the ratio 3:2. On January 01, 2011, their capital balances stood at Rs 2,40,000 and Rs 2,00,000 respectively. After closing the books of accounts on December 31, 2011, it was found that interest on capital was allowed at 12% p.a. instead of 10% p.a. Pass the necessary Journal entry for adjustment of interest on capital.

Solution:

Journal Entry

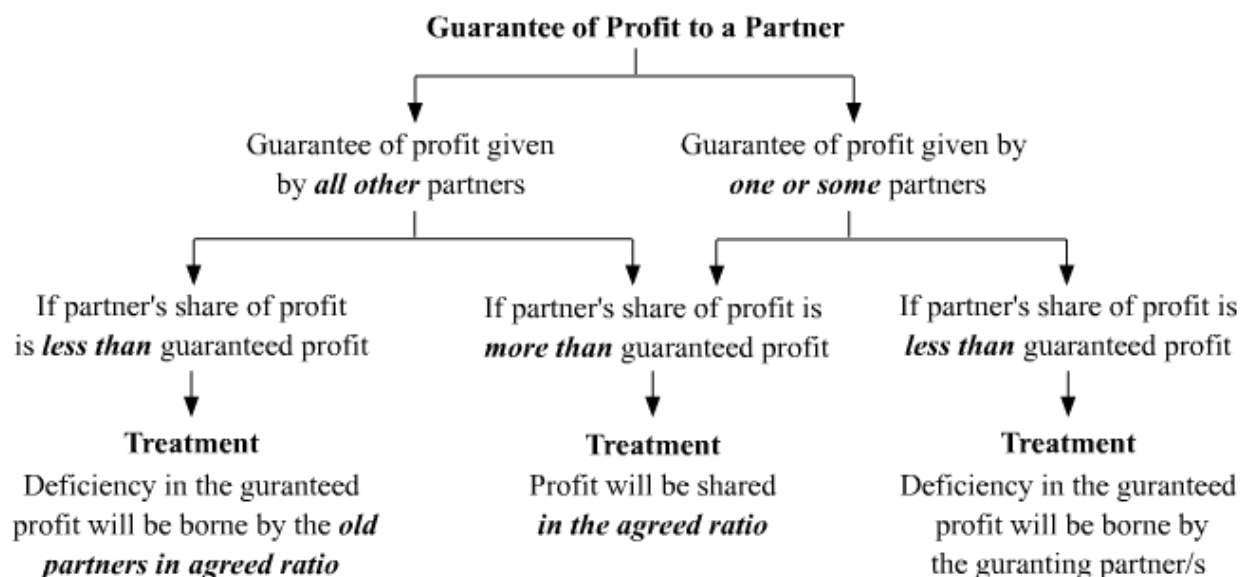
Particulars	L.F.	Debit Amount Rs	Credit Amount Rs
Kabir's Capital A/c Dr. To Saint's Capital A/c (2% excess interest on capital adjusted)		480	480

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Working Note:

	Saint	Kabir	Total
2% Interest on Capital (excess distributed)	(4,800)	(4,000)	= (8,800)
Right distribution of 8,800 (3:2)	5,280	3,520	= 8,800
Adjustment of Profit in Capital Accounts	(480)	480	NIL

❖ Guarantee of Profit to Partner



Example

A and B were partners sharing profits and losses equally. They admitted C for $\frac{1}{3}$ rd share of profit on the condition that C will get a minimum profit of Rs 10,000 and if any deficiency exists, then it will be equally borne by both A and B. The profit earned during the year amounts to Rs 24,000. Prepare Profit and Loss Appropriation Account to show the appropriation of profit among the partners.

Solution

Profit and Loss Appropriation Account

Dr.		Cr.	
Particulars	Amount Rs	Particulars	Amount Rs
Profit transferred to Capital Account		Profit and Loss (Net profit)	24,000
A 8,000 – 1,000	7,000		
B 8,000 – 1,000	7,000		
C 8,000 + 2,000	10,000		
	24,000		24,000

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$$\text{C's share of profit} = 24,000 \times \frac{1}{3} = 8,000$$

But C was guaranteed a minimum profit of Rs 10,000, so the deficiency in C's share of profit = $10,000 - 8,000 = \text{Rs } 2,000$

A and B both will equally bear the deficiency in C's share.

$$\text{A will bear} = 2,000 \times \frac{1}{2} = \text{Rs } 1,000$$

$$\text{B will bear} = 2,000 \times \frac{1}{2} = \text{Rs } 1,000$$

$$\text{C's share of profit} = \text{Rs } 8,000 + \text{Rs } 1,000 + \text{Rs } 1,000 = \text{Rs } 10,000\text{s}$$