ACCOUNTING FOR PARTNERSHIP: BASIC CONCEPTS

PARTNERSHIP:

When two or more persons join hands to set up a business and share its profits and losses in an agreed ratio, they are called partnership.

Section 4 of the 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'.

Persons who have entered into partnership with one another are individually called 'partners' and collectively called 'firm'. The name under which the business is carried is called the 'firm's name'.

Features:

1. Agreement: Partnership is an agreement between two or more partners. It may be oral or written.
2. Sharing of profit: The profit shall be shared by the partners in an agreed ratio.
3. Existence of business: It is formed only for the purpose of carrying on a lawful business.
4. mutual agency: The partnership business may be carried on by all or any one of them acting for all. Thus each partner is principal and so can act in his own right. At the same time, he can act on behalf of other partners as their agent.
5. Number of partners; The minimum number of partners for forming a partnership is two. The maximum number is 10 for banking business and 20 for other.
6. Unlimited liability: The liability of partner is unlimited.
7. Mutual trust: The essence of partnership is Mutual trust.
8. Registration: Registration of partnership is not compulsory.

PAR TNERSHIP DEED:

Partnership is an agreement between two or more partners. It may be oral or written. The Partnership Act does not require that the agreement must be in writing. But wherever it is in writing, the document is called 'Partnership Deed'. It contains the terms and conditions relating to partnership and regulations governing the internal management and organization.
Contents:

i. Name of the firm ii. Names and address of partners
111. Nature of business
iv.Principle place of business
v. Duration of partnership, vi. Amount of capital contributed by each partners Vll. Profit sharing ratio
viii. Amount of salary ix. Amount of drawings
x. Rate of interest on capital or drawings etc.

Rules applicable in the case ofabsence ofpartnership Deed

Profit Sharing Ratio	Shared Equally
Interest on Capital	No partner is entitled to claim any Interest on Capital
Interest on Drawings	No interest is charged on drawings
Interest on Loans/Advances	shall be entitled to get an interest at the rate of 6 per cent per annum.
Salary or other remuneration	No partner is entitled to get salary or other remuneration

Accounting treatment for partnership firm

1. Maintenance of Partners' Capital Accounts;
2. Distribution of Profit and Loss among the partners
3. Adjustments for Wrong Appropriation of Profits in the Past
4. Reconstitution of the Partnership Firm
5. Dissolution of Partnership Firm.

I. Maintenance of Capital Accounts ofPartners

There are two methods by which the capital accounts can be maintained. These are:

a. Fixed Capital Method
b. Fluctuating Capital Method

a. Fixed Capital Method

Under the fixed capital method, the capitals of the partners shall remain fixed. All yearly adjustments like share of profit or loss, interest on capital, drawings, interest on drawings, etc. are recorded in a separate account, called Partner's Current

Account. Thus under Fixed Capital Method, two accounts are maintained for each partner viz., capital account and current account.

b. Fluctuating Capital Method:

Under the fluctuating capital method, only one account, i.e. capital account is prepared for each partner. All yearly adjustments such as share of profit and loss, interest on capital, drawings, interest on drawings, salary or commission to partners, etc. are recorded in the capital accounts. This makes the balance in the capital account to fluctuate from time to time. So this method is called fluctuating capital method.

NOTE: In the absence of any instruction, the capital account should be prepared under Fluctuating Capital Method.

Basis of distinction	Fixed Capital re(hod	Fluctuating Capital
1 . Change in capital	The capital nor:nallv remains unchanged except under special circujnstances.	The capital is changing froni penod to penod

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<tr><td>The capital normally remains unchanged except under special circumstances.</td><td>The capital is changi from period to period.</td></tr>
<tr><td>Each partner has two accounts, namely, Captial Account and Current Account.</td><td>Each partner has only o account i.e., Capi Account.</td></tr>
<tr><td>Capital Account shows always a credit balance.
Current account may sometimes show debit or credit balance.</td><td>Capital Account sho always a credit balance</td></tr>
<tr><td>All adjustments relating to partners are recorded in the Current Accounts.</td><td>All adjustments relating partners are record directly in the Capit Accounts itself.</td></tr>
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11. Distribution ofProfit among Partners

The profits and losses of the firm are distributed among the partners in an agreed ratio. For this purpose, it is customary to prepare a Profit and Loss Appropriation Account of the firm.

a. Profit and Loss Appropriation Account

Profit and Loss Appropriation Account is an extension of the Profit and Loss Account of the firm. It shows how the profits are distributed among the partners. All adjustments in respect of partner's salary, partner's commission, interest on capital, interest on drawings, etc. are made through this account. It starts with the net profit/net loss as per Profit and Loss Account.

Journal Entries

1. Transfer of the balance of Profit and Loss Account to Profit and Loss Appropriation Account:

   (a) If net profit:

   Profit and Loss A/c Dr.

   To Profit and Loss Appropriation A/c

   (b) If net loss:

   Profit and Loss Appropriation A/c Dr.

   To Profit and Loss A/c

2. For interest on capital:

   Profit and Loss Appropriation A/c Dr.

   To Interest on Capital A/c

3. Interest on Drawings:

   Interest on Drawings A/c Dr.

   To Profit and Loss Appropriation A/c

4. Partner's Salary:

   Profit and Loss Appropriation A/c Dr.

To salary

5. Partner's Commission:

Profit and Loss Appropriation A/c Dr.
To Commission to Partners Capital/Current A/c

6. Share of Profit or Loss after appropriations:

(a) IfProfit:

Profit and Loss Appropriation A/c Dr.
To Partner's Capital/Current A/c's (individually)

(b) IfLoss:

Partner's Capital/Current A/c's (individually) Dr.
To Profit and Loss Appropriation A/c

111. Calculation of Interest on Capital

When rate of interest will be as agreed upon by the partners. Interest is charged on the opening balance of the partner's capital account. When additional capital is introduced and some capital is withdrawn permanently, the interest will be calculated on the amount of the capital used in the business during a particular period.

IV. Interest on Drawings

$$\text{Interest on drawing} = \frac{\text{Total Drawing} \times \text{Rate of Interest}}{100} \times \frac{\text{Avg. Period}}{12}$$

Conditions:

Particular	Beginning	Middle	End
Amount withdrawn every month	6.5	6	5.5
Amount withdrawn every quarter	7.5	6	4.5
Amount withdrawn for 6 month	3.5	3	2.5

NOTE: When Dates of Withdrawal are not specified, for calculation of interest, the period would be taken as six months, which is the average period assuming, that amount is withdrawn evenly in the middle ofthe month, throughout the year. v. PAST ADJUSTMENT.

Sometime after closing books of accounts of partnership firm, there were some error or omission in books of accounts like:
a) Omission of Interest on capital
b) Wrong distribution of Interest on capital
c) Wrong distribution of Interest on drawing
d) Distribution of profit in wrong ratio
Then, we have to pass an entry to rectify these errors.

VI. Guarantee of Minimum Profit:

Sometimes, one partner can enjoy the right to have minimum amount ofprofit in a year as per the terms of the partnership agreement. In such case, allocation of profit is done in a normal way if the share of partner, who has been guaranteed minimum profit, is more than the amount of guaranteed profit. However, if share of the partner is less than the guaranteed amount, he takes minimum profit and the excess of guaranteed share of profit over the actual share is borne by the remaining partners as per the agreement.

There are three possibilities as far as share of deficiency by other partners is concerned. These are as follows:

- Excess is payable by one of the remaining partners.
- Excess is payable by at least two or all the partners in an agreed ratio.
- Excess is payable by remaining partners in their mutual profit sharing ratio.

NOTE: Ifthe question is silent about the nature ofguarantee, the burden ofguarantee is borne by the remaining partners in their mutual profit sharing ratio.

FINAL ACCOUNTS

The final accounts of a partnership firm are prepared in the same way as those prepared for a sole trading concern with just one difference which relates to the distribution of profit among the partners. After preparing the Trading and Profit and Loss Account, the net profit or net loss is transferred to Profit and Loss Appropriation Account.