CHAPTER

2 Accounting for Partnership - Basic Concepts

TOPICS COVERED:

- *Meaning and Definition of Partnership*
- *Partnership Deed*
- *Profit and Loss Appropriation Account*
- *Partners' Capital Account & Interest on Capitals*
- *Interest on Drawings*
- *Interest on Partners Loan*
- *Salary or Commission to a Partner*

MEANING AND DEFINITION OF PARTNERSHIP

Meaning of partnership: -

According to Sec. 4 of the Indian 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 one of them acting for all.

Features or Characteristics of Partnership: -

After analyzing the above definition the following are the essential Characteristics of Partnership:-

(1) Association of two or more persons: The minimum number of partners in a firm can be two. Maximum number is guided by Companies Act. According to section 464 of the Indian Companies Act 2013, the number of partners in any association shall not exceed 100. However, the Rules given under the Companies (Miscellaneous) Rules, 2014 restrict the present limit to 50. If this limit is exceed it becomes illegal association

(2) Agreement: There must be an agreement between all partners who are involved in that business.

(3) Business: The agreement should be for the purpose of carrying business between the partners.

(4) Profit sharing Ratio: There must be sharing of profits and loss of business between partners.

(5) Agency Relationship: A partner is both (an agent and the principal) of his own business .A partner is an agent of his own business in the sense that he can bind new partners by his acts and a partner is a principal of his own business in the sense that he can be bound by the acts of other partners of business.

(6) Liability of Partners: Each partner is liable jointly and individually third party for all the acts of the firm done while he is a partner. It means his private assets can also be used for paying off the firm's debts.

Nature of Partnership firm: -

From legal point of view a partnership firm has no separate legal entity apart from the partners constituting it but from accounting point of view, Partnership is a separate business entity. Under section 2(3) of the Income-tax Act, 1961 a partnership firm is a Separate person.

Partners, Firm and Firm Name: –

The persons who have entered into a partnership are individually called as 'partner' of the firm and together they are refer as 'firm', the name under which the business of the firm is carried on is called the 'firm name'.

Accounting Procedure of Partnership Firm:-

The Final Accounts of a Partnership Firm is prepared in same manner in which Final Accounts of sole proprietors is prepared. Because in case of Partnership two or more partners are involve so the Net Profit of the Firm is distributed by Partners in their agreed Ratio. The account which shows the distribution of Profits or loss among the Partners is called "Profit and Loss Appropriation A/c". It is an extension of Profit and Loss Account.

These are the additional points:-

1. Partnership Deed
2. Profit and Loss Appropriation Account
3. Partners' Capital Accounts
4. Interest on Partners Drawings
5. Interest on Partners Capital
6. Salary or Commission to Partners
7. Interest on Partners Loan
8. Adjustments after closing of partnership Accounts.

PARTNERSHIP DEED

- Partnership deed is not compulsory documents, it is Voluntary documents
- A partnership deed is based on an agreement among the partners.

- It contains the terms and condition of partnership as agreed among the partners.
- The partnership agreement can be either oral or written but when it is in writing, it is called 'Partnership Deed'. The deed should be properly drafted and prepared as per the provisions of the 'Stamp Act' and preferably registered with the Registrar of Firms.

The Partnership Deed covers following details.

(1) Name of Firm and the partners.

(2) Commencement and duration of business.

(3) Amount of Capital contributed by each partner.

(4) Amount to be allowed to each partner as drawings and the timing of such drawings.

(5) Rate of Interest to be allowed to each partner on his capital and on his loan to the firm and to be charged on his drawings.

(6) Ratio in which profit or Losses are to be shared.

(7) Whether a partner will be allowed to draw any salary.

(8) Any Variation in the mutual rights and duties of partners.

(9) Method of valuing goodwill on the occasion of changes in the constitution of the firm.

(10) Procedure by which a partner may retire and the method of payment of his dues.

(11) Basis of the determination of the executors of a deceased partner and the method of payment.

(12) Treatment of losses arising out of the insolvency of a Partner.

(13) Procedure to be followed for settlement of dispute among partners.

(14) Preparation of accounts and their audit.

If there is no partnership deed and if partnership deed is available but it is silent on any matter, then the relevant provisions of the Indian Partnership Act, 1932, would be applicable. Some of the provisions of the Act :-

(*a*) Sharing of Profits & Losses - Profits & Losses are to be shared equally according to section [Sec. 13(b)]

(*b*) Interest on Capital - No Interest is to be allowed on Capital according to section [Sec. 13(c)]

(*c*) Interest on Loan & Advances by a partner - Interest @ 6% p.a. is to be allowed on Advances & Loans, according to section [Sec. 13(d)].

(*d*) Interest on Drawings - No Interest is to be charged on Drawings.

(*e*) Salary to a partner - No remuneration for taking part in the conduct of business is to be allowed to any partner according to section [Sec. 13(a)]

PROFIT AND LOSS APPROPRIATION ACCOUNT

This account is prepared to distribute profit or loss among the partners. It is the extension of Profit and Loss Account. This account show what amount of profit is transferred to partner's capital Account.

Profit and Loss Appropriation A/c

For the year Ended on ………………..

Dr. Cr.

Particulars		₹	*Particulars*		₹
To Interest on Capital			By Profit and Loss A/c– Net Profit		xxxx
A	xxx				
B	xxx				
C	xxx	xxxx	By Interest on Drawings		
To Partner Salary			A	xxx	
A	xxx		B	xxx	
B	xxx	xxxx	C	xxx	xxxx
To Partners Commission – A		xxxx			
To Reserve Fund (Transfer)		xxxx			
To Profit transferred to Capital A/c		Balancing Figure			
A (3/6)	xxx				
B (2/6)	xxx				
C (1/6)	xxx	xxxx			
Total		xxxx	Total		xxxx

Note: -

1. Partners Commission:- If Partners commission is allowed on Turnover (Sales) or Purchase of goods it is item of Profit and Loss Account but when Partners allowed commission on Profit it becomes item of Profit and Loss Appropriation A/c

Following are the items of Profit and Loss A/c

- Interest on Partner's Loan and advance
- Manager Commission
- Rent Paid to a partner

Profit and Loss A/c

For the year Ended on ………………..

Dr. Cr.

Particulars	₹	*Particulars*	₹
To Interest on Partners' Loan & Advance	xxxx	By Profit as given	xxxx

Particulars	₹	*Particulars*	₹
To Manager Salary & Commission	xxxx		
To Rent paid to partner	xxxx		
To Net Profit – transferred to P / L Appropriation A/c	xxxx		
	xxxx		xxxx

PARTNERS' CAPITAL ACCOUNT & INTEREST ON CAPITALS

Partners Capital Accounts:

Methods of Maintaining Capital Accounts of Partners

The partner's Capital Account may be maintained in two ways.

(1) Fluctuating Capital method

(2) Fixed Capital method

> In the absence of any instructions, the partners' capital A/c should be prepared on the basis Fluctuating Capital Method

Fluctuating Capital method:

When capital is fluctuating a single Account is prepared that is called Partners Capital Account. In this account amount of capital is change from opening figure to closing figure. All entries such as, Interest on capital, Drawings, Interest on Drawings, Salary of partner, Commission of partner, Share of Profit or Loss and additional / fresh capital introduced by partners are recorded in Partner Capital A/c

Note:- Interest on Loan and Advance to Partners are not recorded in Partners Capital A/c When Partners Capital A/c is fluctuating. In this case it may be recorded in separate account "Accrued Interest A/c"

Fixed Capital method: -

When capital is fixed two Accounts are prepared

1. Partners' Capital Account
2. Partners' Current Account

   1. Partners' Capital Account: - In this account only additional capital introduced and withdrawn from existing capital is shown and no other transactions are recorded.
   2. Partners' Current Account:- In this account all entries such as, Interest on capital, Drawings, Interest on Drawings, Salary of partner, Commission of partner, Share of Profit or Loss are recorded.

> Current Account balance of partners may be fall in both sides whether in debit side or credit side.

Interest on capital:

Calculation of Interest on Capital: Interest on capital is calculated at the pre-defined rate with period for which capital has been used in the business. Interest on capital will be calculated on opening balance of capital account. Interest on capital is also allowed if any capital is introduced during the year.

Certain times closing capital is given then for the purpose of calculating "interest on capital" opening capital will find out

When Capital is fixed:

Calculation of Capital at the Beginning

Particulars	*A*	*B*	*C*
Capital at end	xxxx	xxxx	xxxx
Add: Drawings (withdrawn from Capital)	+	+	+
Less: Additional Capital	–	–	–
Capital at Beginning	xxxx	xxxx	xxxx

When Capital is Fluctuating:

Calculation of Capital at the Beginning

Particulars	*A*	*B*	*C*
Capital at end	xxxx	xxxx	xxxx
Add: Drawings	+	+	+
Add: Interest on Drawings	+	+	+
Less: Additional Capital	–	–	–
Less: Interest on Capital	–	–	–
Less: Share of Profits	–	–	–
Capital at Beginning	xxxx	xxxx	xxxx

Accounting Treatment of Interest on Capital

Case	Rules
1. When partnership agreement is silent as to providing Interest on Capital	Interest on capital is not allowed
2. When partnership agreement is providing Interest on Capital "as a Charge" it means it is allowed even in case of loss	Interest on capital is allowed out of profit as well as from loss.
3. When partnership agreement is providing Interest on Capital but it silent as to the treatment "as a Charge "or "appropriation"(only it is given in partnership agreement that Interest on Capital is allowed)	Interest on capital is allowed only in case of sufficient profit and no Interest on capital is allowed out of Loss. 1. In case of Loss: - No Interest on Capital is allowed.

Case	Rules
	2. If there is Sufficient Profit, it means total interest on capital is allowed out of profit :- Interest on capital is allowed 3. If there is no sufficient Profit, it means total interest on capital can not allowed out of profit :- Interest on capital is allowed only to the extent of profit "in the ratio of capital of each partner"

INTEREST ON DRAWINGS

When company Charge Interest on Drawing - Interest on Drawings will be charged from the partners if the partnership agreement provides for the same. If partnership deed is silent about charging interest on drawings, No interest on Drawings will charge.

Calculation of Interest on Drawings:-

⇒ By Product Method :- Basic method of calculating Interest on Drawings

Date of Withdrawn	Amount	Period (Date of Withdrawn to end of year)	Product
Total			xxxx

Interest on Drawings = Sum of Product × Rate of Interest × Time $\left(\frac{1}{12}\right)$

⇒ **By average period Method :-** Short cut method of calculating Interest on Drawings

Average Period Method should be used only when

(*i*) The amount of Drawings is uniform; and

(*ii*) The time interval between the two consecutive drawings is uniform.

$$\text{Average Period} = \frac{\text{Time left after First Drawings} + \text{Time left after Last Drawings}}{2}$$

Type of Drawings	Timing of Drawings		
	Beginning	Middle	End
Each month for whole year	6 and ½ month	6 months	5 and ½ month
Each month for 6 months only	3 and ½ month	3 months	2 and ½ month
Each Quarter for whole year	7 and ½ month	6 months	4 and ½ month

Accounting Treatment - Interest on drawings is profit or gain to the Firm and credited to the Profit& Loss Appropriation Account. On the other hand, interest on drawings is a loss to the partner and debits to his Current/Capitals Account.

INTEREST ON PARTNERS LOAN

Rate of Interest - In case of any partner gave loan to his firm, that partner is entitled to an interest on that given loan at a pre-decided rate of interest. If there is no agreement for the rate of interest on loan, the partner is entitled to Interest on loan @ 6% p.a. under section [Sec 13(d)].

Nature of Interest - The interest is to be allowed whether there is profit or loss in the business. It is given out of Loss because it is Charge against the Profit

Accounting Treatment - It can be noted that such interest on loan being a charged against the profit shell be transferred to be debit of profit and loss a/c and not to be debit profit and loss appropriate.

SALARY OR COMMISSION TO A PARTNER

When to Allow: Salary or Commission to a partner will be allowed if the partnership agreement is said.

Nature of Payment: Salary or commission to a partner is an appropriation out of profits and not in charge against the profit. We can say that it is to be allowed only there are profit in the business.

Calculation: Commission may be allowed as percentage on Net Profit before charging this commission or after charging this commission.

(*a*) Commission as % of Net Profit before charging this Commission

$$= \frac{\text{Net Profit before Commission} \times \text{Rate of Commission}}{100}$$

(*b*) Commission as % of Net Profit after charging this Commission

$$= \frac{\text{Net Profit before Commission} \times \text{Rate of Commission}}{(100 + \text{Rate of Commission})}$$

Accounting Treatment Salary or commission to a partner being an appropriation of profit so transferred to the debit side of the Profit and Loss Appropriation account and not in Profit and Loss Account.

Important Points:-

- The law relating to Partnership Firm is contained in “The Indian Partnership Act, 1932
- The Indian Partnership Act came in to force on 1st day of October in 1932 or 1/10/1932
- A partnership cannot be formed with a minor partner but after the formation of partnership a minor may be admitted in the Partnership. (All the persons enter-

ing into partnership must be "competent to contract" at the time of formation of partnership)

- A partnership can be formed for carrying Business as well as Profession but it cannot be formed for carrying on a "Charitable Activities".
- The maximum number of partners is mentioned in section 464 of the Indian Companies Act 2013, the number of partners in any association shall not exceed 100. However, the Rules given under the Companies (Miscellaneous) Rules, 2014 restrict the present limit to 50
- Mutual Agency is conclusive evidence of Partnership
- Sharing of Profit is *Prima facie* evidence of Partnership.
- Registration of Partnership Firm is optional
- An unregistered Firm cannot claim Set off in excess of ₹ 100
- In the absence of any agreement, partners are liable to receive interest on their Loans & Advances @ 6 % p.a. [Section 13(d)]
- A partner's act as agent for a Firm
- Partnership Deed and Partnership agreement: - Partnership deed is registered in Court of law it means it is properly stamped where as partnership agreement is not registered.
- Interest on capital will be paid to the partners if provided for in the agreement but only from Current Profits.
- The balance of Partner Current A/c and Partners Capital Account (in Case of Fluctuating capital) may be Debit balance as well as credit balance. But the Balance of Fixed capital is always Credit Balance.
- A partnership firm not a person in the eyes of Law except under section 2(3) of the Income-tax Act, 1961
- Partnership Deed is not necessary. In the lack of Partnership Deed the provision of the Indian Partnership Act, 1932 would be Applicable.
- The partnership Deed is must be signed by all partners.
- A Firm is the collective name under which partners carries its business.
- A Firm does not have a legal existence, apart from its member.
- Registration of Firm can be affected on or after formation of a Firm.
- A minor can be admitted to the benefits of partnership in an Existing Firm with the Consent of Majority of a Partnership.
- Agreement to Share profits does not necessarily mean an agreement to share Losses.
- Rent paid to a Partner and "Interest Allowed on Loan and Advance" to a partner is charge against the profit so it is recorded in Profit and Loss A/c and not Profit

and Loss Appropriation A/c. (Rent paid to a partner is an expenses incurred towards use of property. It is charge of Profit)

- In the absence of an agreement, partners are entitling only to "Interest on Loan and Advance" and share Profit and Loss Equally.
- In case of Partnership an addition Account apart from Profit and Loss A/c is prepared which is called Profit and Loss Appropriation A/c. It is an extension of Profit and Loss A/c. In case of sole Proprietorship Profit and Loss Appropriation A/c is not prepared.
- Profit and Loss Appropriation A/c is prepared for distributing Profit among Partners.
- Interests on Drawing are allowed to partners only when it is provided by an Agreement or agreed by all partners.
- Balance of Partners Drawings A/c is transferred to Credit side of either Partners Current A/c or Partners Capital A/c. When partner Drawings A/c is closed its balance is transferred to Credit side of either Partners Current A/c or Partners Capital A/c.
- The liability of All Partners is jointly and severely unlimited. In case of Loss partners are personally as well collectively liable for bear "loss of the firm"
- In the absence of an agreement "Interest on Capital" is allowed only from "Current Profit" or not from Accumulated profits or past profits.
- Where the "Partnership Deed" is silent on any point the provision of Partnership Act, 1932 will apply.
- Guarantee is always given for Profit When Guarantee is given to any partner it means in case of loss or insufficient profit guaranteed partner must withdraw minimum guarantee amount.
- Unless otherwise provided, it is presumed that all the existing partners have given such guarantee in their existing Profit Sharing Ratio.
- In the absence of any instructions, the partners' capital A/c should be prepared on the basis of Fluctuating Capital Method

MULTIPLE CHOICE QUESTIONS (MCQs)

Meaning and Definition of Partnership

1. The Indian Partnership Act was came into force from the year:

(*a*) 1932 (*b*) 1940

(*c*) 1948 (*d*) 1956

[BHU B.Com Entrance 2010]

2. Partner and Firm are mutually related:

(*a*) Management (*b*) Servant

(*c*) Agent (*d*) Shareholder

[BHU B.Com Entrance 2011]

3. Nominal partner is one who:

(*a*) Invests nominal capital

(*b*) Earns nominal profit

(*c*) Allows the use of his name

(*d*) Allows limited liability

[BHU B.Com Entrance 2016]

4. Which one of the following firm is considered to be illegal to do trading business?

(*a*) A firm with 40 partners

(*b*) A firm with 18 partners

(*c*) A firm with 22 partners

(*d*) A firm with 52 partners

[AMU B.Com Entrance 2017]

5. The maximum number of partners allowed in a firm carrying on a business is:

(*a*) 10 (*b*) 20

(*c*) 50 (*d*) 100

6. A firm:

(*a*) Has a legal existence of its own

(*b*) Does not have a legal existence, apart from its partners

(*c*) Has no legal existence?

(*d*) None of the above

7. Sharing of profit is:

(*a*) *Prima facie* evidence of partnership

(*b*) Conclusive evidence of partnership

(*c*) No evidence of partnership

(*d*) None of these

8. Mutual agency is:

(*a*) *Prima facie* evidence of partnership

(*b*) Conclusive evidence of partnership

(*c*) No evidence of partnership

(*d*) None of these

9. What is the person who, without being a real partner, so behaves as to lead others to believe him to be a partner called?

(*a*) Partner by estoppel

(*b*) Dormant Partner

(*c*) Sub-partner

(*d*) Sleeping partner

10. Property of the firm does not include:

(*a*) Trademark owned by the firm

(*b*) Property acquired by or for the firm

(*c*) Goodwill of the business

(*d*) Property belonging to the partners

11. Match list 1 with list 2

List 1		List 2	
(A)	Limited liability partnership	(1)	It can be formed with a minimum of two individual or body corporate through their nominees.
(B)	Particular Partnership	(2)	It is formed for a specific venture or for a particular nominee.
(C)	Partnership	(3)	It is an association of two or more individuals.
(D)	Mutual agency	(4)	A partner is both an agent and a principal in a partnership firm.

Choose the correct answer from the options given below:

(*a*) (A)-(1), (B)-(2), (C)-(3), (D)-(4)

(*b*) (A)-(2), (B)-(3), (C)-(1), (D)-(4)

(*c*) (A)-(2), (B)-(1), (C)-(3), (D)-(4)

(*d*) (A)-(4), (B)-(2), (C)-(1), (D)-(3)

12. The Indian Partnership Act, 1932 defined partnership as :

(*a*) "The relation between persons who have agreed to share the profits of business carried on by all or any of them acting for all".

(*b*) "As an association of two or more persons to carry on as co-owners a business for profit".

(*c*) "A partnership is a form of business organization in which two or more persons up to a maximum of twenty join together to undertake some form of business activity".

(*d*) "A partnership is an arrangement where parties, known as business partners, agree to cooperate to advance their mutual interests".

13. If a particular partner of a firm represents that another person is also a partner of the firm, and if such a person does not disclaim the partnership relationship even after coming to know about it, such person is called :

(*a*) Partners by holding out

(*b*) Partner in profits

(*c*) Dormant partner

(*d*) Partner by estoppels

14. Which of the following statement is incorrect?

(*a*) A person who receives the profits is always a partner.

(*b*) A person who receives the profits is not necessarily a partner.

(*c*) The true test of partnership is the mutual agency i.e., agency relationship among partners.

(*d*) The partnership comes into existence only an agreement.

15. Limited Liability Partnerships came into existence in India after the enactment of:

(*a*) Indian Partnership Act, 1932

(*b*) Limited Liability Partnership Act, 1932

(*c*) Limited Liability Partnership Act, 2008

(*d*) Indian Companies Act, 2013.

16. Assertion (A): Maximum number of partners in a partnership firm is 50.

Reason(R): Maximum number of partners in a partnership firm is prescribed in Companies (Miscellaneous) Rules, 2014

(*a*) Both (A) and (R) are true and (R) is the correct explanation of (A)

(*b*) Both (A) and (R) are true and (R) is not the correct explanation of (A)

(*c*) (A) is true, but (R) is false

(*d*) (A) is false, but (R) is true.

Partnership Deed

17. In the absence any provision in the partnership deed, the Partnership Act provides for.

(*a*) Interest on capital

(*b*) Interest on drawings

(*c*) Interest on advances

(*d*) None of the three

[BHU B.Com Entrance 2020]

18. In partnership, partnership deed is:

(*a*) Essential (*b*) Compulsory

(*c*) Voluntary (*d*) According to situation

19. In the absence of an agreement profit and losses are divided among the partners in the ratio of:

(*a*) Capital

(*b*) Partners' age

(*c*) Time devoted by partners

(*d*) Equality

20. In the absence of any provision in the partnership deed, interest on capital…

(*a*) Will not be allowed

(*b*) Will be allowed @ 6% p.a.

(*c*) Will be allowed only when there is a profit

(*d*) Will be allowed even if there are no profits.

21. In the absence of any provision in the partnership deed, interest on partner's loan/ advance…

(*a*) Will not be allowed

(*b*) Will be allowed @ 6% p.a.

(*c*) Will be allowed only when there is a profit

(*d*) Will be allowed even if there are no profits.

22. In the absence of any provision in the partnership deed, interest on drawings of a partner…