Accounting for Partnership Firm

Meaning and definition of Partnership:

Partnership is an association between two or more persons who agree to do business and share its profit and losses. Partnership is governed by the **Indian Partnership Act 1932.** The partners act as both agents and principals of the firm.

According to Indian partnership Act 1932, "Partnership is the relation between two or more persons, who have agreed to share the profits of the business carried on by all or any of them acting for all."

The characteristics/ nature/ features/elements/essential of Partnership:

a) **Plurality of persons or Two or more persons:** There must be at least two persons to form a partnership and all such persons must be competent to contract. According to Indian contract Act, 1872, every person except the following is competent to contract: **a)** Minors, **b)** Persons of unsound mind, and **c)** Persons disqualified by any law. Section 464 of companies Act, 2013 empowers the government to prescribe maximum number of partners in a firm subject to maximum of 100 but government prescribed maximum number of partners in a firm to be 50.

b) **Agreement and lawful business:** Partnership is an agreement between two or more persons. The agreement may not be necessarily written. It can be verbal also. The written agreement among the partners is known as partnership deed. Partnership is formed for doing **lawful business**. Any agreement to do unlawful activity is not partnership business. In case they are doing unlawful business of smuggling. Therefore it is not a partnership.

c) **Voluntary Association and collective management:** A partnership is a voluntary association of individuals. The partnership firm has no separate legal existence. The partners and firm are treated as one and same. **As collective management** is concerned the ownership is not separated from management. Each partner is the owner and also a part of management.

d) **Profit motive and sharing of profits:** Profit should be the objective of the business. The partnership should not be formed with service motive and sharing of firms profit according to predetermined ratio. **For example:** Members run charitable hospital cannot be a partnership because profit is the main criteria for partnership.

e) **Registration and Act:** The registration of partnership business is not compulsory as per law. Registration is in the interest of the firm, so the firm should preferably be registered. Partnership is governed by the **Indian Partnership Act 1932.**

Partnerships deed:

Partnership is a commercial relationship among the partners. There must be agreement among the partners for the practical application of this relationship. This relationship may be oral or written. Partnership deed is the document containing the partnership agreement among partners. It contain terms and conditions which are agreed upon by all the

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partners viz. right, duties, powers and obligations of each and every partner. It also contains the rules and regulations through which the business of firm is governed and managed. **According to kohler "Partnership agreement (Deed) is an instrument drafted and signed by partners for defining the various rules and regulations of firm".** The partnership deed is also called as **"articles of association"** or the **constitution** of the partnership firm".

<u>Contents/ Clauses/ Financial aspects of partnership deed</u>:

Partnership deed is not a public document. It primarily covers all those material points which are likely to arise in the course of running the partnership business. But the contents of partnership deed vary according to nature of business. **Following clauses may be contained in a partnership deed.**

- **a)** Name of firm and nature of the business.
- **b)** Name and addresses of the partners.
- **c)** The duration of partnership firm.
- **d)** Amount of capital contributed by each partner.
- **e)** Ratio in which profits or losses are to be shared.
- **f)** Partners capitals and drawings and rate of interest on partner's capital and drawings.
- **g)** Partner loan's rate of interest on loan by a partner to firms.
- **h)** Remuneration of partners such as salary, commission etc.
- **i)** Rules to be followed in case of admission, retirement and death of a partner and
- **j)** Methods of settling disputes amongst partners etc.
- **k)** Methods of keeping accounts whether cash or accrual or both etc.

<u>The main provisions of partnership Act relating to accounting if there is no partnership deed or Rules applicable in absence of partnership deed</u>:

Normally a partnership deed covers all matters relating to the mutual relationship among the partners. But if the deed is silent on certain matters or in the absence of any deed, the relevant provisions of the partnership Act shall be applicable.

Matters	Provisions of Indian partnership Act, 1932
a) Sharing of Profits/ losses	Profits/ losses are shared equally by the partners.
b) Interest on Capital	Interest on capital is not paid to partners.
c) Interest on Drawings	Interest on drawings is not charged from partners.
d) Interest on advances/ loans by partner	Interest on loan is paid @6%p.a. Interest is paid even if there is a loss
e) Remunerations to partners	Remuneration (like salary, commission and bonus etc) is not allowed to any partner.

<u>The Rights and Duties of partners:</u>

Following are the rights of partners: a) Right to take part in management. **b)** Right to inspect the books of accounts (sleeping partner also) **c)** Right to share profits. **d)** Right to be consulted about matters affecting the partnership business. **e)** Right to retire.

Following are the duties of partners. a) He should be faithful to other partners. **b)** He should share the losses of the firm. **c)** To attend his duties diligently. **d)** He should not compete with the firm **e)** He cannot transfer the interest of the firm to any other person.

Profit and loss appropriation account:

Meaning: The net profit as shown by Profit and loss Account requires certain adjustment of partner's transactions such as interest on capital, partners, salary, commission, drawings, interest on drawings etc. is to be shared by all the partners in the agreed profit sharing ratio. For this purpose, a separate account is prepared for distribution of profits between the partners, known as profit & loss appropriation account.This account is an extension of profit & loss account. It is a temporary account and by nature it is a nominal account.

Features/ characteristics of profit and loss appropriation account:

- **a)** It is an extension of profit and loss account.
- **b)** It is a nominal account.
- **c)** It is prepared by partnership firms for distribution of profits however sole proprietorship needs not to prepare it.
- **d)** The entries in this account are recorded according to the terms and conditions contained in the partnership deed.
- **e)** It is not required as per provisions of income tax law. Law does not compel the firm to prepare Profit and loss appropriation account.

Dr. **Profit and loss appropriation account as on ……………** **Cr.**

Particulars	Rs	Particulars	Rs
To Interest on Partner's Capital	**Xxx**	By Profit & Loss A/c (Net Profit) **Xxx**	
To Partner's Salary	**Xxx**	Less:-Manager's Commission **(Xx)**	
To Partner's Commission	**Xxx**	Less:-Interest on Partners Loan **(Xx)**	
To Reserve	**Xxx**	Less:-Rent Paid to a Partner **(Xx)**	**Xxx**
To Profit transferred to capital accounts or current accounts		By Interest on Drawing	**Xxx**
	------		**-----**
	Xxx		**Xxx**

Distinguished between Fixed Capital Account and Fluctuating Capital Account :

Basis	Fixed Capital Account	Fluctuating Capital Account
a) No of Accounts Maintained	Two accounts are maintained for each partner: Fixed Capital Account and Current Account.	Only one Account that is Capital account is maintained for each partner.
b) Frequency of Change	The balance in Fixed capital Account does not change except under specific circumstances.	The balance changes frequently from period to period.
c) Adjustments	All adjustments for drawings, interest on	All adjustments for drawings, interest on

for Drawing etc.	Drawing, interest on capital, salary, share of profit/loss are made in current account.	Drawing, interest on capital, salary, share of profit/loss are made in capital account.
d) Balance	It always shows credit balance in capital Account.	Fluctuating Capital Account can also show debit balance.

Dr. **Fixed capital account** **Cr.**

Particulars	**A Rs.**	**B Rs.**	**Particulars**	**A Rs.**	**B Rs.**
To cash / bank (Permanent withdrawal of capital)	**Xxx**	**Xxx**	By balance b/d (in case of old firms)	**Xxx**	**Xxx**
			By cash/ bank A/c (additional capital)	**Xxx**	**Xxx**
	-----	**-----**		**-----**	**-----**
	Xxx	**xxx**		**Xxx**	**Xxx**

Dr. **Partner's Current account** **Cr.**

Particulars	**A Rs.**	**B Rs.**	**Particulars**	**A Rs.**	**B Rs.**
To balance b/d (Dr. bal)	**Xxx**	**Xxx**	By balance b/d (Cr. bal)	**Xxx**	**Xxx**
To Profit &loss A/c	**Xxx**	**Xxx**	By Interest on capital	**Xxx**	**Xxx**
To Drawing	**Xxx**	**Xxx**	By Commission	**Xxx**	**Xxx**
To Interest on drawing			By Salary	**Xxx**	**Xxx**
To Loss as per profit and loss app. a/c	**Xxx**	**Xxx**	By Profit as per profit and loss app. a/c	**Xxx**	**Xxx**
			By balance c/d*	**Xxx**	**Xxx**
	-----	**-----**		**-----**	**-----**
	Xxx	**Xxx**		**xxx**	**Xxx**

Dr. **Partner's Fluctuating capital account** **Cr.**

Particulars	**A Rs.**	**B Rs.**	**Particulars**	**A Rs.**	**B Rs.**
To balance b/d (Dr. bal)	**Xxx**	**Xxx**	By balance b/d (Cr. bal)	**Xxx**	**Xxx**
To Drawing	**Xxx**	**Xxx**	By Salaries	**Xxx**	**Xxx**
To Interest on drawing			By Commission	**Xxx**	**Xxx**
To Loss as per profit & loss app. a/c	**Xxx**	**Xxx**	By Interest on capital	**Xxx**	**Xxx**
			By Profit per profit & loss app. a/c	**Xxx**	**Xxx**
			By balance c/d*	**Xxx**	**Xxx**
	-----	**-----**		**-----**	**-----**
	Xxx	**xxx**		**xxx**	**Xxx**

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Meaning of Past Adjustments:

Sometimes profits or losses of the firm are distributed among the partners for a particular period without giving due consideration to terms and conditions contained in the partnership deed. Such ignored or omitted terms and conditions may be required to be adjusted after the close of the accounting period. The accounting treatment which is required to correct the past errors or omissions is called past adjustment.

For example: Interest on capital or drawing may have been omitted, charge or allowed at higher or lower rate, profits or losses may have been distributed among partners in a wrong ratio and so on.

How to correct past adjustment: The errors and omissions are rectified by adjusting the capital accounts of the affected partners by passing an adjusting entry.

The concept of Guarantee of profit:

Meaning of guarantee: A partner may be admitted into the firm with a guarantee of minimum profit, which means that if his share of profit is less than that of guaranteed profit, then he would be paid the guaranteed share of profit. The deficiency (difference between guaranteed profit and actual profit) is borne by partner or partners who have guaranteed the profit in agreed ratio.

Drawing Account: when withdrawals of money are made at frequent intervals, it is usual practice to open Drawing account for each partner.

Purpose of Interest on Drawing:

a) Interest on drawing keeps a check on unnecessary drawing and his help in curtailing out flow of funds.

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Interest on drawing:

Interest on drawings 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.

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

Interest on Drawings is calculated with a flat rate irrespective of date of drawings.

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

a. **When date of Drawings is not given**

Interest on Drawing = Total Drawings x Rate/100 x 6/12

Note: Interest is calculated for a period of 6 months

b. **When date of Drawings is given**

Interest on Drawing = Total Drawings x Rate/100 x Time Left after drawings/12

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

Product Method is used.

In this method, the amounts of drawings are multiplied by the period for which it remained withdrawn during the period; Interest for 1 month is calculated on the sum of these products.

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)