Partnership Basics

Basics of Partnership

Concepts

I Partnership ?

When 2 or More persons agree to carry on business for mutual distribution of Profits or losses, they are said to have formed a partnership.

Features of Partnership

① 2 or More persons

- atleast 2 Persons
- Competent to contract

Indian Contract Act 1872
⇓
every person except
- . unsound Mind
- . Disqualified by any law
- . Minor

Maximum no. of Partners
⇓
Section 464 of Companies Act 2013
⇓
CG empowered to no. of Partners [100]
⇓
CG ⇒ Max Partners $\boxed{50}$

② Agreement : written / oral

③ Existence of Business and Profit Motive

④ Mutual agency

	A	B	C
	does an Act	does an Act	does an Act
who is agent	A	B	C
who is Principal	B, C	A, C	A, B

II Partnership deed

In absence of Partnership deed (or when Partnership deed is silent on any provision)

1] Profit sharing ratio → Equally
2] Interest on capital ⇒ No Interest on capital
→ No Interest on drawings

1] Profit sharing ratio => Equally
2] Interest on capital => No interest on capital
3] Interest on drawings => No interest on drawings
4] Remuneration to Partner => No
5] Interest on advances / loans by Partners to firm => 6% p.a.

III **Accounts**

- Trading & Profit & loss A/c [not asked in Exam]
- Profit & loss appropriation Account
- Partner capital A/c
  - Fixed Method
  - Fluctuating Method

Profit & loss Appropriation Account

all the Adjustments in respect of Partner salary, Commission, interest on capital, interest on drawings are made through this account

Journal for preparation of Profit & loss appropriation A/c

① Transfer balance of Profit & loss to Profit & loss appropriation A/c

If net Profit => Profit & loss A/c Dr
To Profit & loss appropriation A/c

If net loss => Profit & loss appropriation A/c Dr
To Profit & loss

② **Interest on capital**

For crediting interest on capital to Partner capital A/c

Interest on capital A/c Dr
To Partner capital A/c / Partner current A/c [individually]

For transfer of Interest on capital

Profit & loss appropriation A/c Dr.
To Interest on capital

③ Interest on Drawings

-> for charging interest on drawings

Partner capital A/c / Partner current A/c Dr (Individually)

③ Interest on drawings

→ for charging interest on drawings
Partner capital A/C / Partner current A/C Dr. (Individually)
To Interest on drawings

For transfer to P&L appropriation
Interest on drawings Dr.
To Profit & loss appropriation

④ Partner salary / commission

For crediting salary / commission
Partner salary / commission Dr.
To Partner capital A/C / Partner current A/C

For t/f to P&L appropriation
Profit & loss appropriation Dr.
To Partner salary / commission

⑤ For transfer of Any Amount to Reserve
Profit & loss appropriation A/C Dr.
To Reserve

⑥ Share of Profit or loss after appropriation

If Profit

Profit & loss Appropriation A/C Dr.
To Partner Capital / Current A/C

If loss

Partner Capital / Partner Current A/C
To Profit & loss appropriation

Profit & loss appropriation A/C

To Profit & loss A/C [net loss t/fd from Profit & loss A/c]	By Profit & loss A/C [net Profit t/fd from P&L A/c]
To Interest on Capital	By Interest on drawings
To Partner salary	By loss t/fd to Partner's Capital A/C (Individually)
To Partner Commission	
To Reserve	
~~To Interest on Partner's loan~~	
To Profit t/fd to Partner's Capital A/C (Individually) A B C	

IV Capital Accounts

IV **Capital Accounts**

Fluctuating capital A/c

- only one Account i.e. capital A/c is maintained for each Partner
- all the Adjustments such as share of Profit, interest on capital, interest on drawing, salary, commission to Partner etc are recorded directly in capital A/c of Partner.

Fixed capital A/c

under this capital of Partner shall remain fixed unless capital is introduced or Part of capital is withdrawn

- under this Method 2 Accounts are Maintained for each partner

Partner capital A/c ⇒ Balance always credit

Partner current A/c ⇒ Balance may be debit / credit

- all the adjustments → interest on capital, interest on drawings, Partner salary, commission, share of Profit is recorded in current A/c of Partner.

Adjustment of drawings if FIXED capital Method is followed

Drawings against capital

Partner capital A/c Dr.
To cash / Bank

Drawings against Profit

Partner current Dr.
To drawings

V **Interest on Drawings**

interest on drawings is charged from Date of drawings to end of year

Journal

Partner capital A/c / Partner current A/c Dr.
To interest on drawings
(Being interest on drawings charged)

interest on drawings Dr.
To Profit & loss appropriation

Methods of calculating Interest on Drawings

1. Simple Method
2. Product Method
3. Average period Method

1. Simple Method

Interest is calculated separately on each drawings from date of drawings till closure of Accounting period

$$\text{Interest on Drawings} = \text{Amount of Drawings} \times \frac{\text{Rate of Interest}}{100} \times \frac{\text{total Months}}{12}$$

2. Product Method

Products are calculated by multiplying each set of Drawings with its duration

Products are added and interest is calculated on total product for 1 Month.

Followed when an unequal Amount is withdrawn at different dates

Refer illus 1

$$\text{Interest on Drawings} = \text{Total of product} \times \frac{ROI}{100} \times \frac{1}{12}$$

3. Average Product Method

This method is applied when fixed Amount is withdrawn at Regular Interval

$$\text{Average Period} = \frac{\text{time left after 1st drawing} + \text{time left after last drawing}}{2}$$

Case 1 When Amount is withdrawn at beginning of each Month

$$\text{Average period} = \frac{12 + 1}{2} = \frac{13}{2} = 6.5 \text{ Months}$$

Case 2 When Amount is withdrawn at end of each Month

$$\text{Average period} = \frac{11 + 0}{2} = \frac{11}{2} = 5.5 \text{ Month}$$

Case 3 When Amount is withdrawn at Middle of each Month

$$\text{Average period} = \frac{11.5 + .5}{2} = \frac{12}{2} = 6 \text{ months}$$

Case 4 When Amount is withdrawn at beginning of each quarter

$$\text{Avg period} = \frac{12 + 3}{2} = \frac{15}{2} = 7.5 \text{ months}$$

When Amount is withdrawn at end of each quarter

Avg period = $\frac{\ldots}{2} = \frac{\ldots}{2}$

<u>case 5</u> when Amount is withdrawn at end of each quarter

$$\text{Avg period} = \frac{9 + 0}{2} = \frac{9}{2} = 4.5 \text{ Months}$$

<u>case 6</u> when Amount is withdrawn at Middle of each quarter

$$\text{Avg period} = \frac{10.5 + 1.5}{2} = \frac{12}{2} = 6 \text{ Months}$$

<u>case 7</u> when Amount is withdrawn at beginning of each Month only during a period of 6 Month and Interest to be calculated for 6 months

$$\text{Avg period} = \frac{6 + 1}{2} = \frac{7}{2} = 3.5 \text{ Months}$$

<u>case 8</u> when Amount is withdrawn at end of each Month only during a period of 6 Month and Interest to be calculated for 6 months

$$\text{Avg period} = \frac{5 + 0}{2} = \frac{5}{2} = 2.5 \text{ Months}$$

$$\text{Interest on Drawings} = \text{Total Drawings} \times \frac{\text{Rate of Interest}}{100} \times \frac{\text{Avg period}}{12}$$

<u>case 9</u> when Rate of Interest is given without the word per annum interest is to charged without considering Time factor

<u>case 10</u> when date of withdrawal are not given but total Amount withdrawn is given it is assumed that Amount was withdrawn evenly throughout the year

Avg period = <u>6 Months</u>

<u>VI</u> Drawings against Profit and Drawings against Capital

Drawings against Profit means drawings by partner against his or her expected share of Profit for the year. Drawings against Profit is debited to drawings A/C and not to capital A/C of Partner.

Drawings against capital is withdrawal of amount out of capital of firm. Drawing against capital is debited to Partner Capital A/C

... is allowed on capital for the period

Partner Capital A/C

Interest on capital is allowed on capital for the period it is used in business. Interest on capital is not allowed to partner on withdrawn amount.

VII Interest on Capital

- Interest on capital is allowed only when it is provided in Partnership deed
- Interest on capital is calculated on opening balance of Partner Capital. If additional capital is introduced during the year interest is allowed on it from date of additional capital till end of Accounting year.
- If capital is withdrawn by partner during the year, Interest is not allowed on amount of capital withdrawn.

Interest on capital

case 1 Partnership deed does not exist OR partnership deed silent regarding interest on capital ⇒ No Interest on capital allowed

case 2 Partnership deed provides interest on capital but is silent whether interest is charge OR appropriation ⇒ Interest on capital is accounted as appropriation of Profit

Interest on Capital is allowed only if there is Profit.

situation 1 loss → no interest will be allowed on Capital

situation 2 Profit before interest on capital ≥ Interest on capital

⇓

Interest on Capital is allowed at agreed rate

situation 3 Profit before interest on capital < Interest on capital

⇓

Interest is allowed / restricted to extent of amount of Profit.

	Interest on capital	Profits
		45000
A	30000	
B	20000	

capital 45000

A 30000
B 20000
C 10000

Actual

0

45000

A : B : C

3 : 2 : 1

22500 15000 7500

Interest is allowed / restricted to extent of Amount of Profit.

Profit will be distributed in ratio of Interest on Capital of each partner

case 3 Partnership provides for Interest on capital as charge => Interest on capital is allowed whether firm has earned Profit or incurred loss

Accounting treatment

as appropriation of Profit

Interest on capital
to Partner capital / current A/c

Profit & loss appropriation
to Interest on capital

charge against Profit

Profit & loss
to interest on capital

Interest on capital when opening capital is Missing

① calculation of opening capital in case of Fixed capital

Closing capital
(+) withdrawl of capital
(-) additional capital introduced during the year

opening capital

OP cap
+ add cap
(-) withdrawl of cap

closing capital

② calculation of opening capital in case of fluctuating capital

closing capital
\+ Drawings against capital
\+ Drawings against Profit
\+ interest on drawings
\+ share of loss
(-) additional capital

\+ share of loss

(–) additional capital

(–) share of Profit

(–) Partner salary / Remuneration/commission

(–) interest on capital

opening capital

VIII Interest on Partner loan to firm

If there is agreement as to rate of Interest on loan
⇓
Partner is entitled to interest at such agreed rate.

If there is no agreement as to rate of interest on loan
⇓
Partner is entitled to interest on loan @ 6% p.a. as per provisions of Partnership Act.

Interest on Partner loan is charge against Profit and not an appropriation of Profit.

In other words, interest on partner loan to be allowed whether there are profits or loss

Journal

Interest on Partner loan A/c Dr.
To Partner loan

Profit & Loss A/c Dr.
To Interest on Partner loan

IX Salary or commission to a Partner
⇓
allowed if Partnership agreement provides for same

- It is an appropriation of Profit and not charged against Profit.
- Commission may be allowed as %age of Net Profit before charging such commission or after charging such commission.

Commission as %age of Net Profit before charging such commission

... rate

Commission as %age of net Profit before charging such commission

$$= \text{net Profit before commission} \times \frac{\text{rate}}{100}$$

Commission as %age of net Profit after charging such commission

$$= \text{net Profit before commission} \times \frac{\text{Rate of Commission}}{100 + \text{rate}}$$

Note: If Amount of available Profit is less than amount of appropriations to be made, the available profit should be distributed in ratio of appropriations to be made.

X **Rent Paid to Partner**

↓

Charge against Profit

Profit & Loss A/C	Dr.
To Rent to Partner	

XI Guarantee of Minimum profit to a Partner

A new partner may be admitted in to a firm for the promotion and expansion. The new partner may be employee or he may be outsider. Normally to induce the new partner, guarantee of Minimum share of Profit is given.

The guarantee for Minimum share of Profit may be given by:-

a) one or More of old Partners to new Partner

b) all of partners in agreed ratio

when guaranteed Partner or new partner share of Profit is more than guaranteed amount, his actual share of profit is given to him instead of guaranteed amount of Profit.

when a new partner is given guarantee for Minimum share of Profit it means he is entitled to receive minimum amount irrespective of actual Profit earned by business.

If share of Profit as per agreed ratio is less than Minimum guaranteed amount then difference is borne by Partners [illegible] to new Partner.

If share of Profit as per agreed ratio is [illegible] guaranteed amount then difference is borne by Partners who have given guarantee to new Partner.

Since it is a loss to Partner who has given guarantee therefore his Capital is debited and new Partner Capital is credited.

Guarantee to a Partner ⇒ It means assurance to give Minimum amount of Profit to Partner

Guaranteed Partner → to whom guarantee of Minimum Profit is given

Guaranteeing Partner ⇒ who has given the guarantee

Guaranteed Amount → Minimum amount for which guarantee is given

Personal guarantee ⇒ when guarantee is given by one or some or all of Partners in ratio different from existing Profit sharing ratio, such guarantee is said to be personal guarantee

If question is silent about nature of guarantee, the burden of guarantee is borne by remaining partners in their Profit sharing ratio.

<u>Example</u> Aatma and Bhoomi are partner Minimum Profit ₹ 2500
new Partner admitted Chudail

Firm Profit 12000
Ratio 2:3:1

Aatma 4000
Bhoomi 6000
Chudail 2000

Deficiency in Chudail share (2500 - 2000) = 500 to be borne by Aatma Bhoomi

in ratio of 2:3
i.e. 200 & 300

A = 4000 − 200 = 3800

B 6000 − 300 = 5700

C = 2000 + 500 = 2500

Journal

1) Actual share is more than guaranteed Profit

Profit & loss appropriation A/c

To Partner Capital A/c

2) If Actual share is less than guaranteed Profit

. Distribute Profit as if no guarantee

Profit & loss appropriation Dr

To Partner capital

Charging deficiency to guaranteeing Partner

Guaranteeing Partner Capital A/c Dr

To Guaranteed Partner capital A/c

Practical steps

1. calculate Actual share of Profit/loss of guaranteed Profit
2. calculate Amount of deficiency

   If profit = Guaranteed Amount − Actual share of Profit

   If loss = Guaranteed Amount + Actual share of loss
3. Distribute deficiency among guaranteeing Partners
4. Distribute Actual /Profit / loss as if no guarantee
5. Recover share of deficiency as in step 3 from guaranteeing Partners