ACCOUNTING FOR PARTNERSHIP: BASIC CONCEPTS

NATURE OF PARTNERSHIP

When two or more people come together to start a business and agree to share its profits and losses, it is called a partnership.

According to the Indian Partnership Act, 1932, partnership means a relationship between people who agree to share profits from a business that is carried on by all or any of them acting for everyone.

The people in a partnership are called **partners**, and together they are called a **firm**. The name under which the business operates is called the **firm's name**. A partnership firm does not have a separate legal identity from its partners.

ESSENTIAL FEATURES OF PARTNERSHIP:

1. Two or More Persons

At least two persons are needed to form a partnership. The maximum number of partners allowed is 50, as prescribed by the Central Government under the Companies Act, 2013.

2. Agreement

Partnership is created by an agreement between two or more persons to do business and share profits and losses.
The agreement can be written or oral. However, a written agreement is better to avoid misunderstandings and disputes.

3. Business

The agreement must be to carry on a business. Simply owning property together is not partnership.
For example:

- If Rohit and Sachin jointly buy land, they are only co-owners.
- But if they buy and sell land to earn profit, they are partners.

4. Mutual Agency

This means every partner can act on behalf of the firm and other partners.
It has two meanings:

- Every partner has the right to take part in the business.
- Every partner is both a principal and an agent.

This means:

- A partner can make decisions that bind other partners.
- A partner is also responsible for actions taken by other partners.

Mutual agency is the most important feature of partnership. Without it, there is no partnership.

5. Sharing of Profit and Loss

Partners agree to share profits and losses of the business.
Even though the law mentions sharing profits, sharing losses is understood automatically.
If people work together only for charity and not profit, it is not partnership.

6. Liability of Partners

Each partner is responsible for the debts of the firm.
Their liability is:

- Joint (with other partners), and
- Several (individually responsible)

Their liability is also unlimited. This means their personal property can be used to pay business debts if needed.

PARTNERSHIP DEED

A partnership is formed by an agreement between partners. This agreement can be **oral or written**.

The Partnership Act does not make it compulsory to have the agreement in writing. However, when the agreement is written, the document is called a **Partnership Deed**.
A Partnership Deed contains all the important details about the partnership and the relationship between partners. It usually includes:

- The **objective** or purpose of the business
- The **capital contributed** by each partner
- The **profit and loss sharing ratio**
- Rules about **interest on capital**
- Rules about **interest on partner's loan**
- Other rights, duties, and responsibilities of partners

The terms of the Partnership Deed can be **changed only with the consent of all partners**.

The deed should be **properly prepared according to the Stamp Act**, and it is advisable to **register it with the Registrar of Firms** for legal safety.

Provisions of Partnership Act Relevant for Accounting

The Partnership Act gives some rules for partnership accounts when the partnership deed does not mention certain things. These are explained below in simple words:

(a) Profit Sharing Ratio

If the partnership deed does not mention how profits and losses will be shared, then profits and losses are shared **equally among partners**, no matter how much capital each partner has invested.

(b) Interest on Capital

Partners do not get interest on their capital automatically. Interest on capital is given **only if it is clearly mentioned in the partnership deed**.
If the deed is silent, **no interest on capital is allowed**.

(c) Interest on Drawings

If partners withdraw money from the firm for personal use (called drawings), **no interest will be charged on drawings** unless it is mentioned in the partnership deed.

(d) Interest on Loan

If a partner gives a loan to the firm, he/she is entitled to receive **interest at 6% per year**, even if the deed does not mention it.

(e) Remuneration (Salary or Commission)

Partners are not entitled to salary, commission, or any other payment for managing the business **unless it is mentioned in the partnership deed**.

Other Important Rules:

(i) Profit earned using firm's resources

If a partner earns any personal profit by using the firm's property, business connection, or firm name, he/she must **give that profit to the firm**.

(ii) Competing business by partner

If a partner starts a business similar to the firm and earns profit from it, he/she must **give that profit to the firm**.

Summary :

SPECIAL ASPECTS OF PARTNERSHIP

The accounting of a partnership firm is similar to that of a sole proprietorship, but there are some special features. These are:

- Maintaining **capital accounts of partners**
- **Sharing profit and loss** among partners
- **Correcting past mistakes** in profit distribution
- **Reconstitution of partnership** (change in partners, ratio, etc.)
- **Dissolution of partnership** (closing the business)

In this chapter, the first three topics are explained. The remaining topics are explained in later chapters.

MAINTENANCE OF CAPITAL ACCOUNTS OF PARTNERS

All transactions related to partners are recorded in their capital accounts. These include:

- Capital introduced by partners
- Withdrawal of capital
- Share of profit or loss
- Interest on capital
- Interest on drawings
- Partner's salary or commission

There are two methods to maintain partners' capital accounts:

1. Fixed Capital Method
2. Fluctuating Capital Method

The main difference is whether all transactions are recorded in the capital account or not.

1. Fixed Capital Method

Under the fixed capital method, the **capital amount of partners remains fixed**. It changes only when:

- Additional capital is introduced, or
- Capital is withdrawn permanently

Other items such as:

- Profit or loss
- Interest on capital
- Drawings
- Interest on drawings
- Salary or commission

are recorded in a separate account called the **Partner's Current Account**, not in the capital account.

Important Points of Fixed Capital Method

- **Two accounts are maintained for each partner:**
  - Capital Account
  - Current Account
- **Capital Account:**
  - Usually remains fixed
  - Always shows a **credit balance**
  - Shown on the **liabilities side** of the balance sheet
- **Current Account:**
  - Records profits, drawings, interest, salary, etc.
  - Can show **credit balance or debit balance**
  - Credit balance → shown on liabilities side
  - Debit balance → shown on assets side

2. Fluctuating Capital Method

Under the fluctuating capital method, only **one account is maintained for each partner**, called the **Capital Account**.

All the transactions related to partners are recorded directly in this capital account. These include:

- Share of profit or loss
- Interest on capital
- Drawings (money withdrawn by partner)
- Interest on drawings
- Salary or commission to partners
- Additional capital introduced
- Withdrawal of capital

Because all these items are recorded in the capital account, the balance of the capital account **keeps changing (increasing or decreasing)**. That is why it is called the **Fluctuating Capital Method**.

Important Points of Fluctuating Capital Method

- Only **one account (Capital Account)** is maintained for each partner
- No separate current account is prepared
- Capital balance **changes frequently** due to profits, drawings, interest, salary, etc.
- This method is used **by default if no method is specified**

Fixed Capital / Fluctuating Capital and Profit & Loss Appropriation is explained further with help of solved examples.

DISTRIBUTION OF PROFIT AMONG PARTNERS

In a partnership firm, profits and losses are shared among partners according to the **agreed profit-sharing ratio** mentioned in the partnership deed.

If the partnership deed does not mention the ratio or there is no written agreement between partners, then profits and losses are shared **equally among all partners**.

In a sole proprietorship, profit or loss is transferred directly to the owner's capital account. But in a partnership firm, some adjustments must be made before distributing profit, such as:

- Interest on drawings
- Interest on capital
- Salary to partners
- Commission to partners

To make these adjustments and distribute profit properly, a special account called the **Profit and Loss Appropriation Account** is prepared.

Profit and Loss Appropriation Account

The Profit and Loss Appropriation Account is an extension of the **Profit and Loss Account**.
Its main purpose is to show **how the firm's profit or loss is distributed among the partners**.

This account is used to record:

- Partner's salary
- Partner's commission
- Interest on capital
- Interest on drawings
- Distribution of remaining profit among partners

This account starts with the **net profit or net loss**, which is taken from the Profit and Loss Account.

Calculation of Interest on Capital when Capital is Added or Withdrawn

When partners add or withdraw capital during the financial year, interest on capital is calculated based on the time the money remained in the business.
The calculation is done as follows:

(i) Interest on Opening Capital

Interest is calculated on the **opening capital balance** for the **full year**, if there is no change.

(ii) Interest on Additional Capital

If a partner brings **additional capital during the year**, interest is calculated from the **date the capital is added** until the **end of the financial year**.
For example:
If capital is added on 1 July, interest is calculated from 1 July to 31 March.

(iii) Interest when Capital is Withdrawn

If a partner **withdraws capital during the year**, interest is calculated in two parts:

- Interest on the **original capital** from the **beginning of the year to the date of withdrawal**
- Interest on the **remaining capital** from the **date of withdrawal to the end of the year**

Another simple way is to calculate interest based on the **amount that remained in the business and for how long it remained**.

INTEREST ON DRAWINGS

Interest on drawings means the interest charged on money withdrawn by partners from the firm for personal use.
Interest on drawings is charged **only if it is mentioned in the partnership deed**. If the deed does not mention it, then **no interest is charged**.
Interest is charged at an **agreed rate** and for the **time period the money remained withdrawn** during the accounting year.
The main purpose of charging interest on drawings is to **discourage partners from withdrawing too much money** from the business.

When Fixed Amount is Withdrawn Every Month

Sometimes partners withdraw a **fixed amount regularly**, such as every month or every quarter then interest on drawings is calculated using the **average period method**.

While calculating interest, it is important to know when the drawings were made:

1. If money is withdrawn at the beginning of every month

Interest is calculated for **6½ months (6.5 months)** on average.

2. If money is withdrawn at the end of every month

Interest is calculated for **5½ months (5.5 months)** on average.

3. If money is withdrawn in the middle of every month

Interest is calculated for **6 months** on average.

Illustration:

Suppose Aashish withdraws ₹ 10,000 every month for personal use & interest on drawings is calculated at 8%.

(a) When amount is withdrawn at the end of each month

If he withdraws money at the **beginning of every month**, the average period will be:
Average Period = (12 months + 1 month) ÷ 2
Average Period = **6.5 months**
This average period is used to calculate interest on drawings.

(b) When money is withdrawn in the middle of each month

In this case, nothing is added or subtracted.
Average Period = (11.5 + 0.5) ÷ 2
= **6 months**
Interest on Drawings = **₹ 4,800**

(c) When amount is withdrawn at the end of each month

Average Period is calculated as:
Average Period = (Months of first drawing + Months of last drawing) ÷ 2
= (11 + 0) ÷ 2
= **5.5 months**
Interest on Drawings = **₹ 4,400**
This is less than the beginning method because the money stays outside the business for a shorter time.

Summary of Monthly Drawings

Time of Withdrawal	Average Period	Interest on Drawings
Beginning of every month	6.5 months	₹5,200
Middle of every month	6 months	₹4,800
End of every month	5.5 months	₹4,400

When Fixed Amount is Withdrawn Quarterly

If money is withdrawn every 3 months (quarterly), the average period depends on timing:

1. Withdrawn at the beginning of each quarter

Average Period = (12+3) ÷ 2
= **7.5 months**

Interest is calculated for **7.5 months**.

2. Withdrawn at the end of each quarter

Average Period = (9 + 0) ÷ 2
= **4.5 months**

Interest is calculated for **4.5 months**.

Simple Trick to Remember

Withdrawal Time	Average Period
Beginning (Monthly)	6.5 months
Middle (Monthly)	6 months
End (Monthly)	5.5 months
Beginning (Quarterly)	7.5 months
End (Quarterly)	4.5 months

GUARANTEE OF PROFIT TO A PARTNER

Sometimes, when a new partner joins a firm, he/she is given a **guarantee of a minimum profit**. This means the partner will receive at least a **fixed minimum amount of profit**, even if the actual profit is less.
This guarantee can be given:

- By **all old partners together**, in an agreed ratio, or
- By **one old partner alone**

What happens if actual profit is less than guaranteed profit?

If the new partner's share of profit (according to the profit-sharing ratio) is **less than the guaranteed amount**, then the difference is paid to the new partner by the old partner(s) who gave the guarantee.

Simple Example:
Suppose a new partner is guaranteed a minimum profit of ₹20,000.
But his actual share of profit is only ₹15,000.
Difference = ₹20,000 − ₹15,000 = ₹5,000
This ₹5,000 will be paid by the old partner(s) who gave the guarantee.

What if the partner's share of actual profits exceeds the guaranteed amount?
Ans:
In such Case Partner will receive the higher of actual amount or Guaranteed Amount

PAST ADJUSTMENTS

Past Adjustments are corrections made for **mistakes or omissions discovered after final accounts are prepared and profits have already been distributed among partners.**
Instead of reopening old accounts, adjustments are made later to correct the partners' capital balances.

Why Past Adjustments are needed

Sometimes certain items are **forgotten or recorded wrongly**, such as:

- Interest on capital not given
- Interest on drawings not charged
- Partner's salary not recorded
- Partner's commission omitted
- Interest on partner's loan omitted
- Outstanding expenses not recorded
- Changes in partnership deed applied retrospectively

These affect the correct profit share of partners, so adjustments are necessary.

Methods of Making Past Adjustments

There are **two methods:**

(a) Through Profit and Loss Adjustment Account

- A separate account is prepared.
- All omitted items are recorded.
- Net profit or loss is transferred to partners' capital accounts in profit-sharing ratio.

(b) Direct Adjustment in Partners' Capital Accounts

- No separate account is prepared.
- Net adjustment amount is calculated.
- Directly debited or credited to partners' capital accounts.

This method is simpler and commonly used.

THE END