Fundamentals of partnership

Partnership – It refers to when two or more persons join together to carry on the business and to share the profit / loss arising thereon.

Right of partners

1. To participate in the management of business
2. To inspect the books of account
3. To share profit or losses with others in agreed ratio.
4. To get indemnified for payments made by them on behalf of the firm.

Partnership Deed – It is a written agreement among partners to avoid any dispute.

Rules in the absence of Partnership Deed.

1. Profit / Losses are shared equally by the partners.
2. Interest on capital is not allowed.
3. Interest on drawings is not charged from partners.
4. Interest on loan @ 6% P.A. is allowed.
5. Remuneration (Salary/Commission) is not paid to any partner.
6. New partner cannot be admitted unless all the partners agree.

Limited Liability Partnership-It is a business venture like partnership with an additional feature of partner's liability being limited.

Interest on Partner's loan

In absence of partnership deed interest on loan will be provided @ 6% P.A.

Nature – It is a charge against profit

Accounting Treatment

Interest on Partner's Loan Account – Dr.

To Partner's Loan Account

Profit and Loss A/c………….Dr.

To Interest on Partner's Loan A/c.

Profit & Loss Appropriation A/c: It is an extension of Profit & Loss Account and is credited with amount of net profit or debited with the amount of net loss.

Dr. Specimen of Profit & Loss Account Cr.

To Profit & Loss A/c. (Net Loss) To Interest on capital To Partner's Salary To Partner's Commission		By Profit & Loss A/c. (Net Profit) By Interest on drawings

To Transfer to Reserve To Share of profit transferred to Partner's Capital /current A/c.		

Rent paid to partner like interest on loan by a partners is a charge against profit.

Note:

1. It is a nominal in nature.
2. Profit that transfer to Profit and Loss Appropriation A/c should be after charging interest on loan, rent, manager's commission .If not, first less these items from this.
3. Profit should be before the interest on capital, salary, commission means these three items should not less from profit earlier. If already subtracted then add back in credit side.
4. In case of loss, we cannot provide interest on capital, salary, commission but interest on loan, rent should be provided as it is charged against the profit.

Journal Entries

(a) Transfer of Profit to P&LA/c

Profit & Loss A/c--------------------Dr.

To Profit & Loss Appropriation A/c

(b) Provision/ Reserves

Profit & Loss A/c--------------------Dr.

To Provision/Reserve A/c

(c) Interest on Capital

Interest on Capital A/c--------------------Dr.

To Partner's Capital/ Current A/c

Profit and Loss Appropriation A/c-------------Dr.

To Interest on Capital A/c

(d) Salary

Salary A/c---------------------Dr.

To Partner's Capital/ Current A/c

Profit & Loss Appropriation A/c-----------Dr.

To Salary A/c

(e) Interest on Drawings:

Partner's Capital/ Current A/c---------Dr.

To Interest on Partner's Drawings

Interest on Partner's Drawings A/c--------------Dr.

To Profit & Loss Appropriation A/c

(f) For transfer of divisible profit:

Profit & Loss Appropriation A/c--------Dr.

To Partner's Capital/ Current A/c

<u>Fixed Capital Account</u>

Dr. **Partner's Capital Account** **Cr.**

Particular	X	Y	Particulars	X	Y
To Cash/ Bank A/c.	-	-	By Balance B/d(in case of Cr. Balance)	-	-
To Balance C/d	-	-	By Cash/ Bank A/c	-	-

In case of Fluctuating Capital

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

Particular	X	Y	Particulars	X	Y
To Balance B/d.	-	-	By Balance B/d (in case of Cr. Balance)	-	-
To Drawings A/c.	-	-	By Interest on Capital A/c.	-	-
To Interest on Drawings A/c	-	-	By Commission A/c.	-	-
To Profit & Loss A/c.	-	-	By Partner's Salary A/c.	-	-
To Balance C/d	-	-	By Profit & Loss Appropriation (Profit)	-	-

Dr. **Partner's Capital Account** **Cr.**

Particular	X	Y	Particulars	X	Y
To Balance B/d. (in case of	-	-	By Balance B/D (in case of Cr.	-	-
Dr. Balance)	-	-	Balance)	-	-
To Cash/Bank (Drawings	-	-	By Cash/Bank (Additional Capital)	-	-
against capital)	-	-	By Interest on Capital A/c.	-	-
To Interest on drawings	-	-	By Commission	-	-
To Profit & Loss A/c. (Loss)	-	-	By Partner's Salary	-	-
To Balance C/D			By Profit & Loss Appropriation A/c.		
-			(Profit)		

Remuneration to partners – It is allowed only if the partnership deed allows it to be paid

Nature – It is an appropriation of profit. It is computed as follow:-

Percentage of Net Profit or Distributable Profit before charging commission

$$\frac{\textit{Net profit before commission X Rate of commission}}{100}$$

Percentage of Net Profit or Distributable profit after charging commission

$$\frac{\textit{Net profit before commission X Rate of commission}}{100+\textit{Rate of commission}}$$

Partner's Drawings

Drawings Against Capital

It is considered for calculating interest on capital

Drawings against profit

It is not considered for calculating interest on capital

Interest on Drawings

Product Method

When unequal amount is withdrawn at different dates or when there is irregular drawings then interest on drawings is calculated with the help of product method.

Date of Drawings	Amount of Drawings	Period for which amount is withdrawn	Product

Interest on drawings =	$\frac{Total\ of\ Product\ X\ rate\ X\ 1}{100\ X\ 12}$

Average period method

This method is use when there are regular drawings or when the amount of drawings is uniform

If drawings are made at the beginning each month	$\frac{total\ drawings\ \ X\ rate\ X\ 6.5}{100\ x\ 12}$
If drawings are made in the mid of each month	$\frac{total\ drawings\ \ X\ rate\ X\ 6}{100\ x\ 12}$
If drawings are made at the end of each month	$\frac{total\ drawings\ \ X\ rate\ X\ 5.5}{100\ x\ 12}$
If drawings are made at the beginning of each quarter	$\frac{total\ drawings\ \ X\ rate\ X\ 7.5}{100\ x\ 12}$
If drawings are made at the mid of each quarter	$\frac{total\ drawings\ \ X\ rate\ X\ 6}{100\ x\ 12}$
If drawings are made at the end of each quarter	$\frac{total\ drawings\ \ X\ rate\ X\ 4.5}{100\ x\ 12}$

Points to remember

- **If the date of withdrawal is not given the interest on drawing is calculated for six month on the average basis.**
- **When the rate of interest is given without the word per annum, interest is charged without considering the time factor.**

<u>**Interest on Capital**</u>

Case – I : When the partnership deed does not exist or does not provide for interest on capital. Interest on capital is not allowed**.**

Case – II : When the partnership deed provides for interest on capital but does not provide whether interest is a charge or appropriation**.**

Interest on capital is accounted as appropriation of profit. Interest on capital is allowed only If there is profit.

Situation – I **Situation – II** **Situation – III**

(Loss is incurred) ↓ No interest on capital will Be provided.

Profit before Interest is equal to Or more than interest ↓ Interest on capital is allowed at Agreed rate.

Profit before interest Less than interest ↓ Interest on capital is allowed to The extent of profit in ratio of capital

Case-III: **When partnership deed provides for interest on capital as a charge-**It is allowed whether the firm has earned profit or has incurred loss.
Accounting Treatment –

Interest on Capital A/c. – Dr.

To Partner's Capital/ Current A/c.

Profit & Loss Appropriation A/c.– Dr.

To Interest on Capital.

<u>Past Adjustments</u>

When an adjustment is passed

Step – 1. Prepare an analytical table

Particulars	X's Capital/ Current A/c		Y's Capital/ Current A/c		Z's Capital/ Current A/c		Firm (P&L Adj. Account	
	Dr.	Cr.	Dr.	Cr.	Dr.	Cr.	Dr.	Cr.
Interest on capital								
Interest on drawings								

Step – 2. Calculate interest on capital earlier omitted.

Step – 3. Calculate interest on drawings earlier omitted to be considered.

Step – 4. Repeat the process for any other expenses or income omitted.

Step – 5. Find out balance of the columns designed for the firm.

Step – 6. Divide profit or loss (as per steps above) among the partners in their profit sharing ratio.

Step – 7. Find the balance of each partner separately. In case one partner has debit balance, the other partner must have credit balance of the same amount.

Step – 8. Pass adjustment journal entry with the amount determined as per step 7.

When adjustment journal entries are passed

Adjustment entries for the items which are to be credited.

Profit & Loss Adjustment Account – Dr.

To Partner's Capital/Current A/c

Adjustment entries for the items which are to debited

Partner's Capital/Current Account – Dr.

To Profit & loss Adjustment Account

For net profit/loss due to above adjustments.

For profit

Profit & Loss Adjustment Account – Dr.

To Partner's Capital/Current Account

For Loss

Partner's Capital/Current Account – Dr.

To Profit & Loss Adjustment Account

Manager admitted as partner with retrospective effect.

Step-1. Compute the amount paid as remuneration to the manager.

Step-2. Compute the amount which should be allowed to the manager on becoming a partner.

Step-3. Determine the difference and if amount as per Step-2 is more, it is credited to his account and debited to old partners in old profit sharing ratios vice-versa.

Guarantee of profit

Case-1. Guarantee of profit by all the remaining partners.

Step-1. Share of profit as per profit sharing ratio is determined.

Step-2. Minimum guaranteed profit is determined.

The higher of above two amounts is given to the guaranteed partner. If the share of profit is less than guaranteed amount, the difference in the amount of profit i.e. minimum guaranteed profit minus share of profit of the guaranteed partner is borne by the remaining partner in agreed ratio.

Case-II. Guarantee of profit by one or more of the existing or old partners.

Step-1. Distribute the profit among the partners as per their profit sharing ratio.

Step-2. If share of profit of the guaranteed partner is less than the minimum guaranteed profit the difference is deducted from the share of profit of the partner who has guaranteed and it is added to the share of profit of the guaranteed partner.

Points to remember:

1. Items that are charged against profit must be shown in Profit & Loss A/c.
2. In case of fixed capital of partners, adjustment entries are made in partner's current account.
3. In the absence of information, interest on drawings are calculated for 6 months.
4. Interest on capital is calculated on opening balance of capital, if there is no withdrawal or addition of capital.

COMMON ERRORS:

1. While preparing Profit and loss Appropriation A/c care should be taken that items charge against profit not to be shown.
2. Students usually commit errors to pass journal entries regarding past adjustment that they do with partner's capital account instead of partner's current account.
3. In case of interest on capital as a charge against profit students usually show it in Profit & Loss Appropriation Account instead of Profit & Loss Account