Accounting of partnership Firm

The entire system of partnership is based on the twin principles of mutual trust and faith. For this principles to exist and for the partnership to run smoothly and peacefully, it is essential that the books of accounts are maintained with transparency, honesty, integrity, accuracy and equity.

The double entry system of book –keeping is followed to maintain partnership accounts, as in case of proprietorship, except for the fact that capital accounts of the partners have to keep separately. Transaction of partnership firm is recorded according to principle of double entry system and as in the case of sole proprietorship concern.

The only difference between accounting of sole trading concern and that of partnership firm is that capital account of the partner have to be kept separately and the profit of the firm are divided among the partners for the purpose profit/ loss as per profit loss account is transferred into profit and loss appropriation account. In this case firm prepare **trading account, profit/loss account, profit and loss appropriation account, and balance sheet** at the end of every year.

For the purpose of the accounting treatment transaction of the firm are divided into two categories

Transaction of the Firm

Transaction relating from operating Activities of the firm

.Sale of goods

.Purchase of goods

.Salary paid, Rent Paid etc

Not in Syllabus

Transaction relating between Partnership firm and Partners

. Capital Contribution by partners

. Interest on capital

.Drawing by partner

.Interest on Drawing

.Remuneration to Partners

.Loan taken from partners by firm

.Interest on partners Loan

.Distribution of Profit nd Loss of firm

Discuss in Syllabus

The journal entries that are passed for various items Shown in the profit and loss appropriation account and partners capital account are as follows :

1. When capital Contribution by partners

Cash/Bank A/c ....Dr
To Partners capital A/c
(being capital contribution by partners)

2. When Drawing By partners

Drawing (partners capital a/c)...........Dr
To Cash/Bank A/c
(being drawing by partners)

3. Entry for Interest on Capital

(1) on allowing interest on capital

interest on capital A/c Dr
To partner's capital a/c / current a/c.
(interest on capital at -----% p.a.)

(2) on closure of interest on capital A/c

profit & loss appropriation A/c Dr
To interest on capital A/c

5. Entry for Interest on Drawings

(1) on charging interest on drawings

Partner's capitals A/c /current a/c Dr
To interest on drawings A/c
(Interest on drawings at-----% p.a.)

(2) on closure of interest on drawings A/c

Interest on drawings A/c Dr
To profit & loss appropriation a/c

6. Entry for Salary or Commission(remuneration) Payable to a Partner

(1) on allowing salary or commission to a partner

Partner's salary / commission A/c Dr
To partner's capital A/c / current A/c

(2) on closure of salary or commission account

profit & loss appropriation A/c Dr
To partner's salary / commission a/c.

7. Entry for Transferring a Part of Profit to Reserve:

Profit & loss appropriation A/c Dr
To reserve A/c

8. Entry for transfer of credit balance of profit & loss appropriation A/c (being profit)

Profit & loss appropriation A/c Dr
To partner's capital or current A/c

9. Entry for Transfer of debit balance of profit & loss appropriation A/c (being loss)

Partner's capital or current a/c Dr
To profit & loss appropriation A/c

Partners Capital Account

Parter's Capital Accounts: It is an account which represents the partners interest in the business.

In case of partnership business, a separate capital account is main tend for each partner. The capital accounts of partners may be maintained by any of the following two methods.

1. Fixed Capital Accounts
2. Fluctuating Capital Accounts

1. Fixed Capital Accounts

Under this method the original capitals invested by the partners remain constant, unless additional capital is introduced by an agreement. All entries relating to drawings, interest on capitals, interest on drawings, salary to partner, share of profits/losses are made in separate account which is called as Current Account. Thus the following two accounts are maintained

when capitals are fixed.

(i) Capital Account

This account will always show a credit balance: Balance of Capital account remains fixed, it does not change every year that is why it is called fixed capital method and only the following two transactions are recorded in the Fixed Capital Accounts:

Permanent Additional Capital Introduced

·Permanent Capital Withdrawn or Drawings out of Capital only

Partner's Capital A/Cs

Particulars	X(Rs.)	Y(Rs.)	Particulars	X(Rs.)	Y(Rs.)
To Cash/Bank A/c			By Balance b/d		

(Capital Withdrawn) To Balance c/d (Closing balance)			(Opening Cr. Balance) By Cash/Bank A/c (Additional Capital Introduced)		

(ii) Current Account

The Current account may show a debit or credit balance. All the usual adjustments such as interest on Capital, partner's salary/commission, drawings (out of profits), interest on drawings and share in profits or losses etc. are recorded in this account. All the Current Year's adjustments are recorded in this account, that is why it is called Current account.

Partner's Current A/Cs

Particulars	X(Rs.)	Y(Rs.)	Particulars	X(Rs.)	Y(Rs.)
To Balance b/d (Opening Dr. Balance)			By Balance b/d (Opening Cr. Balance)		
To Drawings (out of Profits)			By Interest on Capital By Partner's Salary or Commission By Profit and Loss		
To Interest on Drawings To Profit and Loss A/c (Share in losses) To Balance c/d (Closing credit Balance)			Appropriation A/c (Share in Profits) By Balance c/d (Closing Dr. Balance)		

Note :

1. Debit balance of Current Account is shown in Assets side of Balance Sheet.
2. Credits balance of Current Account A/c is shown in Liabilities side of balance Sheet.
3. Balance of Fixed Capital Accounts are always shown in Liabilities side of Balance Sheet as it will be always be credit balance.

2. Fluctuating Capital Accounts

In this method only one account i.e., Capital Account of each and every partner is prepared and all the adjustment such as interest on capital interest on drawings etc, are recorded in this account under this method, Capital account may show a debit or credit balance and the balance of this account changes frequently from time to time therefore it is called fluctuating Capital Account. In this method the capitals are not fixed. **In the absence of information, the Capital Accounts should be prepared by this method.**

Partner's Capital

Particulars	X(Rs.)	Y(Rs.)	Particulars	X(Rs.)	Y(Rs.)
To Balance b/d (Opening Dr. Balance) To Cash/Bank A/c (Capital Withdrawn) To Drawings (out of profits) To Interest on Drawings To Profit and Loss A/c (share in loss) To Balance C/D (Closing)			By Balance b/d (Opening Cr. Balance) By Cash/Bank A/c (Additional Capital Introduced) By Interest on Capital By Partner's Salary or Commission By Profit and Loss Appropriation A/c(share in profit) By balance C/D		

Distinction Between Fixed Capital Accounts and Fluctuating Capital Accounts

Fixed Capital Accounts	Fluctuating Capitals Accounts
The balance in capital account usually remains unchanged except in extraordinary circumstances. Partners have two accounts capital accounts and current accounts All transactions relating to partner account are not made in capital account but are entered in separate current account. This cannot show a negative balance.	The Balance of Capital accounts change in time to time Partners have only capital account ; All transactions relating to partner account are made in their capital accounts. This can show a negative balance

Profit/Loss Appropriation Account

Meaning of Profit and Loss Appropriation Account: Such Profit and Loss Appropriation Account is an extension of the Profit and Loss Account and therefore, the credit balance of the Profit and Loss Account is transferred to Profit and Loss Appropriation Account. Such amount is then utilized for the following:

i. interest on the capitals of partners, if provided by the partnership deed;

ii. salaries or commissions to partners, if provided by the partnership deed;

iii. Transferring part of profit to Reserve;

iv. Distribution of profit among the partners in their profit sharing ratio.

Specimen of Profit and Loss Appropriation Account:

Profit and Loss Appropriation Account

Dr. for the year ended … Cr.

Particulars	Amount	Particulars	Amount
To Profit and Loss A/c (Net loss transferred from Profit and Loss Account)	…	By Profit and Loss A/c (Net Profit transferred from Profit and Loss Account)	
To Interest on Capitals:		By Interest on Drawings:	
A …		A …	
B …	…	B …	…
To Partners' Salaries	…		
To Partners' Commissions	…		
To Reserve	…		
To Profit transferred to:			
*A's Capital A/c …			
*B's Capital A/c …	…		
	…		…

*In case of Fluctuating Capital Method, Profit will be transferred to Partners' Capital Accounts. In case of Fixed Capital Method, Profit will be transferred to Partners' Current Accounts.

Difference between Profit and Loss Account and Profit and Loss Appropriation Account:

	Basis	Profit and Loss Account	Profit and Loss Appropriation Account
1	**Stage of Preparation**	It is prepared after Trading Account and therefore, starts with Gross Profit or Gross Loss transferred from the Trading Account.	It is prepared after Profit and Loss Account and therefore, starts with Net Profit or Net Loss as transferred from the Profit and Loss Account.
2	**Objective**	It determines net profit earned or net loss incurred during the accounting year.	It shows appropriation of net profit i.e., distribution of Net Profit for the accounting period among the partners.
3	**Nature of Items**	It is debited with the expenses and credited with the income, not being business income to determine net profit for accounting period.	It is debited with the items of appropriation of profit like salary, commission, interest on capital, transfer to reserve, etc. and credited with the items of income being debited to Partners' Capital Account or Current Accounts such as interest on drawings.
4	**Partnership Deed**	This account is not guided by the Partnership Deed or Agreement.	This account is prepared as guided by the Partnership Deed or Agreement or provisions of Indian Partnership Act, 1932.
5	**Matching Principle**	It follows the Matching Principle where revenue is matched against expense.	It does not follow the Matching Principle.

INTEREST ON CAPITAL

Interest on partners capital will be allowed only when it has been specifically mentioned in the partnership deed. If interest on capital is to be allowed as per the agreement, it should be calculated with respect to the time, rate of interest and the amount of capital.

Important point regarding interest on capital

i. In order to compensate a partner for contributing capital to the firm in excess of the profit-sharing ratio, firm pays such interest on partner's capital.

ii. In case any amount is contributed by the partner to the firm in the form of additional capital during the year, interest on such additional capital is allowed for the period it has remained in business.

iii. In case if any amount of capital is withdrawn by the partner during the year, no interest is allowed on the capital amount withdrawn.

Important provisions relating to Interest on Capital:

i. **If there is no Partnership Deed or there is no clause in the deed as to interest on capital:** Interest on Capital is not allowed.

ii. **If the Partnership Deed provides for interest on capital but is silent as to the treatment of interest as a charge or appropriation:** Interest on capital is treated as appropriation of profit. Such interest is payable only if the firm is making profits. Following are possible situations:

   a. In case of loss: No interest is allowed.

   b. In case of profit, where profit before interest is equal to or more than the interest: Interest is allowed at the agreed rate.

   c. In case of profit, where profit before interest is less than the interest: Interest is allowed only to the extent of profit in the ratio of interest on capital of each partner.

iii. **If the Partnership Deed provides for interest as a charge (i.e., to be allowed whether there are profits or loss):** Interest on capital is allowed whether there is profit or loss.

Other word Interest on Capital can be treated as either:

a. An Appropriation of profit; or

b. A charge against profit.

A. Interest on Capital: An Appropriation of Profits:

In case of Losses	Interest on Capital is NOT ALLOWED
In cases of Sufficient Profits	Interest on Capital is ALLOWED IN FULL
In case of Insufficient Profits	Interest will be restricted to the amount of profit. Hence, profit will be distributed in the ratio of interest on capital of each partner.

B. Interest on Capital: As a Charge against Profits:

Interest on Capital is always allowed in full irrespective of amount of profits of losses.

Note: Interest on Capital is always calculated on the OPENING CAPITAL

- **Calculation of Interest on Additional Capital:**

$$\text{Interest on capital} = \text{Additional capital introduced During the period} \times \text{Rate}/100 \times \frac{\text{Time}}{12/365/52}$$

- **Calculation of Interest on Opening Capital:**

  i. In case where the partner has not withdrawn capital or has not introduced additional capital during the year, closing balance of Capital Account of the previous year is the opening balance in the Capital Account.

  ii. Interest on Capital is allowed on the Opening Capital of the partner.

  iii. If the opening capital is not given, it can be determined by preparing Capital Accounts or with the help of following tables:

a. In case of Fixed Capital:

Calculation of Opening Capital

Capital at the end of the year Add: Withdrawal of Capital	… …
Less: Additional Capital Introduced during the year	… …
Capital in the beginning of the year	…

b. In case of Fluctuating Capital:

Calculation of Opening Capital

Capital at the end of the year Add: Drawings Against Capital Drawings Against Profit Interest on Drawings Share of Loss for the year*	… … … … …
Less: Additional Capital introduced during the year Partner's Salary/Remuneration Interest on Capital Share of Profit for the year*	… … … … …
Capital in the beginning of the year	…

***** Either loss or profit will appear at a time.

$$\textbf{Interest on capital} = \textbf{Amount of Opening capital} \times \frac{\textbf{Rate}}{\textbf{100}}$$

Journal Entries for recording Interest on Capital:

a. **Interest on Capital A/c ...Dr.**

To Partners' Current A/c/Partners capital A/c

(Being the interest on capital allowed to partners)

b. **Profit and Loss Appropriation A/c ...Dr.**

To Interest on Capital A/c

(Being the interest on capital transferred to Profit and Loss Appropriation Account)

Alternatively: only one entry can be passed in place of above 2 entries as follows:

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

To Partners' Current A/c/Partners capital A/c

(Being the interest on capital allowed to partners)

INTEREST ON DRAWINGS

Interest on drawing 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. There are two cases in which calulation of interest on drawings may arise:

- **When date of Drawings is given**

Interest on Drawing = $Total\ Drawings \times \frac{\text{Rate}}{100} \times \frac{\text{TIME}}{12/365}$

- **When date of Drawing is not given**

Interest on Drawing = $Total\ Drawings \times \frac{Rate}{100} \times \frac{6}{12}$

Note: Interest is calculated for a period of 6 months, we assume drawings have been done evenly during the year, that is why we take average six months tenure.

- **When different amount are withdrawn on different dates:**

We have the following two methods to calculate the amount of interest on Drawing:

1. Simple Interest Method

In this method, interest on drawing is calculated for each amount of drawing individually on the basis of periods for which it remained withdrawn till the close of accounting period.

2. Product Method

In this method, the amounts of drawings are multiplied by the period for which it remained withdrawn during the period; thereafter the products are added and interest is calculated on the total of products so arrived at for one month. The advantage of this system is that separate calculations are not required each time.

We can explain the above mentioned two methods with the help of an example.

Month	**Date**	**Drawings Amount**
May	1	12000
July	31	6000
September	30	9000
November	30	12000
Janurary	1	8000
March	31	7000

Interest on drawings is to be charged @ 9% p.a

SIMPLE METHOD

DATE	**AMOUNT**	**PERIOD**	**INTEREST @9%**

1 MAY	12000	11	990
31 JULY	6000	8	360
30 SEP	9000	6	405
30 NOV	12000	4	360
1 JAN	8000	3	180
31 MAR	7000	0	00
Total	54000		2295

PRODUCT METHOD

DATE	AMOUNT (A)	PERIOD (B)	PRODUCTS P=A*B
1 MAY	12000	11	132000
31 JULY	6000	8	48000
30 SEP	9000	6	54000
30 NOV	12000	4	48000
1 JAN	8000	3	24000
31 MAR	7000	0	00
TOTAL	**54000**		**306000**

Interest =Total of product× $\frac{\text{Rate}}{100}$ × $\frac{1}{12/365}$

Interest = Total of products * 9/100* 1/12= 306000*9/100*1/12 = Rs 2295/-.

- **Average Method: (Different situations)**

Case (1) When Drawings is made in the beginning of every month: If the drawings of equal amount

Average period = <u>Time left after first drawings + Time left after last drawings</u>

$$= \frac{12 \text{ Months} + 1 \text{ Month}}{2} = 6\frac{1}{2} \text{ Months}$$

Case (2) When Drawings are made at the end of every month:

$$\text{Average period} = \frac{\text{Time left after first drawings} + \text{Time left after last drawings}}{2}$$

$$= \frac{11 \text{ Months} + 0 \text{ Month}}{2} = 5\frac{1}{2} \text{ Months}$$

Case (3) When Drawings are made in middle or at any time during the month: (middle)

$$\text{Average period} = \frac{\text{Time left after first drawings} + \text{time left after last drawings}}{2}$$

$$= \frac{11.5 \text{ Months} + 0.5 \text{ Month}}{2} = 6 \text{ Months}$$

Case (4) When drawings of equal amount are made in the beginning of each quarter:

$$\text{Average period} = \frac{\text{Time left after first drawings} + \text{Time left after last drawings}}{2}$$

$$= \frac{12 \text{ Month} + 3 \text{ month}}{2} = 7\frac{1}{2} \text{ Months}$$

Case (5) When drawings of equal amount are made at the end of each quarter:

$$\text{Average period} = \frac{\text{Time left after first drawings} + \text{Time left after last drawings}}{2}$$

$$= \frac{9 \text{ Months} + 0 \text{ Month}}{2} = 4\frac{1}{2} \text{ Months}$$

Case (6) When drawings of equal amount are made during the middle of each quarter:

$$\text{Average period} = \frac{\text{Time left after first drawings} + \text{Time left after last drawings}}{2}$$

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

Case (7) When drawings of equal amount are made only during a period of 6 Months:

(i) In the beginning of each month:

$$\text{Average period} = \frac{6 \text{ Months} + 1 \text{ Month}}{2} = 3\tfrac{1}{2} \text{ Months}$$

(ii) At the end of each month:

$$\text{Average period} = \frac{5 \text{ Months} + 0 \text{ Month}}{2} = 2\tfrac{1}{2} \text{ Months}$$

(iii) In the middle of each month:

$$\text{Average period} = \frac{5\tfrac{1}{2} \text{ Months} + \tfrac{1}{2} \text{ Month}}{2} = 3 \text{ Months}$$

Case (8) When drawings of equal amount are made during 9 months.

(i) **In the beginning of each month**

$$\text{Average period} = \frac{\text{Time left after first drawings} + \text{Time left after last drawings}}{2}$$

$$= \frac{9 \text{ Months} + 1 \text{ Month}}{2} = 5 \text{ Months}$$

(ii) **At the end of each month**

$$\text{Average period} = \frac{\text{Time left after first drawings} + \text{Time left after last drawings}}{2}$$

$$= \frac{8 \text{ Months} + 0 \text{ Month}}{2} = 4 \text{ Months}$$

(iii) **In the middle of each month**

$$\text{Average period} = \frac{\text{Time left after first drawings} + \text{Time left after last drawings}}{2}$$

$$= \frac{8.5 \text{ Months} + 0.5 \text{ Month}}{2} = 4.5 \text{ Months}$$

case (9) When the rate of interest is given without the word 'per annum' interest will be charged without considering time or date of drawings.

1. Interest on Drawings is charged @ 10% per anum

$$\text{Amount on Drawings} \times \frac{\text{Rate of Interest}}{100} \times \frac{6}{12}$$

2. **Interest on Drawings is charged @ 10%**

$$\text{Amount on Drawings} \times \frac{\text{Rate of Interest}}{100}$$

Interest on Partner's Loan

If a partner has given loan to the firm, he is entitled to receive interest on such loan at an agreed rate. **It is a charge against profits. It is provided irrespective of profits or loss.** The rate of interest on partners' loan is specified in the Partnership Deed. **It will also be provided in the absence of Partnership Deed @ 6% per annum.**

Accounting Treatment: Journal Entries passed are as follows:

To provide Interest on Partners' Loan:

Interest on Partner's Loan A/c ...Dr.

To Partners' Loan A/c

To close the Interest on Partners' Loan A/c:

Profit and Loss A/c ……………………..Dr

To interest on partners loan A/c

It is always DEBITED to Profit and Loss A/c

Rent Paid to Partner.

Rent paid to a partner is also a charge against profits and it will also be DEBITED to Profit and Loss A/c

Note:

Interest on A's Loan = $Loan\ Amount \times \frac{Rate}{100} \times \frac{Time\ left\ after\ loan\ taken}{12}$

$= 200000 \times \frac{6}{100} \times \frac{05}{12}$ =Rs. 5,000

Salary or Commission (Remuneration) to Partners:

i. In order to compensate the partners for looking after the business, the firm pays salary or commission to the partners.

ii. Such salary or commission can be allowed to the partners only if the Partnership Deed allows it to be paid.

iii. Such amount paid to the partners is an appropriation of profit and not a charge against the profit. Therefore, it can be paid only if the firm is making profits during the year.

iv. Salary to partners is normally stated as an amount, whereas, Commission to partners is normally stated as a percentage of profit where the profit considered can be either before commission or after commission.

V. Formula for computing commission under the 2 methods is as follows

(1) On profits before charging such commission

$$\text{Profit (before commission)} \times \frac{\text{Rate of Commission}}{100}$$

(2) On profits after charging such commission

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

vi. Accounting treatment: Salary or Commission, is an appropriation of profit, therefore, accounting treatment will be as follows:

a. On allowing Salaries/Commissions to Partners:

Partners salaries/commissions A/c ……………….Dr

To Partners capital/Current A/c

b. On closure of Salaries/Commissions A/c

Profit and Loss Appropriation A/c …Dr.

To Partners' Salaries/ Commissions A/c

GUARANTEE OF PROFITS TO A PARTNER

Guarantee is an assurance given to the partner of the firm that at least a fixed amount shall be given to him/her irrespective of his/her actual share in profits of the firm. If actual share in profits is less than the guaranteed amount in that case the deficit amount shall be borne either by the firm or by any partner as the case may be or as may have been decided bya na agreement.

Note:

Guarantee to a partner is given for minimum share in profits. If the actual share in profits is more than the minimum share in profits, then the actual profits will be allowed to the partner. **Case: 1. when guarantee is given by FIRM (i.e. by all the Partners of the firm)**

1. If share in actual profits is less than the guaranteed amount then. Guaranteed amount to a partner is first written off against the profits and then,

2. Remaining profits are distributed among the remaining partners in the remaining ratio.

Case2. When guarantee is given by a partner or partners to another partner.

Calculate the share in profits for the partner to whom guarantee is given.

If share in profits is more than the guaranteed amount, distribute the profit as per the profit and loss sharing ratio in usual manner.

If share in profits is less than the guaranteed amount, find the difference between the share in profits and the guaranteed amount and the difference known as deficiency.

Deficiency is contributed by the partner or partners who guaranteed in certain ratio and subtracted from his or their respective shares.