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Accounting for Partnership : Basic Concepts

Question 1:

What is partnership? What are its chief characteristics? Explain.

ANSWER:

According to the Section 4 of the Partnership Act, 1932, partnership is an agreement between two or more persons who have agreed to share profits or losses of a business that will be carried by all or any one of them acting for all.

Person who joined their hands to set up the business are called 'partners' *individually* and 'firm' *collectively* and the name under which they carry out their business is termed as 'firm name'.

Important Characteristics of Partnership

The following are the important characteristics of partnership.

1.***Two or more persons*****:** Partnership is an agreement between two or more persons coming together for a common goal. There should be at least two persons to form a partnership. Although as per the Partnership Act of 1932, there is ***no maximum limit*** on the number of partners in a partnership firm, but as per the ***Rule (10) of the Companies (Miscellaneous) Rules Act 2014, the maximum number of partners permissible is 50***. Therefore, in case the number of partners exceeds the aforesaid limit, then the concerned partnership is considered to be illegal. In this regards it must be noted that Section 464 of Companies Act 2013, the maximum number of partners permissible is one humdred. However, it must be noted that the maximum number of partners is not limited in case an association or partnership is formed by professionals such as chartered accountants, lawyers, company secretaries, etc. These professionals are governed by their the special laws as formed by their respective professional institutions. Prior to the enforcement of Companies Act of 2013, the earlier act of 1956, imposed restrictions on the maximum number of partners to 10 in case of banking business and 20 in case of any other kind of business. However, with effect from April 01, 2014, Companies Act of 1956 has been replaced by Companies Act of 2013.

2.***Partnership Deed*:** The partnership among the partners should be backed up by a partnership deed. A partnership deed is an agreement among the partners governing them in carrying out the proposed business. The deed may be oral or written.

3.***Business*:** A partnership is formed to carry out a legal business. Partnerships in smuggling, black marketing etc. are illegal business activities and hence, the partnership is also illegal.

4. ***Sharing of profit*:** The profit or loss earned by a partnership firm must be distributed as per the partnership deed or equally among the partners (in absence of partnership deed). It is a very important feature of partnership. If a group is formed for charitable purpose, not to earn profit then this group will not be regarded as a partnership.

5.***Liability*:** Liability of a partnership firm is unlimited and each partner is liable for firm's liabilities whether individually and jointly with other partners to the third party. Moreover, each partner along with his/her co-partners is responsible for all the acts of the partnership firm.

6. ***Mutual agency*:** Partnership may be carried on by all or any one of them acting on behalf of all. It means all the partners of a firm are equally entitled to participate in the activities of the business or any one of them who is acting on behalf of all. Every partner acts as an agent for others and binds others by his/her act and in turn is bound by others by their act.

Note: *In case of any question regarding the permissible limit on the maximum number of partners in a partnership firm, the students shall take the limit as 50.*

Question 2:

Discuss the main provisions of the Indian Partnership Act, 1932 that are relevant to partnership accounts if there is no partnership deed.

ANSWER:

The following are the main provisions of the Indian partnership Act, 1932 that are relevant to the partnership accounts in absence of partnership deed.

1.***Profit Sharing Ratio*:** If the partnership deed is silent on sharing of profit or losses among the partners of a firm, then according to the Partnership Act of 1932, profits and losses are to be shared equally by all the partners of the firm.

2.***Interest on Capital*:** If the partnership deed is silent on interest on partner's capital, then according to the Partnership Act of 1932, **no** interest on capital should be given to the partners of the firm. However, interest on capital is given only out of the profits, if mutually agreed by all the partners.

3.***Interest on Drawings*****:** If the partnership deed is silent on interest on partner's drawings, then according to the Partnership Act of 1932, **no** interest on drawing should be charged from the partners of the firm for the amount of capital withdrawn in the form of drawings.

4.***Interest on Partner's Loan*****:** If the partnership deed is silent on interest on partner's loan, then according to the Partnership Act of 1932, the partners are entitled for 6% p.a. interest on the loan forwarded by them to the firm.

5.***Salary to Partner*****:** If the partnership deed is silent on salary to a partner, then according to the Partnership Act of 1932, **no** salary should be given to any partner.

Question 3:

Explain why it is considered better to make a partnership agreement in writing.

ANSWER:

A partnership deed forms the basis of a partnership firm. A partnership deed consists of all the pre-determined terms and conditions that are agreed to by all the partners while forming the partnership. Generally the following details are included in a partnership deed.

1. Objective of business of the firm

2. Name and address of the firm

3. Name and address of all partners

4. Profit and loss sharing ratio

5. Contribution to capital by each partner

6. Rights, types of roles and duties of partners

7. Duration of partnership

8. Rate of interest on capital, drawings and loans

9. Salaries, commission, if payable to partners.

10. Rules regarding admission, retiring, death and dissolution of the firm, etc. It ensures the

A partnership deed can both be oral or written. Although, it is not compulsory to form partnership agreement in writing under the Partnership Act of 1932, however, written partnership deed is more desirable than the oral agreements. This is because it ensures the smooth functioning of the business of the partnership firm. It helps in avoiding disputes and misunderstandings among the partners. Also, it helps in settling t the disputes (as the case may be) among the partners, as written partnership deed can be referred to anytime. If written partnership deed is duly signed and registered under Partnership Act, then it can be used as evidence in the court of law. Moreover, any changes (if needed) in the partnership deed cannot be made without the consent of all the partners of the firm. Therefore, it is desirable to form partnership deed in writing because of the merits associated with written documents over its oral counterparts.

Question 4:

Illustrate how interest on drawings will be calculated under various situations.

ANSWER:

When a partner withdraws any amount, either in cash or in any other form, from the firm for his/her personal use, then it is termed as drawings. The interest charged by the firm on the amount of drawings is termed as interest on drawings. The method of calculating interest on drawings depends on the information available for time and frequency of the drawings made by the partner. The following different situations of drawings made illustrate the calculation of interest charged on drawings.

Situation 1: When information regarding Amount, Date and Rate of Interest on drawings are given.

If a partner withdrew Rs 10,000 on May 01 and interest on drawing is charged at 10% p.a. and the firm closes its books on December 31 every year then interest of drawings amounts to Rs 667.

$$\text{Interest on drawings} = \text{Total Amount} \times \frac{\text{Rate of Interest}}{100} \times \frac{\text{Period}}{12}$$

$$\text{Interest on drawings} = 10{,}000 \times \frac{10}{100} \times \frac{8}{12} = \text{Rs } 667$$

Situation 2: When information regarding Amount, Rate of Interest on drawings is given

Case I: If the Amount and Rate of Interest on drawings (***per annumn***) is given but date is not mentioned

If the details regarding the amount of drawings and rate of interest of drawings (p.a.) is given but the date of drawings is not mentioned then interest is charged on average basis and the period of drawings is taken as 6 months.

Example- If a partner withdrew Rs 10,000 and rate of interest on drawings is 10% p.a. then the interest of drawings amounts to Rs 500

$$\text{Interest on drawings} = 10{,}000 \times \frac{10}{100} \times \frac{6}{12} = 500$$

Case II*:** If the Amount and Rate of Interest on drawings is given but the date and ***per annumn rate of interest is not mentioned

If the date and the rate of interest are given but per annum is not specified, then annual interest is charged.

Example- If a partner withdrew Rs 20,000 and interest rate is 10% , then the interest on drawings amounts to Rs 2,000.

$$\text{Interest on drawings} = 20{,}000 \times \frac{10}{100} = \text{Rs } 2{,}000$$

Situation 3: When a fixed amount is withdrawn at regular interval

***Case I*:** If a fixed amount is withdrawn at the beginning of each month, then the interest is calculated for 6.5 months.

Example- If a partner withdraws Rs 1,000 in the beginning of every month and the rate of interest is 10% p.a., then the interest on drawings amount to Rs 650.

Interest on drawings $= 12{,}000 \times \frac{10}{100} \times \frac{6.5}{12} = 650$

***Case II*:** If a fixed amount is withdrawn at the end of each month, then the interest is calculated for 5.5 months

Example- If a partner withdraws Rs 1,000 at the end of each month and rate of interest is 10% p.a., then the interest on drawings amount to Rs 550.

$$\text{Interest on drawings} = 12{,}000 \times \frac{10}{100} \times \frac{5.5}{12} = \text{Rs } 550$$

***Case III*:** If a fixed amount is withdrawn in the middle of every month then assuming that the drawings are made on15th of every month then interest on drawings is calculated for 6 months

Example- If a partner withdraws Rs 1,000 on 15th of every month and the rate of interest is 10% p.a., then the interest on drawings amount to Rs 600.

$$\text{Interest on drawings} = 12{,}000 \times \frac{10}{100} \times \frac{6}{12} = \text{Rs } 600$$

***Case IV*:** If a fixed amount is withdrawn in the beginning of every quarter then the interest is calculated for 7.5 months

Example- If a partner withdraws Rs 3,000 in the beginning of every quarter and the rate of interest is 10% p.a. then the interest on drawings amount to Rs 750

$$\text{Interest on drawings} = 12{,}000 \times \frac{10}{100} \times \frac{7.5}{12} = \text{Rs } 750$$

***Case V*:** If a fixed amount is withdrawn at the end of every quarter, then the interest is calculated for 4.5 months

Example- If a partner withdraws Rs 3,000 at the end of every quarter and the rate of interest is 10% p.a., then the interest on drawings amounts to Rs 450.

$$\text{Interest on drawings} = 12{,}000 \times \frac{10}{100} \times \frac{4.5}{12} = \text{Rs } 450$$

Situation 4:

When different amount is at different intervals

If different amount is withdrawn by a partner at different points of time then the interest is calculated by ***Product Method***. The period of drawings is calculated from the date of withdrawal to the last date of the accounting year.

Example- A partner withdraws Rs 5,000 on Feb 01, Rs 3000 on May 01, Rs 5,000 on Sep. 30 and Rs 1000 on Dec. 31 and the rate of interest on drawings is 10% p.a. The firm closes its book on December 31.

Calculation of Interest on Drawings by Product Method

Interest on Drawings					
Date	**Amount Rs**	**Outstanding Period**	**Product**		
Feb. 01	5,000	11	5,000 × 11	=	55,000
May. 01	3,000	8	3,000 × 8	=	24,000
Sep. 30	5,000	3	5,000 × 3	=	15,000
Dec. 31	1,000	0	1,000 × 0	=	0
					94,000

$$\text{Interest on drawings} = \text{Sum of Product} \times \frac{\text{Rate}}{100} \times \frac{1}{12}$$

$$\text{Interest on drawings} = 94{,}000 \times \frac{10}{100} \times \frac{1}{12} = 783.33$$

Question 5:

How will you deal with a change in the profit sharing ratio among existing partners?

Take imaginary figures to illustrate your answer?

ANSWER:

Usually due to the admission, retirement or death of a partner or sometimes due to the general agreement among the partners, they may decide to change the profit sharing ratio. Various adjustments that should be considered during the change in the profit sharing ratio are , goodwill, reserves and accumulated profits, profit or loss on the revaluation of assets and liabilities and adjustment of capitals, etc. The general reserves and accumulated profits (if any) and profit (or loss) on revaluation on assets and liabilities should be credited (debited) in the Partner's Capital Account in their old profit sharing ratio.

But if the existing partners decide to change the profit sharing ratio then some partners gain (gaining partners) at the cost of other partners (sacrificing partners). Thus, the former should compensate the latter. Therefore, the gaining Partners' Capital Account s are debited to the extent of their gain and sacrificing Partners' Capital Accounts are credited to extent of their sacrifice. The following Journal entry is passed.

Gaining Partner's Capital A/c Dr.

To Sacrificing Partner's Capital A/c

(Adjustment entry passed)

Example:

A, B, C are partners in a firm sharing profit and loss in 3:2:1 ratio. They decide to share profit and loss equally in future. On that date, the books of the firm shows Rs 1,20,000 as general reserve, profit due to revaluation of building Rs 30,000. The following adjustment entry is passed through the capital accounts without affecting the books of accounts.

Particulars	**A**	**B**	**C**
Share of profit as per 3:2:1 Profit on revaluation of building	60,000 15,000	40,000 10,000	20,000 5,000
	75,000	50,000	25,000
Share of profit as per 1:1:1	50,000	50,000	5,000
Difference (Gain or Loss)	25,000 (Loss)	-	25,000 (Gain)

Hence, in this example, C gains at the cost of A, so the partner A needs to be compensated by C with the amount of Rs 25,000. The following adjustment entry is passed.

Adjustment entry:

C's Capital A/c	Dr.	25,000	
To A's Capital A/c			25,000
(Adjustment entry passed)			