Class 12th NOTES;
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chapter-1st
Fundamentals to partnership

THE; Term ''BUSINESS''

A business can be organized in the form of a sole proprietorship, a partnership firm or a company. In Sole Proprietorship total capital is invested by only one person and only he is responsible for functioning and all the profits and losses. The main disadvantage of single ownership is that his all personal properties are always at risk and may be used for the payment of the business liabilities. That's why the need of partnership takes place. In partnership loss is shared by all the partners while in single proprietorship only one person is suffering for all losses. The main advantage of partnership is that there are two or more persons to take the responsibility of business. All profits and losses are distributed among the partners. Partnership comes into existence out of agreement. The agreement may be written or oral among the partners. It is better to have a written agreement among the partners to avoid the conflicts or disputes. Whenever there is dispute for the distribution of the profits among the partners, in such case Indian partnership act 1932 is applicable.

Meaning and Definition of Partnership

A partnership is formed by an agreement. Partnership agreement may be written or oral. The agreement should be to share the profits of the business. The firm's business may be carried on by all the partners or any one of them acting for all. As per the law, it is not necessary to have a written agreement but to avoid the trouble in managing the affairs of the partnership firm, it is always advisable to have a written partnership deed which should be signed by all the partners.
Definition According to Section 4 of the Indian Partnership Act, 1932 :
"Partnership is the relationship between persons who have agreed to the share the profits of a business carried on by al or any one of them acting for all"

Features/Characteristics of Partnership

1. Two or More Persons :
A partnership business can be commenced with two or more partners. According to Companies Miscellaneous Act, 2014; maximum number of persons -(50) And minimum number of person - (2) according to Indian partnership Act, 1932.

2. Agreement Between the Partners :
A partnership is formed by an agreement.
Partnership agreement can be written or oral. There is no fixed or compulsory law for the formation of written partnership agreement but in the absence of a written agreement partners may face difficulty in managing the affairs of the partnership firm. Therefore, to avoid the conflicts/disputes among the partners, it is also advisable to have a written partnership agreement.

3. Lawful Business :
The agreement should be carrying on some legal business. Unlawful

activities are not considered as partnership business.

Example 1 : Vinod and Yuvraj purchased a piece of land jointly and sold after sometime at a profit. The profit earned from sale of land was shared by Vinod and Yuvraj Equally. It will not be treated as partnership business.

Example 2 : David and John are partners doing smuggling and share the amount earned equally. It is not a partnership business.

4. Sharing of Profits :

It is necessary to share the profits/losses of a partnership business among the partners. A group of people doing some charitable activities, will not be termed as partnership. The ratio of sharing profits/losses should be determined by the agreement and in case if there is not partnership deed, in such a situation profits/losses should be shared equally.

5. Business Carried on by all or any of them acting for all:

It is not necessary for all the partners to participate in day-to-day activities of the business.
A partnership business can be carried on by all the partners or any one of them acting for all on behalf of other partners.
In Acutal, partnership is based on the concept of Mutual Agency relationship.
A partner is both an agent and a principal because he binds other partners by his acts and in the same manner he is also bound by the acts of the other partners.

Meaning and Contents of Partnership Deed

A Partnership is formed by an agreement. This agreement may be written or oral. In actual, Partnership deed is a written agreement signed by all the partners. It is a document which contains all terms and conditions of partnership agreed by the partners. As we know that partnership is the result of agreement among the partners. The agreement may be written or oral. In absence of a written agreement, there may be dispute or conflicts among other partners regarding profits. Therefore, an agreement should be written and signed by all the partners. Partners can make changes in the clauses of partnership deed time to time with the consent of all partners.

Contents of partnership deed

The partnership deed usually contains the following particulars:

1. Name of the Firm ; address of Firm ; its main Business
2. Names and addresses of all partners
3. Date of commencement of partnership
4. Capital contributed by each partners
5. Ratios in which profits and losses are to be shared by the partners
6. Salaries, commission, allowances payable to the partners
7. Rights, duties and liabilities of the partners
8. Duration of partnership, if any
9. Mode of auditors appointment
10. Accounting period of the firm
11. Rules regarding the operation of bank account
12. Loan given to the firm by a partner, interest on that loan payable to the partners
13. Method of valuation of goodwill
14. Rules to be followed in case of admission, retirement and death of a partner
15. Settlement of accounts at the time of dissolution
16. Settlement of disputes among other partners

Advantages/Benefits of Partnership deed

(1) A written partnership deed plays important role in avoiding disputes and conflicts among the partners in future.

(2) A writtten partnership deed can be used as an evidence in the court of law.

(3) Facilitates smooth functioning of business by avoiding misunderstanding

Provisions Affecting Accounting Treatment

In the absence of a written partnership deed or if the deed is silent on certain matters, following provisions for the Indian Partnership Act, 1932 will be applicable:
Particulars Treatment

1. Profit Sharing In the absence of partnership deed or if deed is silent on profit sharing, in such a case profits will be shared equally by the partners.

2. Interest on capital No Interest on capital is allowed to partners in the absence of partnership deed.

3. Interest on Loan If any partner, apart from his share of capital, advances some amount to the partnership firm as a loan, he is entitled to interest on such amount at the rate of 6% p.a. Such interest will be paid to the partner whether there is profit or loss in the business. He is entitled for the full amount of interest on such loan.

4. Interest on Drawings In the absence of partnership deed, no interest will be charged on the drawings made by the partners.

5. Salary/Remuneration to Partners In the absence of partnership deed, no salary/remuneration will be paid to any partner whether his participation in the business is more than other partners.

Rights of partners

Right to take part in management
Right to inspect the books of accounts
Right to share profits
Right to be consulted about matters affecting the partnership business
Right to retire

Duties of partners

He should be faithful to other partners
He should share the losses of the firm
To attend his duties diligently
He should not compete with the firm

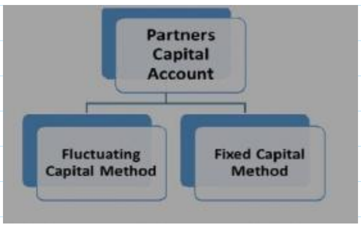
Preparation of Profit & Loss Appropriation Account

In case of a partnership firm, all charge are shown in profit and loss account and all appropriations are shown in Profit and Loss Appropriation Account. The main purpose of preparing Profit and Loss Appropriation Account is to show the distribution of profits among partners as per the provision of Partnership Deed (or as per the provision of Indian Partnership Act, 1932 in the absence of Partnership Deed). It is an extension of Profit and Loss Account. It is a temporary account and by nature it is a nominal account.

Proforma of Profit and Loss Appropriation Account

Particulars	Amount	Particulars	Amount
To Interest on Capital		By Profit & Loss A/c (profit)	xxxx
X xxxx		By interest on Drawings :	
Y xxxx		X xxxx	
Z xxxx	xxxx	Y xxxx	
		Z xxxx	xxxx
To Partners Salary			
X xxxx			
Y xxxx			
Z xxxx	xxxx		
To Partners Commission			
X xxxx			
Y xxxx			
Z xxxx	xxxx		
To Transfer to Reserve	xxxx		
To Profit Transferred to			
X's Capital/Current A/c xxxx			
Y's Capital/Current A/c xxxx			
Z's Capital/Current A/c xxxx	xxxx		
	xxxx		xxxx

Preparation of Partners Capital Accounts



Partner's Capital Accounts :
It is an account which represents the partner's interest in the business.
In case of partnership business, a separate capital account is maintained for each partner. The capital accounts of partners may be maintained by following any of the following *two methods:*

(1) Fixed Capital Accounts :

Under this method capitals of the partners remain fixed. Capital accounts of the partners will show always Credit balances. Under This method mainly two accounts are prepared i.e. Partners Capital Account and Partners Current Account. There are only two situations when fixed capitals of the partners may change :
Situation 1:
When Additional Capital is introduced by the partners
Situation 2:
When Some part of capital is withdrawn permanently by the partners

Only two items are shown in the credit side i.e. opening balance or capital introduced by the partners and additional capital (if any) introduced by the partners.
In the debit side withdrawn of capital (permanently) and closing balance is shown

Performa of partners capital and current accounts

Partners Capital Account

Particulars	A	B	Particulars	A	B
To Cash/bank (withdrawn of capital)	xxxx	xxxx	By Balance b/d	xxxx	xxxx
To balance c/d	xxxx	xxxx			
	xxxx	xxxx		xxxx	xxxx

Partners Current Account

Particulars	A	B	Particulars	A	B
To Cash/bank (withdrawn of capital)	xxxx	xxxx	By Balance b/d	xxxx	xxxx
			By Interest on Capital	xxxx	xxxx
			By Salary/Remuneration	xxxx	xxxx
			By Commission/Bonus	xxxx	xxxx
To balance c/d	xxxx	xxxx	By Balance c/d (if any)	xxxx	xxxx
	xxxx	xxxx		xxxx	xxxx

Note :

1. Debit balance of Current Account is shown in Assets side of Balance Sheet.
2. Credit balance of Current Account is shown in Liabilities side of Balance Sheet.
3. Balance of Capital Accounts are always shown in Liabilities side of Balance Sheet as this account

(2) Fluctuating Capital Accounts:

Under this method only one account is prepared i.e. Partners Capital Account. ;
It may show Debit or Credit balance.

Credit Side Items :

(a) Balance of Capital or Capital Introduced by the partners
(b) Additional Capital (if any) contributed by the partners during the year
(c) Interest on capital (if any)
(d) Salary/Remuneration to the partners (if any)
(e) Commission/Bonus to the partners (if any)
(f) Share of Profit

Debit Side Items

(a) Withdrawal of capital (if any)
(b) Drawings made during the year (if any)
(c) Interest on drawings (if any)
(d) Share of loss (if any)
(e) Closing balance

Performa of partners capital account by fluctuating method

Partners Capital Account

Particulars	A	B	Particulars	A	B
To Cash/bank (withdrawn of capital)	xxxx	xxxx	By Balance b/d	xxxx	xxxx
			By Cash/Bank (additional cap.)	xxxx	xxxx
			By Interest on Capital	xxxx	xxxx
To Drawings	xxxx	xxxx	By Salary/Remuneration	xxxx	xxxx
To Int. on Drawings	xxxx	xxxx	By Commission/Bonus	xxxx	xxxx
To P/L A/c (if loss)	xxxx	xxxx	By Balance c/d (if any)	xxxx	xxxx
To balance c/d	xxxx	xxxx			
	xxxx	xxxx		xxxx	xxxx

INTEREST ON CAPITAL

Interest on partners' capital will be allowed only when it has been specifically mentioned in the partnership deed. Interest on Capital can be treated as either an Appropriation of profit or a charge against profits.

Charge

Charge is compulsory in nature. Whether there is profit or loss, all charge items will be met.
Example of Charge:
Office Rent
Salary to Employees
Manager's Commission etc.

Appropriation

Appropriation is not compulsory in nature. Appropriation is that amount of profit which is paid to the partners in the form of interest on capital, salary, commission/bonus etc.
The concept of appropriation is applicable only when there is some profit.
In case of loss no appropriations.
Example of Appropriation:
Interest on capital, salary or remuneration to partners, bonus or commission to partners etc.

A. Interest on Capital : An Appropriation of Profits:

When there is loss;
Interest on Capital is not allowed because it is an appropriation and will be paid only when there is some profit

In Case of Sufficient Profits ;
Interest on Capital is allowed in full. All partners are entitled for the interest on capital at the agreed rate or rate of interest on capital already mentioned in the partnership deed.

In case of Insufficient Profits ;
Interest on Capital is allowed only to the extent of profits in the ratio of interest on capital of each partner. In this case partners do not get full amount of interest.

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

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

Note :
Interest on Capital is always calculated on the opening capital. If Opening Capital is not given in the question, it should be ascertained as follows :

Calculation of Opening Capital

Capital at the end (closing capital)	xxxx
ADD : Drawings made during the year	xxxx
ADD : Share of Loss During the year (if any)	xxxx
	xxxx
Less : Additional Capital introduced (if any)	xxxx
Less : Share of Profit during the year (if any)	xxxx
Capital in the beginning	**xxxx**

For additional capital interest is calculated for period for which capital is utilized;

e.g. if additional capital is introduced on 1st October in firm where accounts are closed on 31st March.
Interest = Amount introduced x Rate/100 x 6/12 as money is utilized for 6 months

Interest on Drawings

Drawings means cash or goods withdrawn from the business by the proprietor for personal use. It reduces the capital of the proprietor. Interest on drawings will be charged from the partner's capital account, only if it is mentioned in the partnership deed. If partnership deed is silent, no interest on drawings will be charged. According to the business entity concept interest on drawings will be treated as income for the business and loss for the partners.

Distinction between drawings against profit and drawings against capital

Drawings against profit

1. This is the amount withdrawn from profits.
2. It is shown in the debit side of drawings account
3. It is made out of profit, so does not affect the capital
4. It is ignored at the time of calculation of interest on drawings

Drawings against capital

1. This is the amount withdrawn from capital
2. It is shown on the debit side of capital account
3. It is made out of capital, it reduces the capital
4. It is considered for the calculation of interest

Methods for Calculation of interest on drawings

1. When a fixed amount is withdrawn by the partners after regular intervals and rate of interest is given in the question with the word per annum

Step 1. Calculate average period :

$$\text{average period} = \frac{\text{Time after first drawing + time after last drawing}}{2}$$

Step 2. Calculate interest on drawings :

$$\text{interest on drawings} = \text{Total drawings} \times \frac{\text{Rate}}{100} \times \text{Average period}$$

2. When rate of interest is given without the word per annum

In such a case, Interest on Drawings is calculated with a flat rate irrespective of date of drawings.

3. When Different amounts are withdrawn at different time intervals

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 of the basis of periods for which

2. Product Method

In this method, the amounts of drawings are multiplied by the period for which it *remained withdrawn during the period, Interest for 1 month is calculated on the sum of these products.*

4. Half Yearly Drawings

Half yearly Drawings for year when:

(a) Drawings are made in the begnning of each period (half-year) ;

$$\text{Interest on drawing} = \text{Amount} \times \frac{\text{Rate}}{100} \times \frac{9}{12}$$

(b) Drawings are made in the middle of each period (half year)

Interest on drawing = Amount x Rate/100x 6/12

(c) Drawings are made at the end of each period (half year)

Interest on drawing = Amount x Rate/100 x 3/12

For monthly drawings for 6 months

(a) Drawings are made in beginning of each month

Interest = Amount x Rate/100 x 3.5/12

(b) When drawings are made in the middle of each month

Interest = Amount x Rate/100 x 3/12

NOTE; When date of withdrawal is not specified;

Sometimes date of withdrawal is not given in the question; amount withdrawn by the partners as drawings is given only. In such a case it is assumed that the amount is withdrawn at average basis or withdrawn evenly throughout the year and interest will be charged for the average period which will be assumed to be 6 months. It is assumed that amount is withdrawn in the middle of every month. The following formula will be used.

Interest on Drawings = Total Drawings x Rate/100 x 6/12

Concept of Past Adjustment

Past Adjustments are concerned with the previous entries which were left out or omitted or wrongly entered in the accounts. If, after preparation of Final Accounts of firm, it is found that some errors or omission in accounts has occurred than such errors or omissions are rectified in the next year by passing an adjustment entry.
A statement is prepared to ascertain the net effect of such errors or omissions on partner's capital/current accounts in the following manner.

Adjustment Table

Particulars	A	B
Step 1. What Amount partners should get (Interest + Salary + Commission + Profits etc.)	xxxxx	xxxxx
Step 2. Less : Amount already received (wrong Profit)	xxxxx	xxxxx
	xxxxx	xxxxx

Now compare Step 1 and Step 2 and decide Partner is gainer or sacrificing.
After this make the following entry :

Gainer partner's A/c Dr.
To Sacrificing Partner's 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.

Note : Guarantee to a partner is given for minimum share in profits. If the actual share in profits is more than the minimum guaranteed amount 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. Guaranteed amount to a partner is written in Profit and Loss Appropriation A/c
2. Remaining profits are distributed among the remaining partners in their remaining ratio.

Case 2:
When guarantee is given by a partner or partners to another partner
1. Calculate the share in profits for the partner to whom guarantee is given
2. If share in profits is more than the guaranteed amount, distribute the profits as per the profit and loss sharing ratio in usual manner.
3. 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 is known as Deficiency. Deficiency is distributed among the partner or partners who guaranteed in a certain ratio and subtracted from his or their respective shares.