

## **Partnership Accounts Theory related to Distribution of Profits**

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### **Nature of Partnership Firm**

A sole trader does business under certain limitations. He may not be in possession of requisite capital, skill, experience to run the business. Even, if he has all these, he may not have the initiative to take the risk involved in starting a new business. These limitations may induce a sole trader to enter into partnership with others. Partnership is form of business organisation in which two or more than persons can carry business jointly. They do management of business and arrangement of capital according to their ability. Thus it is a combination of such persons who have different qualities either some are rich or some are good in manner or some are good manager. Under an agreement they contribute the financial and human resources for carrying legal business to earn profits. It is called partnership. Partnership agreement is based on mutual relationship. To avoid distrust and disputes amongst the partner, it is necessary that partnership accounts be maintained in true, fair of partnership; meaning of partnership deed and provision affecting partnership accounting treatment as given in the Partnership Account.

### **Meaning of Partnership**

Partnership is an association of person who agree to combine their financial resources and managerial abilities to run a business and share profits in an agreed ratio. Section 4 of Indian Partnership Act, 1932 defines partnership ‘ ‘ Partnership is the relation between person who have agreed to share the profits of a business carried on by all or any of them acting for all.’ ’ The Act further states that the persons who have entered into partnership are known individually as partner and collectively as firm, the name in which the partnership business is carried on is called firm name.

### **Features of Partnership**

The definitions reveal the following essential features of a partnership :

1. **Association of two or more person :** There must be at least two competent persons to form a partnership. As regards the maximum number of partners in a firm, Section 11 of the Companies Act, 2013 provides that the number of partners in a firm carrying on banking business should not exceed 10 and in any other business 20. If the number of partners exceeds this limit, the partnership becomes an illegal association. It ceases to be a partnership if the number gets reduced to one by any reason.

**2. Agreement:** The partnership relation is one of a contractual nature. It arises from contract and not from status. An agreement between the partners is the basis of this contract. The agreement may be either oral or in writing. Partnership is thus created by contract; it does not arise by operation of law (as in the case of co-owners) or from status (as in the case of a joint Hindu family) or from inheritance.

**3. Business:** A partnership can be formed only for the purpose of carrying on some business. Business includes every trade, occupation and profession. For example, the jobs of doctors and lawyers are not called business but there can be a partnership between two doctors or lawyers. The business to be carried on by the firm must be legal.

**4. Sharing of Profits:** The object of partnership must be to make profit and that profit must be distributed among the partners in an agreed ratio. The sharing of profit also involves sharing of loss which in fact is negative profit. But as between the partners, it may be agreed that one or more of them shall not be liable for losses. Importantly, an agreement entered into by individuals for charitable purpose will not be treated as a partnership.

**5. Mutual Agency:** The business of partnership may be carried on by all the partners or any of them acting for all. A partner is both an agent (in the sense that he can bind by his acts to other partners). And the principal (in the sense that he can be bound by the acts of the other partners). Consequently, in a partnership there is a mutual agency among the partners and in the ordinary course of business; acts of one partner are considered to be the acts of the firm.

### **Meaning of Partnership**

Deed a partnership is created by an agreement. The agreement may be either oral or in writing. From the law point of view, it is not necessary that the partnership agreement should be in writing but practically it is desirable to have it in writing so as to avoid disputes later on. Thus a document which contains the terms of partnership as agreed to by the partners is called partnership Deed or Articles of Partnership. Partnership Deed is a legal document signed by all the partners. It must be duly stamped as required by the Indian Stamp Act, 1889 and each partner should have a copy of it.

### **Contents of Partnership Deed**

Partnership deed lays down the terms and condition of partnership; the rights, duties and obligations of partners. The following contents are generally covered in the Deed :

1. Date of Commencement of partnership
2. Name of the firm

3. Name and addresses of all partners
4. Nature and place of the business
5. Duration of partnership
6. Amount of capital contributed by each partner
7. Profit sharing ratio
8. Drawings by partners
9. Interest on capitals and drawings
10. Salaries, commission etc. if payable to any partner
11. Interest on loan by the partners to the firm
12. Rules to be followed in case of admission, retirement or death of a partner
13. Settlement of accounts on dissolution of the firm
14. Methods of setting disputes amongst partners.

### **Provisions Affecting Partnership Accounting Treatment**

Generally a partnership deed contains all important matters regarding to the mutual relationship amongst the partners. If there is no partnership agreement amongst partners in writing or oral, in that case the relevant provisions of the Indian Partnership Act, 1932 shall become applicable.

So certain provisions of the Act which have direct bearing on the accounting treatment are as follows:

1. Profits sharing ratio : The partners shall share firm' s profits or losses equally irrespective of their capital contribution.
2. Interest on partner' s loan : If any partner a part from his share of capital, advances money to the firm as a loan, he is entitled to interest on such loan @ 6% p.a.
3. Interest on capital : No interest is allowed to partners on the capital invested by them.
4. Interest on drawings : No interest will be charged on drawings made by the partners.
5. Remuneration to partners : No partners is entitled to any salary, commission, bonus etc. as remuneration for participating in the business of the firm.

It should be remembered that the above rules are applicable only in the absence of partnership deed or verbal agreement or if the partnership deed is silent on a particular point and partners may change any the above rules by an agreement at any time.

### Special Aspects of Partnership Account

A business can be organised in the form of a sole proprietorship, a partnership firm etc. Accounts of partnership firm are maintained in the same manner as those of sole proprietorship. But in case of partnership firm, the special features relate to the distribution of profits and the maintenance of capital account are applicable separately. It is, therefore, necessary to study the special aspect related to transactions of partnership firm for recording.

These aspects are as follows :

1. Distribution of Profits
2. Capital Account
3. Drawings Account

1. Distribution of Profits: In case of sole proprietorship, the net profit shown by the Profit & Loss Account belongs to the sole trader. All net profit is transferred to his capital account. However, in case of a partnership, the net profit (after adjustment of partner' s transactions such as interest on capital, partner' s salary, commission, drawings, interest on drawings etc.) is to be shared by all the partners in the agreed profit sharing ratio.

Thus, a separate account is prepared for distribution of profits between the partners is known as Profit & Loss Appropriation Account. It is a nominal account in nature and prepared just like Profit & Loss Account. It is debited with amount due to partners (expenses from firm' s point of view) and credited with amount due from partners (income from firm' s point of view). After that divisible profit or loss is calculated from that account. This profit is to be distributed among the partners in their agreed profit sharing ratio and partner' s share of profit is transferred to his Capital A/c or Current A/c.

2. Capital Account: In partnership account, a separate capital account will be opened for each partners. Thus, there will be as many capital account as the number of partners. The transactions relating to partners are recorded in their respective capital account. The partner' s capital account can be maintained in any one of the following two methods : (i) Fluctuating Capital Method or floating capital method (ii) Fixed Capital Method (i) Fluctuating Capital Method : Under this method, only one account viz. The capital account of each partners is maintained. It records all transactions affecting partner' s account like amount contributed by a partner, interest on capital, salary, commission, share of profit or loss, drawings etc. In capital account itself. As a result of these, the amount of each partner' s capital at the end of the year is different from it was at the year of the beginning or in order

words the balance in the capital account keeps on changing year to year. So it is called fluctuating capital method.

3. Drawings Account : Each partner can withdraw either cash or goods or both for his personal use according to partnership deed. For recording it a separate Drawings Account for each partner is maintained. It records both cash and goods withdrawn by a partner. At the end of the year, the balance of drawing account is transferred to the debit side of respective partner's capital account and the following entry will be made :

Partner's Capital A/c Dr.

To Partner's Drawings A/c

1. Interest on Capital : Interest on capital is to be allowed to the partners if the same has been specifically provided in the partnership deed and is allowed at the given rate with reference to time period for the capital ratio and is justified particularly in the following cases :

(a) Where partners share equally in the profits but have unequal capital, the partner with smaller capital would otherwise be given at the expense of the other.

(b) Where the partners have equal capitals but share profits unequally, the partners, who take the larger share of profits would otherwise get an advantage over the other. The following formula will be applied for calculating interest on Capital :  $\text{Amount of Capital} \times \text{Rate} \times \frac{\text{Time}}{100}$   
Time Accounting treatment : Interest on Capital is a loss to the firm, but for partners it is a gain. It is shown at the debit side of Profit & Loss Appropriation Account and at the credit side of Partners' Capital Account.

2. Salary to Partners : If in a firm there are some active partners and some sleeping partners, the active partners may be allowed salary for the work. The payment of salaries may be justified in the following circumstances:

(a) Where one of the partners devotes more time to the business or possesses greater skill and experience as compared to their fellow partners.

(b) Where the junior partner has comparatively little capital in the business and receives only a small share of profits, he may be paid a fixed salary in order that he shall at least obtain a certain minimum income from the firm. Account treatment : Salary payable to the partners is a business expense, but for partner it is a gain. It is shown at the debit side of Profit & Loss Appropriation Account and at the credit side of Partner's Capital Account.

3. Interest on Drawings: Sometimes, interest is not only allowed on capital but is also charged on drawings. In such case, the interest will be charged if the same has been specifically provided in the partnership agreement. The practice is appropriate in order to prevent one partner getting an advantage over the other in the following circumstances.

(a) Where there is no stated date or limits fixed for drawings by partners.

(b) Where drawings of the partners are unequal in the amount, though they are equal as regards capital and share of profits. Accounting treatment: Interest on drawings is credited in Profit & Loss Appropriation A/c as it is an item of income for the firm and debited in Partner' s Capital A/c as it decreases the capital.

Thanking you!