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Accounting for Partnership

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JAYASEKERA MANAGEMENT CENTRE (PVT) LTD
Estd. 1972

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1. Partnership

Partnership is the relation which subsists between persons carrying on a business in common with a view of profit.
(Section 1 of partnership ordinance 1890)

2. Ways of forming a Partnership

1. Oral
2. Implied
3. Written

As per the prevention of fraud ordinance, any agreement for establishing a partnership should be in writing if the opening capital exceeds Rs. 1,000/=.

3. Key elements

- Two or more individuals
- Business carried on common view
- Profit motive
- Unincorporated business entity

4. Advantages and Disadvantages of a Partnership

Advantages

- Business risks are spread among more than one person.
- Individual partners can develop specialist skills upon which the other partners can rely.
- Certain partners may be able to inject more capital resources.
- Less formal than setting up a company, which requires the issue of shares and the appointment of directors. If the partners wish to dissolve the business, that is easier to achieve by a partnership than by a company.

Disadvantages

- Effect of disputes between partners.
- 'Joint and several liability' for the debts of the partnership.
  This means that if one partner is being sued in relation to the business of the partnership, the other partners share in the responsibility
- In a company the shareholders may be protected from the creditors of the company as regards the payment of outstanding debts.

5. Legal background of Partnership

Partnerships are governed by the Partnership ordinance 1890; the relevant provisions with regards to accounting are section 24 and section 42.

Section 24 provisions

Section 24 of the partnership ordinance 1890 applies either when there is no agreement partnership deed among partners or when the agreement fails to cover any situations.

1. All partners are entitled to share equally in the capital and Profits in the business and must contribute equally towards the losses whether capital or otherwise.
2. No interest to be allowed to partners' capital balances
3. No interest to be charged to any partners drawings
4. Interest to be allowed to partners loans at 5 % per annum
5. No partner shall be entitled to receive remuneration for acting in the partnership
6. Every partner may take part in the management of the partnership
7. Every partner has access to the books when he thinks fit. Those books should be kept at the principal place of the business
8. Admission of a new partner needs unanimous consent.

Section 42 provisions

Section 42 of the partnership act provides that interest should be paid on any amount owing to an outgoing partner either at 5 % per annum or at such rate as a court would determines as attributable to the use of the assets of the partner concern.

6. What is meant by Article of Partnership (Partnership agreement)?

A written agreement which contains the various terms and conditions as to the relationship of the partners to each other is called the Article of Partnership of Partnership deed.

7. Contents of a Partnership Agreement

1. Agreements for sharing of profits
2. The agreed ratio of holding capital balances
3. Any additional responsibility and rewards
4. Limitation on partners drawings, if any
5. Authority to obtain loans and enter into contracts
6. Authority to change the nature of the business
7. Authority to admit a new partner
8. Requirements on accounting and auditing

8. Why is it necessary to have a partnership deed (Partnership Agreement)?

The three reasons for having a written agreement (partnership deed) are as follows:-

I. In case of dispute it will serve as evidence in the court of law.

II. Accounts of partnership firm are regulated by those contents.
III. It regulates the rights, duties and responsibilities of each partner.

9. In the absence of partnership deed, how are mutual relations of partners governed?

In the absence of partnership deed rules in 'Partnership Ordinance 1980' will be applied for governing the partnership (Section 24 and Section 42)

a) Partners contribute capital equally;
b) Partners share profits and contribute equally towards losses;
c) Partners are not entitled to interest on capital;
d) Partners are not entitled to receive salaries;
e) Partners are entitled to interest at 5% per annum on any advances beyond their agreed capital from the date of advance;
f) A new partner may not be introduced without the consent of all the existing partners;
g) Matter arising from disagreements must be decided by a majority of partners.

10. Special Accounts in partnership

- Capital Account
- Current Account
- Profit and Loss Appropriation Account

1. EXERCISE

Information regarding Shah, Rukh, Khan Partnership for the year ended 31st of March 2009 were as follows.

I. According to the partnership agreement, Shah, Rukh & Khan shall share profits & losses in 5:3:2 ratios.
II. Shah & Khan shall receive an annual salary of Rs 3,000 each.
III. All partners should receive a 5% annual interest on their fixed capital.
IV. Fixed capital of each partner:

Shah	Rs 120 000
Rukh	Rs 100 000
Khan	Rs 80 000

V. Net profit for the year ended 31/3/2009 is Rs. 140 000.

Show Profit & Loss Appropriation A/C.

2. EXERCISE

Daddy, Mammy and Son are partners of Family & Co. a partnership sharing profit and losses in the ratio of 3:2:1 respectively. Their partnership agreement contains the following provisions.

I. Partners are entitled to an interest on capital at 12 % per annum
II. Daddy, Mammy and Son are entitled to a monthly salary of Rs. 10,000/-, 12,000/- and 15,000/- respectively.

III. Current account will be credited or charged a 10 % interest per annum.
IV. 10 % interest will be charged on partners drawings
The following relevant information are given to you with regard to their business.

- Capital account balances as at 1st April 2xx1.

Daddy	500,000/-
Mummy	400,000/-
Son	300,000/-

- Current account balances as at 1st April 2xx1.

Daddy	60,000/-
Mummy	30,000/-
Son	(20,000/-) debit balance

- Net profit for the year ended 31st march 2xx2 was Rs. 740,000/-, before charging partners salaries interest on current account and capital account and before crediting interest on drawings and interest on debit balances in the current account.
- Partners' drawings during the year ended 31st March 2xx2 were as follows.

Daddy	18,000/-
Mummy	24,000/-
on	20,000/-

The above drawings were made on the first day of the beginning of the financial year.

You are required to prepare the followings:
Appropriation account for the year ended 31st march 2xx2

11. Special Adjustments

Interest on drawings

- Interest on drawings is charged from the partners when they have drawn sums from the partnership for their personal purposes.
- The partners may withdraw goods as well as cash.
- Forms of drawings
    - Regular drawing – Draw equal sum repeatedly on a definite date of each month.
    - Irregular/ Other drawings – All other drawings.

- **Computation of interest on drawings**
    - Regular drawings

- **At the beginning of each month**

  A Partner has drawn Rs. 1,000 at the beginning of each month. Calculate interest on drawings for one year at the rate of 12% per annum.

- **At the middle of each month**

  A Partner has drawn Rs. 1,000 at the middle of each month. Calculate interest on drawings for one year at the rate of 12% per annum.

- **At the end of each month**

  A Partner has drawn Rs. 1,000 at the end of each month. Calculate interest on drawings for one year at the rate of 12% per annum.

3. EXERCISE

Dayai, Ruvani and Waruni are the partners of DARUWA traders. Their financial year-ends on March 31, the following information are made available to you.

Drawings for the financial year ended 31st march 2010
D - 1000 each monthly from 1st July 2009to throughout the year
R - 1000 each monthly from 15th April 2009 to 15th January 2010
W-1000 each once in two months from 30th April 2009 to throughout the year
The partnership charges 10 % interest per annum on drawings

- Calculate the interest on drawings for the financial year ended 31st March 2002.

4. Exercise

A, B and C in a partnership sharing profits and losses in the ratio of 3:2:1. The particulars of the partnership for the year ended 31st march 2012 are as follows.

a) The net profit for the year ended 31st march 2012 was Rs. 1,000,000.

b) A, B and C have drawn equal sums of Rs. 3,000, 2,000 and 1,000 per month respectively whilst A has taken at the beginning of each month, B at the 15th day and C at end of each month.

c) A, B and C are entitled for salaries of Rs. 5,000, 4,000 and 3,000 respectively.

d) The interest on capital is 10% per annum, interest on current account balances 5% and 5% is to charge on the drawings.

e) The opening balance of current accounts of A, B and C were Rs. 40,000, 25,000 and 5,000 (debit) respectively.

f) The capital balances of A,B and C as at 31st march 2012 were Rs. 600,000, 400,000 and 200,000 respectively.

- Show the profit & loss appropriation account and the partners current accounts

Loans given by partners to the partnership

- The rate of interest for the loans given by the partners would be determined according to the terms and conditions of the partnership agreement (Partnership deed).
- In the absence of the partnership agreement or the terms, the rate of interest should be 5% per annum according to Section 24 of the Partnership Act of 1980.

  Accounting treatment
  - Recording of interest on loan

Loan interest Account	Dr	
Partners Current Account	Cr	

  - Payment of interest

Partners Current Account	Dr	
Cash Account		Cr

  - If the amount is paid in cash without crediting to the current account

Loan interest Account	Dr	
Cash Account		Cr

Exercise

RSM Partnership Agreement showed following terms

10% of annual profit shall be transferred to the general reserve.
10% p.a will be paid on partners' fixed capital balances.
12% interest p.a will be charged on drawings
R & S are entitled for a monthly salary of Rs 2 000.
Balance profit shall be distributed among partners in following manner.

1st	Rs	1 000	equally
Next	Rs	10 000	5:3:2
Balance			2:2:1

Books for the year ended 31/3/2011 showed followings:

		Dr	Cr
Capital Accounts	R		100 000
	S		80 000
	M		60 000
Current Accounts	R		6 000

(1/4/10)	S		3 000
	M		2 000
Drawings	R (Beginning)	12 000	
	S (Middle)	12 000	
	M (end)	12 000	
Loan – S			100,000
Net profit for the year			120 000

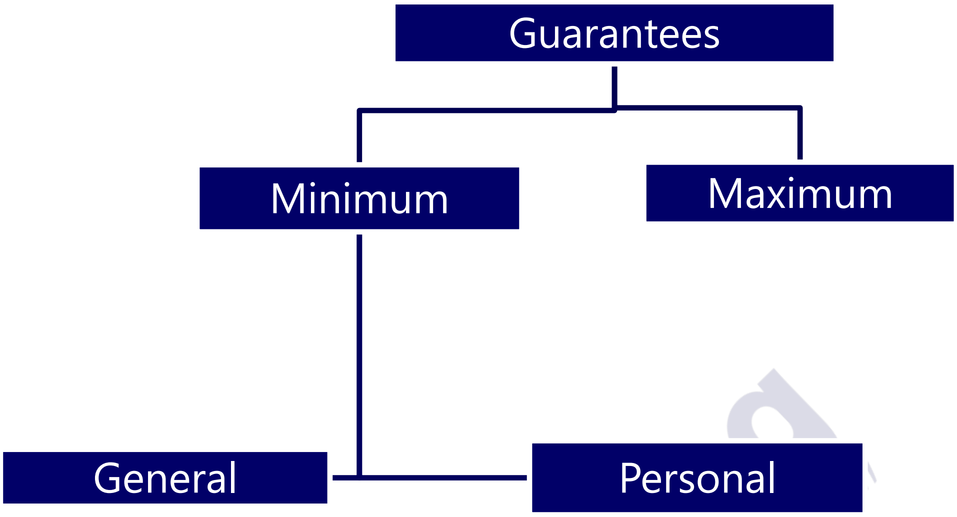
Show the Profit & Loss Appropriation Account and the partners' current Accounts.

Guarantee of partnership profit/income

- If one partner or few partners have guaranteed another partner for his profit share or income, that is known as a Profit share or Income Guarantee.
- There are two values that the partners can give their guarantee.

i. Profit share of a partner
ii. Income or Profit of a partner (the total return as a partner)

Followings are the methods of guaranteeing.



Exercise

A and B are partners of a partnership sharing profits in the ratio of 3:2. C was admitted as a partner on 01.01.2010 after which the profit sharing ratio between A, B and C was 4:3:1 subject to a guaranteed profit of Rs. 40,000 per annum to C. The profit for the year ended 31.03.2010 was Rs. 400,000 and was generated evenly over the year.

Calculate profit share of each partner

a) If the guarantee was given by the partner A

b) If the guarantee is given by A and B jointly

Exercise

C, B & K are in partnership sharing P/L 5:3:2. K however is guaranteed for a minimum income of Rs. 5,000.

Net profit for 2010 10,000

Capital Balances C 25,0

B 17,000

K 8,000

Interest on capital is 10 % p.a.

Prepare appropriation a/c.

Exercise

Lal & Nihal are equal partners in a partnership. An employee of them, Sunil is promoted as a new partner with a ¼ entitlement to the profits & losses.

As an employee, Sunil received Rs 10 000 salary and a commission of 4% from net profit after deducting salary & commission. Lal guaranteed Sunil that he will not receive anything lesser than what he received as an employee.

In the 1st year after admitting Sunil as a partner the partnership made a net profit Rs: 36,000.

Show how this profit is distributed among the partners.

3. Ratios Related with Changes

i. Old profit sharing ratio.
This is the ratio that partners shared profits and losses before the change of the partnership.

ii. New profit sharing ratio.
This is the ratio that partners share profits and losses after the change of the partnership.

iii. Sacrificing ratio.
This applies when there is an admission of new partner. This is the ratio that the old partners sacrifice from their profits to give part of the business's profit to the new partner. This is calculated by deducting the NPSR from the OPSR.

iv. Growth ratio.
This applies when there is a retirement of a partner. This is the ratio that the remaining partners will add to their profit proportions when one partner is left. This is calculated by deducting the OPSR from the NPSR.

Exercise

a. A and B are partners in a business sharing profits and losses in the ratio of 3:2. They admit a new partner C with 1/5 share in the profits. Calculate the new profit sharing ratio of the partners.

b. L and M are partners in a business sharing profits and losses in the ratio of 3:2. They admit N with 1/5 share in the profits, which he get equally from L and M. calculate the new profit sharing ratio.

c. P & Q shares profits 3:2. R is entered as a new partner. NPSR is 5:3:2. Calculate the profit sacrificing ratio.

d. X, Y & Z shares profits 3:2:1. Z retires. X & Y continues the business sharing profits 4:3. Calculate profit growth ratio.

