Accounting for Partnership: Basics Concepts

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 in absence of partnership deed.
3. Interest on Loan by Partner	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.

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.

The Journal Entries regarding Profit and Loss Appropriation Account are as follows:

1. When Profit or Loss from Profit and Loss Account is transferred to the P/L Appropriation A/c

(a) If Profit and Loss Account shows a credit balance (Net Profit)

Profit and Loss A/c Dr.

To Profit and Loss Appropriation A/c
(Being profit transferred to P & L Appropriation A/c)

(b) If Profit and Loss Account shows a debit balance (Net Loss)
Profit and Loss Appropriation A/c Dr.
To Profit and Loss A/c
(Being loss transferred to P & L Appropriation A/c)

2. For Interest on Capital

(a) For allowing Interest on capital
Interest on Capital A/c Dr.
To Partners' Capital/Current A/cs (individually)
(Being interest on capital allowed @ ___ % p.a)

(b) For transferring Interest on Capital to Profit and Loss Appropriation A/c :
Profit and Loss Appropriation A/c Dr.
To Interest on Capital A/c
(Being interest on capital transferred to P & L Appropriation A/c)

3. For Salary of Commission payable to a partner

(a) For allowing Salary or Commission to a partner :
Partner's Salary/Commission A/c Dr.
To Partner's Capital /Current A/cs (individually)
(Being salary/commission payable to a partner)

(b) For transferring Partner's Salary/Commission A/c to Profit and Loss Appropriation A/c :
Profit and Loss appropriation A/c Dr.
To Partner's Salary/ Commission A/c

4. For transfer of Reserves :
Profit and Loss Appropriation A/c Dr.
To Reserve A/c
(Being reserve created)

5. For Interest on Drawings :
(a) For charging interest on a partner's drawings :
Partner's Capital /Current A/c Dr.
To Interest on Drawings A/c
(Being interest on drawings charged @ ____%p.a.)

(b) For transferring Interest on drawings to Profit and Loss Appropriation A/c :
Interest on Drawings A/c Dr.
To Profit and Loss Appropriation A/c
(Being interest on drawings transferred to P & L Appropriation A/c)

6. For transfer of Profit or Loss (i.e. Balance of Profit and Loss Appropriation Account:
(a) If Profit
Profit and Loss Appropriation A/c Dr.
To Partners Capital A/cs
(Being profit distributed among partners)

(b) If Loss
Partners Capital A/cs Dr.
To Profit and Loss Appropriation A/c
(Being loss distributed among partners)

Proforma of Profit and Loss Appropriation Account

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

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.

Dr. **Partners Capital Account** **Cr.**

Particulars	A	B	Particulars	A	B
To Cash/bank (permanent withdrawn of capital)	xxx	xxx	By Balance b/d	xxx	xxx
To Balance c/d	xxx	xxx	By Cash/ Bank (fresh capital introduced)	xxx	xxx
	xxx	xxx		xxx	xxx

Dr. **Partners Current Account** **Cr.**

Particulars	A	B	Particulars	A	B
To Balance b/d (in case Debit Bal.)	xxx	xxx	By Balance b/d (Opening Credit Bal.)	xxx	xxx
To Drawing	xxx	xxx	By Interest on Capital	xxx	xxx
To Interest on Drawings	xxx	xxx	By Salary/Remuneration	xxx	xxx
To Profit & Loss Appropriation(Loss)	xxx	xxx	By Commission/Bonus	xxx	xxx
To balance c/d (credit closing Bal.)	xxx	xxx	By Profit & Loss Appropriation (Profit)	xxx	xxx
			By Balance c/d (if any)	xxx	xxx
	xxx	xxx		xxx	xxx

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 will always show a credit balance when capital is fixed

(2) Fluctuating Capital Accounts: Under this method only one account i.e. Partners Capital Account is prepared for each partner. All the adjustments such as share of profit or loss, interest on capital, interest on drawings, drawings, salary or commission to partners etc. are recorded in the capital accounts of the partners. This makes the balance in the capital accounts to fluctuate from time to time. It may show Debit or Credit balance. In the absence of instruction the capital account should be prepared by this method.

Dr. **Partners Capital Account** **Cr.**

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

INTEREST ON CAPITAL

Interest on partners' capital will be allowed only when it has been specifically mentioned in the partnership deed. Interest on Capital is generally provided for in two situations :

i. When the partners contribute unequal amounts of capitals but share profit equally.
ii. When the capital contribution is same but profit sharing is unequal.

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.

Journal Entries
a. In case of sufficient profits
Profit and Loss Appropriation A/c Dr.
To Interest on Capital A/c
(Being interest on capital transferred to P & L Appropriation A/c)
b. In case of Insufficient Profits or Losses
Profit and Loss / Profit and Loss Adjustment A/c Dr.
To Interest on Capital A/c
(Being interest on capital transferred to P&L Adjustment A/c)

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)	xxx
ADD : Drawings made during the year	xxx
ADD : Share of Loss During the year (if any)	xxx
Less : Additional Capital introduced (if any)	xxx
Less : Share of Profit during the year (if any)	xxx
Capital in the beginning	xxx

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 x 6/12 as money is utilized for 6 months

Interest on Drawings

Drawing 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	Drawings against capital
1.	This is the amount withdrawn from profits.	This is the amount withdrawn from capital.
2.	It is shown in the debit side of drawings account	It is shown on the debit side of capital account
3.	It is made out of profit, so does not affect the capital	It is made out of capital, it reduces the capital
4.	It is ignored at the time of calculation of interest on drawings	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 :
Average period = (Time after first drawing + time after last drawing)/2
Step 2. Calculate interest on drawings :
Interest on drawings = Total drawings x Rate x 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 :
a. Simple Interest Method : In this method, interest on drawing is calculated for each amount of drawing individually of the basis of periods for which
b. 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*:
(a) Drawings are made in the beginning of each half: Interest = Amount x Rate x 9/12
(b) Drawings are made in the middle of each half : Interest = Amount x Rate x 6/12
(c) Drawings are made at the end of each period half : Interest = Amount x Rate x 3/12

5. *For monthly drawings*
(a) Drawings are made in beginning of each month : Interest = Amount x Rate x 6.5/12
(b) Drawings are made in the middle of each month : Interest = Amount x Rate x 6/12

(c) Drawings are made in the end of each month : Interest = Amount x Rate x 5.5/12

6. *For Quarterly drawings*
(a) Drawings are made in beginning of each Quarter : Interest = Amount x Rate x 7.5/12
(b) Drawings are made in the middle of each Quarter : Interest = Amount x Rate x 6/12
(c) Drawings are made in the end of each Quarter : Interest = Amount x Rate x 4.5/12

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 x 6/12

Important Points
1. When date of withdrawal is not given, it is mainly assumed to be in the middle of month.
2. When different amounts are withdrawn at different intervals, product method is used for the calculation of interest.
3. In the absence of partnership deed or if partnership deed is there but silent about interest, No interest will be charged on drawings.
4. Interest will be credited to P/L Appropriation Account and Debited to partners' capital/current Account.

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.)	xxx	xxx
Step 2. Less : Amount already received (wrong Profit)	xxx	xxx
	xxx	xxx

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

Gaining 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.

Methods for Valuation of Goodwill

Average Profit Method
This method is based on the assumption that a new business firm will not be able to earn high profits in the first few years of its operations. That is why goodwill is valued at an agreed number of years purchase of the average profits of the past few years. The profit earned by a Firm during previous accounting periods on an average basis is called average profit. Goodwill is calculated on the basis of average profit due to future expectations of earning capacity of the firm.

Steps of Calculating the Average Profits
Step 1. Calculate the adjusted Profits:
Sometimes profits for last few years are given with some adjustments.
To calculate the adjusted profits :
(+) Non Recurring Losses and Non Business Expenses.
(+) Recurring Incomes and Gains.
(-) Non Recurring incomes and Gains.
(-) Recurring expenses and losses.
Step 2. Calculate Average Profit :
Average Profits = Adjusted profits/No. of years

Step 3.Calculation of Goodwill Average Profit Method
After calculating the adjusted profit calculated goodwill by multiplying the adjusted profit with Agreed No. of Years Purchase.
Goodwill = Adjusted Average Profit x No. of Years Purchase

Weighted Average Profit Method :

When the profits are increasing at decreasing trend it is better to use the weighted average profit method. This method is modified version of average profit method. This method is better than the simple average method because it gives weightage to latest profit, which is likely to be maintained in the future by the firm. It is applicable when the profit shows a rising or falling trend. To calculate the goodwill by weighted average profit method, following steps should be taken:

Step 1. Multiply each years profits with the respective number of weights i.e., 1 ,2 , 3, 4, 5 etc., in order to find out the value of total products.

Step 2. Calculate weighted average profit : Total of Products of profits/total of weights

Step 3. Calculate the Goodwill: Weighted average profits x Agreed No. of years purchase

Super Profit Method

The Term super profit is described as excess profit of a business made over normal profit. In simple words, it is the difference (excess) between Average Annual Earning (actual) of the business and the expected or normal return on capital invested.

To calculate the goodwill under super profit method , first we calculate the actual average profit and than Normal Profit (which is calculated on the basis of capital employed) difference of average profit and normal profit is known as super profit.

If a firm earns higher profit in comparison to normal profit (generaly earned by other firms of same industry) then the difference is called Super Profit. Goodwil is calculated on the basis of Super profit due to future expectations of learning capacity of the firm.

Super profit = Average profit - Normal profit

Normal Profit = Investment (Capital Employed) x Normal Rate of Return/100

Distinction Between Average Profit Method and Super Profit Method

Basis	Average Profit Method	Super Profit Method
Meaning	This is the average of last few years profit divided by No. of years	This is the excess of average profit over normal profits
Calculation of Goodwill	Average Profit x No. of years Purchase	Super Profit x No. of years purchase

Capitalisation Method

In this method capitalized value of the firm is calculated on the basis of normal rate of return. Difference between the capitalized value and actual capital employed is called goodwill.

Capitalisation of Average Profit

Under this method, to find out the value of goodwill, deduct the actual capital employed (net assets) in the business from the capitalized value of the average profits on the basis of normal rate of return. This involves the following steps:

(i) First of all find out the average profit (on the basis of last few years profit)

(ii) Capitalize the average profits on the basis of the normal rate of return to ascertain the capitalised value of average profits as follows:

Average Profits × 100/Normal Rate of Return

(iii) Find out the actual capital employed (net assets) by deducting outside liabilities from the total assets (excluding goodwill).

Capital Employed = Total Assets (excluding goodwill) – Outside Liabilities

(iv) To find out the value of goodwill deduct net assets from the capitalised value of average profits, i.e. (iii) – (iv).

Capitalisation of Super Profit
Sometimes Goodwill can also be calculated by capitalising the super profit directly. Under this method there is no need to work out the capitalised value of average profits. It involves the following steps.
(i) Calculate capital employed of the firm, which is equal to total assets minus outside liabilities.
(ii) Calculate normal profits on capital employed.
(iii) Calculate average profit for past years, as specified.
(iv) Calculate super profits by deducting normal profits from average profits.
(v) Multiply the super profits by the required rate of return multiplier, that is,
Goodwill = Super Profits × 100/ Normal Rate of Return

Admission of a Partner

At the time of admission of a new partner, following adjustments are required:
1. Calculation of new profit sharing ratio and sacrificing ratio.
2. Accounting treatment of Goodwill.
3. Accounting treatment of accumulated profit.
4. Accounting treatment of revaluation of assets and reassessment of liabilities.
5. Adjustment of capital in new profit sharing ratio

'Section 31 of the Indian Partnership Act 1932' _____
Provides that a new partner can be admitted into a firm with the consent of all the partners. When a new partner is admitted, the existing partnership agreement comes to an end and a new agreement comes into effect. This is called reconstitution of partnership.

The Main Rights of a new partner:
1. Right to share in the future profits of the partnership firm.
2. Right to share the assets of the partnership firm.

Effects of admission of a Partner
1. Old partnership agreement comes to an end, and a new partnership agreement takes place.
2. He will share the future profits of the firm.
3. He will contribute capital and his share of premium for goodwill.
4. Goodwill of the firm is valued , assets are revalued, liabilities are Re-assessed and necessary adjustments are made.

Calculation of Ratios
Sacrificing Ratio **:** Ratio in which partners sacrifice their share of profit in favour of a new partner or incoming partner is called sacrificing ratio. It is the difference of old share and new share of the partners.

Sacrificing Ratio = Old Ratio - New Ratio

New Ratio = Old Ratio – Sacrificing ratio

Treatment of Goodwill

At the time of admission of a new partner goodwill is valued and Old goodwill (purchased goodwill) is written off by the old partners. Goodwill is the result of hard work and the efforts made by the existing partners. At the time of the admission of a new partner who will share the future profits of the firm, he must compensate the existing partners by making payment to them. This compensation is called premium for goodwill. From accounting point of view, there may be different situations related to treatment of goodwill which are given below:

1. When premium for goodwill is paid privately.
When premium for goodwill brought by a new partner is paid privately by new partner to the old partners without bringing that money into the business, In such a Case, no entry will be recorded in the books of Accounts.

2. When premium brought in cash and retained or withdrawn by Old Partners fully or partially.

Accounting Treatment :

For premium for Goodwill brought in cash by the new partner	Cash/Bank A/c Dr. To New Partners Capital A/c To Premium for Goodwill A/c
When Full premium is brought by New partner	Premium for Goodwill A/c Dr. To Sacrificing Partners Capital A/c
When only part of premium is brought by New partner	Premium for Goodwill A/c Dr. New Partners Capital A/c To Sacrificing Partners Capital A/c
For Withdrawal of premium fully or partially	Sacrificing Partner's Capital A/c To Cash / Bank A/c

3. When premium is brought in kind
A new partner instead of bringing in cash may bring his share of premium in the form of assets.
Following journal entries are recorded for the same:

Assets A/c Dr.
To Premium for Goodwill A/c
To New partner's Capital A/c
(Being capital and premium brought by the new partner)

Premium for Goodwill A/c Dr.
To Sacrificing partners capital / Current A/c
(Being premium transferred to sacrificing partners)

4. Goodwill already existing in books
At the time of admission of a new partner goodwill appearing in the balance sheet should be written off by the old partners in their old profit ratio.

Old Partners Capital A/c Dr.
To Goodwill A/c
(Being goodwill account written off)

5. Hidden Goodwill
When the value of Goodwill is not mentioned, it is assumed that goodwill is hidden or to be calculated. At the time of admission of a new partner the total goodwill of the firm is calculated to know the share of new partners. In such a case goodwill is calculated on the basis of an inferred method of profit sharing ratio or capitalization method.

Calculation of Hidden Goodwill

Step 1.	Calculate closing capital of old partner's. (Through Capital Accounts)
Step 2.	Calculate combined Capital : Combined Capital = Closing Capitals of old partners + Capital of new partner
Step 3.	Calculate Total Capital of the Firm : Total Capital = New partner's Capital x Reciprocal of his share For example if he brings Rs.20,000 as capital for 1/5th share in profits. Total capital of the firm will be : 20,000 x 5/1 = 1,00,000
Step 4.	Calculate Goodwill : Goodwill = Total Capital of the firm – Combined Capital

Note : This method is known as inferred method of Goodwill.

Revaluation of Assets and Re-assessment of liabilities

When a new partner is admitted to the partnership firm, he brings capital and his share of premium for goodwill. He acquires the ownership rights of the assets and also makes himself responsible for the firms liabilities. He can access freely all records and books of accounts, to know that assets and liabilities are correctly valued or revalued. At this time there may be increase or decrease in the value of assets and liabilities. Such increase or decrease are treated as partnership profits or losses and should be distributed among the old partners in old ratio.
For recording this, a separate account is opened, which is known as Profit and Loss Adjustment Account or Revaluation Account.
Following journal entries are recorded on Revaluation of assets and Re-assessment of liabilities.

For increase in the value of Assets	Asset A/c Dr. To Revaluation A/c
For Decrease in the value of Asset	Revaluation A/c Dr. To Asset A/c
For increase in the value of liabilities	Revaluation A/c Dr. To Liability A/c
For Decrease in the value of liabilities	Liability A/c Dr. To Revaluation A/c

When unrecorded assets are recorded	Asset A/c Dr. To Revaluation A/c
When unrecorded liabilities are recorded	Revaluation A/c Dr. To Liability A/c
When profit on revaluation transferred to old partners	Revaluation A/c Dr. To Old partners Capital A/c's
When loss on revaluation transferred to old partners	Old partner's Capital A/c's To Revaluation A/c

Proforma of Revaluation Account:

Particulars	Amount	Particulars	Amount
To Asset A/c	xxx	By Asset A/c	xxx
To Liabilities A/c	xxx	By Liabilities A/c	xxx
To Unrecorded liabilities A/c	xxx	By Unrecorded Asset A/c	xxx
To profit on revaluation transferred to old partners in old ratio.	xxx	By Loss on revaluation transferred to old partners in old ratio.	xxx
	xxx		xxx

Treatment of Reserve and Accumulated profits

At the time of admission of a new partner, A firm may have Reserves and accumulated profits or losses. All free Reserves and profits given in the liabilities side should be credited to partners capital accounts or Current Accounts (if capitals are fixed) and all fictitious Assets/Accumulated losses should be debited to the partners capital account or current Account (if capitals are fixed). A new partner is not entitled to any share in such accumulated balances of the firm while transferring these reserves and profits/ losses to the partners capital accounts, student must remember that these Reserves and profits/losses are only for old partners and should be transferred to them only, in old ratio.

Following journal entries are recorded in the books of accounts:

General Reserve A/c Dr.
Profit and Loss A/c Dr.
Workmen's Compensation Reserve A/c Dr.
To Old Partners Capital A/c's
(Being Reserves and Accumulated profits credited to old partners in their old Ratio)

Old Partner's Capital A/c's Dr.
To Preliminary Expense A/c
To Advertisement Suspense A/c
To Profit and Loss A/c
To Goodwill A/c
(Being Accumulated losses and fictitious assets debited to old partners in their old ratio)

Note : Do not distribute1) E.P.F or employee provident fund 2) Taxation reserve3) Machinery replacement fund

Adjustment of Capital

It is obvious to adjust the capitals at the time of admission of a new partner. When a new partner is admitted, the partners decide to adjust their capitals according to the new profit sharing ratio. Partners can adjust their capitals according to capital of the new partner, but sometimes a new partner may required to bring capital according to his share in profits of the firm. When the capital of new partner is given, total capital of the firm can be calculated easily.

For example if new partner brings Rs.50,000 as capital for 1/5 share in the profits, than total capital of the firm can be found as 50,000 x 5/1 = 2,50,000 (Total capital of firm)

After calculating total capital of the firm , Capital of the other partners can also be calculated on the basis of total capital. For example if ratio between three partners is 2 : 2 : 1

A's Capital = 2,50,000 x 2/5 = 1,00,000

B's Capital = 2,50,000 x 2/5 = 1,00,000

C's Capital = 50,000

After calculating these capitals, show these capitals as balance c/d in the partners capital A/c. And now see the difference coming on the debit side or credit side. If difference on debit side it means it is excess and should be withdrawn by the partner if difference on credit side it means partner will bring more capital (Adjust Difference through Cash A/c).

But sometime excess or deficiency is adjusted through current Accounts. There are different cases for the adjustment of capital.

1. When new partner's Capital is given and old partners adjust their capitals according to new partner's capital. Excess and deficiency will be adjusted though cash A/c.
2. When new partner's Capital is given and old partners adjust their capitals according to new partner's capital. Excess and deficiency will be adjusted though current A/c.
3. When new partner's Capital is not given.
4. When new partner's capital is not given and old partners also adjusting their capitals.
5. When Total capital of the firm is given in the adjustment.

Note :

To find out the total capital of the firm use following formula:

New partner's capital x Reciprocal of new partners share

Retirement/Death of a Partner

Amount payable to a Retiring partner

(To be credited to his capital account)

1. Credit Balance of his capital.
2. Credit Balance of his current account (if any)
3. Share of Goodwill.
4. Share of Reserves or Undistributed profits.
5. His share in the profit revaluation of assets and liabilities.
6. Share in profits up to the date of Retirement/Death.
7. Interest on capital if involved.
8. Salary if any

Deduction from the above sum(to be debited to the capital account)

1. Debit balance of his current account (if any)

2. Share of Goodwill to be writ en off.
3. Share of Accumulated loss.
4. Drawings and interest on drawings (if any)
5. Share of loss on account of Revaluation of assets and liabilities.
6. His share of business loss.

Accounting Treatement
1. Calculation of new profit sharing ratio and gaining ratio
2. Treatment of goodwill .
3. Revaluation Account preparation with the adjustment in the respect of unrecorded assets/liabilities.
4. Distribution of reserves and accumulated profits/loss.
5. Ascertainment of share of profits/loss till the date of retirement
6. Adjustment of capital if required
7. Settlement of the Accounts due to Retired partner

Death of a Partner

Amounts to be Credited in the Decease partners capital Account :
i) Balance of Capital
ii) Share in Revaluation Profit
iii) Interest on Capital
iv) Accumulated profits/ Reserves etc.
v) P/L Suspense A/c (Profit)
vi) Commission/ Salary etc.
vii) Any Liability taken over
Amounts to be Debited in the Decease partners capital Account :
i) Accumulated losses
ii) Goodwill A/c
iii) Interest on Drawings
iv) Drawings
v) Any Asset taken over
vi) Revaluation loss (if any)
vii) P/L Suspense A/c (Loss)

Profit till death of partner is calculated by any one of the two methods given below:-
a) On Time Basis: - in this method proportionaly profit for the time period is calculated either on the basis of last year's profit or on the basis of average profits of last few years and then deceased partner's share is calculated based on his share of profits.
b) On Turnover or Sales Basis- In this method the profits upto the date of death for the current year are calculated on the basis of current year's sales upto the date of death by using the formula. Profits for the current year upto the date of death = (Sales of the current year upto the date of death/total sales of last year) x Profit for the last year.

Then from this profit the deceased partner's share of profit is calculated.

Journal Entry for the Profit of deceased partner will be :
Profit and Loss Suspense A/c Dr.
To Deceased Partner's Capital/current A/c
(Being amount of profit transferred in deceased partners capital/current account)

Joint Life Policy

A partnership firm may decide to take a Joint Life Insurance Policy on the lives of all partners. The firm pays the premium and the amount of policy is payable to the firm on the death of any partner or on the maturity of policy whichever is earlier. The objective of taking such a policy is to minimise the financial hardships to the event of payment of a large sum to the legal representatives of a deceased partner or to the retiring partner.

The accounting treatment for the premium paid and the Joint Life Policy may be in any of the following ways:

1. When premium paid is treated as an expense: When premium is treated as an expense then it is closed every year by transferring to profit and loss account. In this case complete amount received from the insurance company either on a surrender of policy or on the death of the partner becomes a gain.

Accounting entries are:

(a) On payment of premium

Joint Life Policy Insurance Premium A/c Dr.

To Bank A/c

(b) On charging to Profit and Loss Account

Profit and Loss Account Dr.

To Joint Life Policy Insurance Premium A/c

(c) On maturity of the Policy

Insurance Company/ Bank Account Dr.

To Partners' Capital A/cs (individually)

(Including the account of the representative of a deceased partner)

2. When premium paid is treated as an asset: In this case insurance premium paid is first debited to life policy account and credited to bank account. At the end of the year the amount in excess of surrender value is treated as a loss and is transferred to Profit and Loss Account. In this case the amount received from the insurance company in excess of the surrender value results in a gain at the time of receipt of such amount which is transferred to Capital Accounts of the partners in the profit sharing ratio.

3. Creation of Joint Policy Reserve Account: Under this method, premium paid is debited to policy account and credited to bank account. At the end of the year, amount equal to premium is transferred from Profit and Loss Appropriation Account to Policy Reserve Account. After this, policy account is brought down to its surrender value by debiting the life policy reserve account with amount which exceeds the surrender value of the policy. Thus, in this method, policy account appears on the assets side and policy reserve account appears on the liabilities side of the Balance Sheet until it is realised. Both these accounts appear in the Balance Sheet at the surrender value of the policy. This method is different from the method discussed in (2) above only in respect of reserve account.

On the death of a partner Joint Life Policy Reserve Account is transferred to Joint Life Policy Account and then the balance is transferred to Partners' Capital Accounts.

Right of Outgoing Partner in Certain Cases to Share Subsequent

Profits As per provisions of Section 37 of the Indian Partnership Act., "Where any member of a firm has died or otherwise ceased to be a partner, and the surviving or continuing partners carry on the business of the firm with the property of the firm without any final settlement of accounts as between them and the outgoing partner or his estate, then, in the absence of a contract to the contrary, the outgoing partner or his estate is entitled at the option of himself or his representatives to such share of the profits made since he ceased to be a partner as may be attributable to the use of his share of the property of the firm or to interest at the rate of six per cent per annum on the amount of his share in the property of the firm.

Provided that whereby contract between the partners an option is given to surviving or continuing partners to purchase the interest of a deceased or outgoing partner, and that option is duly exercised, the estate of the deceased partner, or the outgoing partner or his estate, as the case may be, is not entitled to any further or other share of profits; but if any partner assuming to act in exercise of the option does not in all material respects comply with the terms thereof, he is liable to account under the foregoing provisions of this section.

This way, the outgoing partner has the option to receive,

interest at the rate of 6% p.a.

or

the share of profit earned on the unsettled amounts for the period till his dues are settled by the firm in the absence of any contract made to the contrary.

"You can never be overdressed or overeducated."
