

1. Introduction

Business activities often require **more capital, skill, and effort** than what a single person can provide. To overcome these limitations, people come together and form a **partnership**.

In partnership:

- Ownership is shared
- Profits and losses are shared
- Decisions are taken jointly
- Business risks are distributed

Accounting for partnership firms is more complex than sole proprietorship because:

- Profit sharing ratios differ
- Capital contributions vary
- Interest, salary, commission may be allowed
- Adjustments are frequently required

2. MEANING OF PARTNERSHIP

A **partnership** is a relationship between persons who agree to:

- Carry on a business
- Share its profits and losses

Legal Definition

According to **Indian Partnership Act, 1932**:

“Partnership is the relation between persons who have agreed to share the profits of a business carried on by all or any of them acting for all.”

3. ESSENTIAL ELEMENTS OF PARTNERSHIP (Deep Explanation)

1. Agreement

- Partnership arises from **agreement**, not status
- Agreement may be **written or oral**

2. Two or More Persons

- Minimum: 2 persons
- Maximum:
 - 10 (banking business)
 - 20 (other businesses)

3. Business

- Must involve **economic activity**
- Not formed for charity

4. Sharing of Profits

- Profit sharing is compulsory
- Loss sharing usually follows profit ratio

5. Mutual Agency (Most Important)

- Every partner acts as **agent and principal**
- Act of one partner binds the firm



❖ Flowchart: Elements of Partnership

Agreement



Business



Profit Sharing



Mutual Agency

4. PARTNERSHIP DEED

A **Partnership Deed** is a written document containing the **terms and conditions** agreed upon by partners.

Importance

- Avoids disputes
- Provides clarity
- Acts as legal evidence

Contents of Partnership Deed

1. Name and address of firm
2. Nature of business
3. Capital contribution
4. Profit sharing ratio
5. Interest on capital
6. Interest on drawings
7. Partner's salary/commission
8. Admission/retirement rules
9. Valuation of goodwill
10. Settlement of disputes

5. RULES IN ABSENCE OF PARTNERSHIP DEED

If deed is silent:

- Profit shared **equally**
- No interest on capital
- No interest on drawings
- No salary or commission
- Interest on loan @ **6% p.a.**

6. PROFIT SHARING RATIO (PSR)

Meaning

The ratio in which partners agree to share profits and losses.

Types

- Equal ratio
- Unequal ratio
- New ratio (after change)

7. CAPITAL ACCOUNTS OF PARTNERS

Capital account records:

- Capital introduced
- Withdrawals

- Profit share
- Adjustments

❖ Types of Capital Accounts



Fixed Capital Fluctuating Capital

❖ Fixed Capital Method

- Capital remains fixed
- Separate **Current Account** maintained

Capital Account Records:

- Capital introduced
- Permanent changes only

Current Account Records:

- Interest on capital
- Drawings
- Salary
- Share of profit

❖ Fluctuating Capital Method

- Only one account
- Capital changes frequently
- All items recorded in capital account

8. DRAWINGS

Meaning

Amount withdrawn by partners for **personal use**.

Forms of Drawings

- Cash
- Goods
- Assets

9. INTEREST ON DRAWINGS

Purpose

- Discourage excessive withdrawals
- Compensate firm

Methods of Calculation

1. Simple Method
2. Product Method

Journal Entry

Partner's Capital A/c Dr.

To Interest on Drawings A/c

10. INTEREST ON CAPITAL

Meaning

Interest allowed on capital invested by partners.

Conditions

- Allowed only if deed permits
- Treated as **appropriation of profit**

Journal Entry

Interest on Capital A/c Dr.
To Partner's Capital A/c

11. PARTNER'S SALARY / COMMISSION

- Reward for extra effort
- Allowed only if deed exists
- Appropriation of profit

12. PROFIT & LOSS APPROPRIATION ACCOUNT

Meaning

Prepared to show **distribution of net profit** among partners.

Format

Profit & Loss Appropriation A/c

Dr.	Cr.
Interest on Capital	Net Profit
Partner's Salary	Interest on Drawings
Commission	
Share of Profit	

13. DIFFERENCE: P&L A/c vs P&L APPROPRIATION A/c

Basis	P&L A/c	P&L Appropriation
Objective	Find profit	Distribute profit
Stage	Before	After
Nature	Nominal	Extension

14. GUARANTEE OF PROFIT

Meaning

Guarantee given to partner for minimum profit.

Treatment

- If actual < guaranteed → deficiency borne by:
 - Firm, or
 - Other partners

15. PAST ADJUSTMENTS

Meaning

Corrections of errors made in past years.

Common Errors

- Omission of interest
- Wrong PSR
- Salary not given

❖ Flowchart

Identify Error



Calculate Correct Amount



Find Difference



Adjustment Entry

16. ADJUSTMENT ENTRY

Single journal entry passed to correct all past errors.

17. CLOSING ENTRIES IN PARTNERSHIP

- Transfer P&L balance
- Transfer appropriations
- Balance capital accounts

18. IMPORTANT ACCOUNTING TERMS

- Mutual Agency
- Drawings
- Appropriation
- Capital
- Profit sharing ratio

19. NUMERICAL PRACTICE AREAS

- Interest on drawings (dates based)
- P&L Appropriation A/c
- Fixed vs fluctuating capital
- Adjustment entries

20. EXAM-ORIENTED QUESTIONS

Very Short

- Define partnership
- What is PSR?

Short

- Explain partnership deed
- Interest on capital

Long

- Capital accounts methods
- P&L Appropriation A/c
- Guarantee of profit

21. COMMON MISTAKES BY STUDENTS

- Allowing interest without deed
- Wrong order in appropriation
- Ignoring past adjustments

21. ONE-DAY REVISION POINTS

- Deed > Rules
- Interest & salary = appropriation
- Fixed capital → current account

- Mutual agency is key feature

FINAL SUMMARY

This chapter lays the **foundation of partnership accounting**. A strong command over this chapter is essential for:

- Admission of partner
- Retirement
- Death
- Dissolution

NUMERICAL 1: Profit Sharing Ratio

A and B are partners sharing profits in the ratio **3 : 2**.

They admit **C** for **1/5th share**.

Find the **new profit sharing ratio**.

Solution:

Old PSR = 3 : 2

A's share = $\frac{3}{5}$

B's share = $\frac{2}{5}$

C's share = $\frac{1}{5}$

Remaining share = $1 - \frac{1}{5} = \frac{4}{5}$

New PSR:

- $A = \frac{3}{5} \times \frac{4}{5} = \frac{12}{25}$
- $B = \frac{2}{5} \times \frac{4}{5} = \frac{8}{25}$
- $C = \frac{5}{25}$

New PSR = 12 : 8 : 5

NUMERICAL 2: Interest on Capital

A and B are partners with capitals ₹1,00,000 and ₹80,000.

Interest on capital @ **10% p.a.**

Profit for the year = ₹30,000.

Solution:

Interest on Capital:

- $A = 10\% \text{ of } 1,00,000 = ₹10,000$
- $B = 10\% \text{ of } 80,000 = ₹8,000$

Total Interest = ₹18,000

Remaining profit = $30,000 - 18,000 = ₹12,000$

Shared equally:

A = ₹6,000

B = ₹6,000

NUMERICAL 3: Interest on Drawings

A withdrew ₹2,000 at the **beginning of every month**.

Rate of interest = **12% p.a.**

Solution:

Total Drawings = $2,000 \times 12 = ₹24,000$

Average Period = $(12 + 1) / 2 = 6.5 \text{ months}$

$$\text{Interest} = 24,000 \times 12\% \times 6.5 / 12 \\ = \text{₹1,560}$$

NUMERICAL 4: Fixed Capital Method

Partners A and B have fixed capitals of ₹2,00,000 and ₹1,50,000.

Interest on capital @ 10%.

Profit = ₹70,000.

PSR = 3 : 2.

Solution:

Interest:

- A = ₹20,000
- B = ₹15,000

Balance profit = 70,000 – 35,000 = ₹35,000

Profit Share:

- A = 35,000 × 3/5 = ₹21,000
- B = 35,000 × 2/5 = ₹14,000

NUMERICAL 5: Fluctuating Capital Method

A and B have opening capitals ₹1,00,000 and ₹80,000.

Profit = ₹36,000 shared equally.

Drawings: A ₹10,000, B ₹8,000.

Solution:

Profit share:

- A = ₹18,000
- B = ₹18,000

Closing Capital:

- A = 1,00,000 + 18,000 – 10,000 = ₹1,08,000
- B = 80,000 + 18,000 – 8,000 = ₹90,000

NUMERICAL 6: Partner's Salary

A and B share profits equally.

B is allowed salary ₹12,000 p.a.

Profit = ₹52,000.

Solution:

Profit after salary = 52,000 – 12,000 = ₹40,000

Profit share:

A = ₹20,000
B = ₹20,000

Total for B = 20,000 + 12,000 = ₹32,000

NUMERICAL 7: Guarantee of Profit

P and Q share profits in 3 : 2.

Q is guaranteed ₹25,000.

Actual profit = ₹40,000.

Solution:

Actual share:

P = 40,000 × 3/5 = ₹24,000
Q = 40,000 × 2/5 = ₹16,000

Deficiency to Q = 25,000 – 16,000 = ₹9,000

Borne by P.

Final share:

P = 24,000 – 9,000 = ₹15,000

Q = ₹25,000

NUMERICAL 8: Past Adjustment

A and B share profits equally.

Interest on capital @10% was omitted.

Capitals: A ₹1,00,000, B ₹50,000.

Solution:

Interest:

A = ₹10,000

B = ₹5,000

Difference = ₹5,000

Adjustment Entry:

A's Capital A/c Dr. 2,500

To B's Capital A/c 2,500

NUMERICAL 9: Interest on Drawings (Different Dates)

A withdrew:

₹5,000 on 1 Jan

₹5,000 on 1 April

Rate = 12% p.a.

Solution:

Interest:

Jan: $5,000 \times 12\% \times 12/12 = ₹600$

April: $5,000 \times 12\% \times 9/12 = ₹450$

Total Interest = ₹1,050

NUMERICAL 10: Profit & Loss Appropriation A/c

Profit = ₹60,000

Interest on capital ₹10,000

Partner's salary ₹6,000

Solution:

Balance profit = $60,000 - 16,000 = ₹44,000$

Distributed as per PSR.

A. CONCEPT FLOW CHARTS (VERY SCORING)

1. Formation of Partnership – Accounting Flow

Agreement Between Partners



Capital Contribution



Profit Sharing Ratio Decided



Interest on Capital (if agreed)



Interest on Drawings (if agreed)



Preparation of:

- P&L A/c
- P&L Appropriation A/c
- Capital Accounts

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Exam Use:

Asked in theory as

“Explain accounting procedure of a partnership firm.”

2. Flow Chart: Profit Distribution Process

Net Profit (from P&L A/c)



Transferred to
P&L Appropriation A/c



Less:

- Interest on Capital
- Partner's Salary/Commission



Add:

- Interest on Drawings



Remaining Profit



Distributed in Profit Sharing Ratio

Key Rule:

✗ No appropriation directly from P&L A/c.

3. Flow Chart: When Partnership Deed Exists

Partnership Deed Present



Follow Deed Provisions



Apply:

- Interest on Capital (rate given)
- Interest on Drawings
- Salary/Commission
- Profit Sharing Ratio

4. Flow Chart: When Partnership Deed is Absent

No Partnership Deed



Apply Indian Partnership Act, 1932



Rules:

- Equal profit sharing
- No interest on capital
- No salary
- Interest on drawings @6%

B. DIAGRAMS (FOR CONCEPT CLARITY)

1. Structure of Partner's Capital Accounts

Partner's Capital A/c

- Fixed Capital Method
(Capital A/c remains constant)
- Fluctuating Capital Method
(Capital A/c changes every year)

Exam Tip:

Method must be mentioned before writing journal entries.

2. Diagram: Fixed Capital Method Accounts

Partner's Capital A/c	Partner's Current A/c
-----	-----
Opening Capital	Interest on Capital
	Salary/Commission
	Share of Profit
	Drawings
	Interest on Drawings

- Capital A/c = Fixed
- Adjustments go to Current A/c

3. Diagram: Fluctuating Capital Method

Partner's Capital A/c

Opening Capital
 + Interest on Capital
 + Salary/Commission
 + Share of Profit
 - Drawings
 - Interest on Drawings
 = Closing Capital

- Only **ONE** account per partner

4. Diagram: Relationship Between Accounts

P&L A/c



P&L Appropriation A/c



Partners' Capital A/c

- **Golden Rule:**
Profit is first **earned**, then **appropriated**, then **distributed**.

C. IMPORTANT FORMULAS (NOT COMMONLY EXPLAINED)

1. Interest on Capital Formula

Interest on Capital

= Capital × Rate × Time

- Calculated **only if profits exist** (unless guaranteed).

2. Interest on Drawings (When Drawings are Uniform)

Interest = Total Drawings $\times$ Rate $\times$ Average Period

- Average Period:

Beginning of year $\rightarrow$ 6.5 months

Middle of year $\rightarrow$ 6 months

End of year $\rightarrow$ 0 months

3. Profit Sharing Formula

Partner's Share of Profit

= Total Profit $\times$ Partner's Ratio

4. Guarantee of Profit (Basic Formula)

Deficiency

= Guaranteed Amount – Actual Share

- Deficiency borne by **guaranteeing partner only**.

5. Closing Capital Formula

Closing Capital

= Opening Capital

+ Share of Profit

+ Interest on Capital

+ Salary/Commission

- Drawings

- Interest on Drawings

6. Manager's Commission Formula

- On Profit before Commission

Commission = Profit $\times$ Rate / 100

- On Profit after Commission

Commission = Profit $\times$ Rate / (100 + Rate)

For questions like

"Explain Profit & Loss Appropriation Account"

Write in order:

1. Meaning
2. Flow chart
3. Diagram
4. Formula
5. Journal entry

E. QUICK MEMORY TRICKS

- Profit is earned $\rightarrow$ then shared
- Interest on Capital = Appropriation
- Drawings always reduce capital
- No deed = Equal sharing
- Appropriation $\neq$ Expense



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