

1. Nature of Partnership Firm

Definition and Essential Features

According to **Section 4 of the Indian Partnership Act, 1932**, partnership is defined as 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**".

Individuals who enter into a partnership are called '**partners**', and collectively they are known as a '**firm**'. The business operates under a '**firm's name**'.

The essential characteristics of a partnership include:

- **Two or More Persons:** There must be at least two persons. While the Companies Act 2013 allows for up to 100 partners, the Central Government has currently prescribed a **maximum limit of 50 partners**.
- **Agreement:** Partnership arises from a contract (oral or written), not from status. This agreement forms the basis of the partners' relationship.
- **Business:** The purpose must be to carry out a legal business with a profit motive. Mere co-ownership of property is not a partnership.
- **Mutual Agency:** This is the "cardinal principle". The business can be carried on by all or any partner acting for all. Each partner is both a **principal** (bound by others' acts) and an **agent** (can bind others by his acts).
- **Sharing of Profit:** Partners must agree to share profits and losses. Charitable activities do not constitute a partnership.
- **Unlimited Liability:** Every partner is **jointly and severally liable** for all acts of the firm.

Their private assets can be used to settle firm debts.

The Partnership Deed

While the law does not mandate a written agreement, it is highly desirable to have one to avoid future disputes. A written document containing the agreed terms is called the **Partnership Deed**.

Importance of the Deed:

- It regulates the rights, duties, and liabilities of each partner.
- It serves as evidence in the event of a dispute.
- It clarifies financial arrangements like profit-sharing ratios and interest rates.

Common Contents of a Deed: Names/addresses of the firm and partners, capital contributions, PSR (Profit Sharing Ratio), interest on capital/drawings, salary/commission, and rules for admission, retirement, or dissolution.

Provisions of the Indian Partnership Act, 1932 (In the Absence of a Deed)

In CUET, a common area of testing is the application of rules when a deed is silent. If there is no express agreement, the following provisions apply:

1. **Profit Sharing Ratio:** Profits and losses are shared **equally**, regardless of capital contribution.
2. **Interest on Capital (IOC):** No partner is entitled to IOC.
3. **Interest on Drawings (IOD):** No interest is charged on drawings.

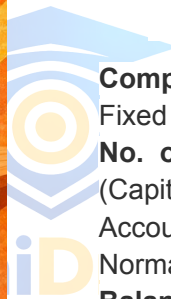
- Interest on Partner's Loan:** If a partner provides a loan beyond their capital, they are entitled to interest at **6% per annum**.
- Remuneration:** No partner is entitled to any salary or commission for taking part in the business.

- Partner's Current Account:** Records all other adjustments such as drawings, interest on drawings, IOC, salary, commission, and share of profit/loss. This account may show a **debit or credit balance**.

II. Fluctuating Capital Method

This is the default method if no specific instruction is given. Under this method, **only one account** (the Capital Account) is maintained for each partner.

- All transactions (capital, drawings, IOC, IOD, salary, etc.) are recorded directly in this single account.
- Consequently, the balance of the account **fluctuates** regularly.
- The account may sometimes show a **debit balance** (e.g., in case of heavy losses or excessive drawings).



2. Accounts of Partnership: Maintenance of Capital Accounts

All transactions between the partners and the firm (capital, drawings, profit shares, interest, etc.) are recorded in the **Partners' Capital Accounts**. There are two primary methods for maintaining these accounts:

I. Fixed Capital Method

Under this method, the capital of partners remains fixed unless additional capital is introduced or a permanent withdrawal of capital is made. **Two accounts** are maintained for each partner:

- Partner's Capital Account:** Records only the initial capital, additional capital, and permanent withdrawals of capital. It **always shows a credit balance**.

Comparison Table for CUET Revision:			
Basis		Fixed Capital	
Fluctuating Capital		:---	
No. of Accounts		Two (Capital & Current)	
Adjustments		Made in Current Account	
Balance		Normally remains unchanged	
Balance Type		Always Credit	

3. Division of Profit Among Partners

In a sole proprietorship, net profit is transferred directly to the owner's capital account. In a partnership, profits must be adjusted for partner-specific items like IOC and salary before final distribution.

Profit and Loss Appropriation Account

The **P&L Appropriation Account** is an **extension of the Profit and Loss Account**. Its purpose is to show how the net profit is appropriated (distributed) among the partners.

Key Features:

- It starts with the **Net Profit** (credited) or **Net Loss** (debited) transferred from the P&L Account.

- **Debited with:** Interest on Capital, Partner Salaries, Partner Commissions, and transfers to Reserves.
- **Credited with:** Interest on Drawings.
- **Final Balance:** The remaining profit or loss is distributed among partners in their **agreed Profit Sharing Ratio**.

Crucial Note for CUET: If the firm suffers a **net loss**, no interest on capital or salaries are allowed to partners. If the profit is insufficient to cover all appropriations, the available profit is distributed in the **ratio of the appropriations** (e.g., the ratio of IOC due to each partner).

4. Guarantee of Profit to a Partner

Sometimes, a partner is admitted with an assurance that their share of profit will not fall below a specific **guaranteed amount**.

Scenarios of Guarantee:

1. **Guarantee by the Firm:** All old partners bear the deficiency in their existing PSR.
2. **Guarantee by One Partner:** Only that specific partner bears the entire deficiency.
3. **Guarantee by Multiple Partners in a Specific Ratio:** The deficiency is borne by specific partners in an agreed-upon ratio.

Steps to Calculate:

1. Calculate the actual share of profit for the guaranteed partner based on the PSR.
2. Determine the **deficiency** (Guaranteed Amount - Actual Share).

3. Distribute this deficiency among the guaranteeing partners in their agreed ratio.
4. Subtract the deficiency from the guaranteeing partners' shares and add it to the guaranteed partner's share.



5. Past Adjustments (Rectification of Errors)

If errors or omissions (like forgetting IOC, IOD, or using the wrong PSR) are discovered **after** the final accounts are prepared and profits distributed, the firm does not alter the closed accounts. Instead, an **adjustment entry** is passed.

Types of Adjustments:

- **Through P&L Adjustment Account:** A temporary account is opened to rectify errors, and the net profit/loss of this account is then distributed among partners.
- **Directly in Partners' Capital Accounts:** This is done by preparing a **Statement showing Net Effect of Omissions**.

The Statement Approach:

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| <ol style="list-style-type: none"> 1. List the amounts that should have been credited to each partner (e.g., IOC, Salary). 2. List the amounts that should have been debited (e.g., IOD). 3. Calculate the net amount that was incorrectly distributed as profit. 4. Compare the "Correct Credit/Debit" with what was "Actually Distributed". 5. Pass a single journal entry: Gaining Partner's Capital A/c Dr. to Sacrificing Partner's Capital A/c. | <p>calculated on the opening capital; adjust for additional capital or permanent withdrawals.</p> <ul style="list-style-type: none"> • Interest on Drawings (Average Period Method): If withdrawn on the first day of every quarter, interest is calculated for 7.5 months. If at the end of every quarter, it is 4.5 months. • Sacrificing Ratio: Old Share–New Share. • Gaining Ratio: New Share–Old Share. |
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Summary of Relevant Accounting Principles for CUET

- **Business Entity:** The firm is a separate accounting entity, though not a separate legal entity from its partners.
- **Accrual Basis:** Interest and salaries are provided based on the time period they relate to, regardless of cash payment.
- **Consistency:** Methods for capital accounts (Fixed vs. Fluctuating) should generally be applied consistently across periods.
- **Full Disclosure:** All terms affecting partner relationships should be documented in the Deed to provide transparency.

Quick Formula Reference

- **Interest on Capital:** Capital Amount × Rate × Time. Note: Always