

Chapter-2

Accounting for Partnership-Basic Concept

Partnership is a form of business organization in which two or more competent persons join hands to carry on any lawful business after entering into an agreement to share the profit and loss of the business. Persons who have entered into partnership are individually called partners and collectively called firm.

Definition

Section_4 of the Indian Partnership Act 1932 defines partnership as “the relation between persons who have agreed to share the profits of a business carried on by all or any one of them acting for all”.

Nature of partnership

The essential features of partnership are:

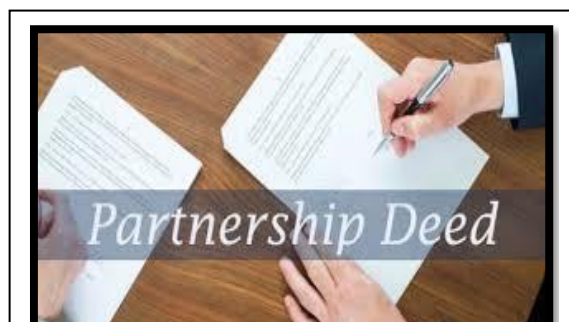
- 1 **Number of persons:** In order to form a partnership there must be at least **two** persons. Maximum limit is **hundred**.
- 2 **Agreement:** In order to form a partnership there must be an agreement .The agreement may be oral or written.
Note: It is not necessary to that such agreement is in written form. An oral agreement is equally valid. But in order to avoid disputes, it is preferred that the partners have written agreement. The written agreement is known as **partnership deed**.
- 1 **Always to conduct a business:** The agreement should be to carry on some lawful business.
- 2 **Unlimited liability:** In partnership the liability of each partner is unlimited. It is joint and several.
- 3 **No separate legal existence:** A partnership is not a legal entity. It has no separate legal existence apart from its members. It can't purchase property on its own name.
- 4 **Sharing of profit/ loss:** The profit should be shared by the partners in an agreed ratio. If there is no specific agreement in this regard, the partners will share the profit equally.
- 5 **Mutual agency:** Each partner can participate in the conduct of a business and act for the firm. Similarly, each partner is bound by the acts of other partners. Thus a partner is both an agent and a principal. He is an agent when he makes the other partners liable for his acts. He is the principal when the other partners make him liable for their acts.

Partnership Deed/Articles of partnership

To form a partnership there must be an agreement between partners. The agreement may be oral or written. The written agreement between partners, containing the terms and conditions of partnership called '**partnership deed**'.

Contents of partnership deed

- 1 Name of the firm.
- 2 Names and addresses of all partners.
- 3 Nature and places of business.



- 4 Date of commencement of partnership.
- 5 Duration of partnership, if any.
- 6 Rules regarding operation of bank accounts.
- 7 Amount of capital contributed by each partner.
- 8 Profit sharing ratio between partners, if any.
- 9 Interest on partner's loan to the firm, if any.
- 10 Interest on partner's capital and drawings, if any.
- 11 Salary, commission, if any, payable to a partner.
- 12 Method of computation and treatment of goodwill on the reconstitution of a firm.
- 13 Mode of settlement of accounts at the time of admission, retirement, death and dissolution of firms.

Rules applicable in the absence of Partnership Deed

In the absence of partnership deed or if the deed is silent on any matter, provisions of the partnership act will automatically apply in the following way:

1. The partners are entitled to share **profit and losses equally** irrespective of their capital contribution.
2. The partners are **not entitled to get interest on their capitals**.
3. **No interest will be charged on drawings** of the partners.
4. **No partner is entitled to get salary or any other remuneration** for any extra work done for the firm.
5. **Partners are entitled to get Interest @ 6%p.a on loans** granted by partners to the firm.
6. Partner's capital shall be fluctuating (Fluctuating Capital Method).

Special aspects of partnership accounts

Accounting treatment for partnership is similar to that of a sole trading concern with the exception of the following aspects.

- a) Maintenance of partner's capital account.
- b) Distribution of profit and loss among partners.
- c) Adjustments for wrong appropriation of profits in the past.
- d) Reconstitution of the partnership firm.
- e) Dissolution of partnership firm.

A.Maintenance of capital accounts of partners

All transactions relating to the partners of the firm are recorded in their capital accounts. This includes the amount of money brought in as capital, additional capital introduced withdrawal of capital, share of profit, interest on capital, interest on drawings, partner's salary, partner's commission etc. Partner's capital account is a personal account. Partner's capital account can be maintained in two ways:-

1. Fixed Capital Method

2. Fluctuating Capital Method

1. Fixed Capital Method

Under fixed capital method, two accounts are prepared for each partner, i.e Partner's Capital Account and Partner's Current Account. Adjustments like drawings, interest on drawings, interest on capital, partner's salary, commission, share of profit or loss etc are not recorded in capital account, but a separate account known as partner's current account. Original capital

investment, additional capital contribution and capital withdrawals only are recorded in partner's current account. Capital Account balance will remain unaltered unless additional capital introduced or withdrawn.

Format:- Capital account under Fixed Capital method

Two
Accounts

Partners capital account and Current Account

(i) Capital account					
Dr			Partners' Capital Account		
Particulars	X (₹)	Y (₹)	Particulars	X (₹)	Y (₹)
To Cash/Bank A/c (Capital withdrawn)			By Balance b/d (Opening credit balance)		
To Balance c/d (Closing balance)			By Cash/Bank A/c (Additional capital introduced)		

(ii) Current account					
Dr			Partners' Current Account		
Particulars	X (₹)	Y (₹)	Particulars	X (₹)	Y (₹)
To Balance b/d (Opening debit balance)			By Balance b/d (Opening credit balance)		
To Drawings A/c (Out of profits)			By Interest on Capital A/c		
To Interest on Drawings A/c			By Partner's Salary or Commission A/c		
To Profit and Loss A/c (Share in losses)			By Profit and Loss Appropriation A/c (Share in profits)		
To Balance c/d (Closing credit balance)			By Balance c/d (Closing debit balance)		

Note: 1 It may be noted that capital accounts of partners will be shown at the same balance from year to year unless some amount of capital is introduced or withdrawn.

Note: 2 At the end of the year **current account** should be balanced which may show **debit** or **credit** balance. If it shows a **debit** balance it should be shown on the **asset** side of the balance sheet. If it is a **credit** balance it should be shown on the **liability** side of the balance sheet.

Note:3 In fixed capital method **both capital and current** account balance should be shown separately in Balance Sheet .



2. Fluctuating Capital Method

Under fluctuating capital method, there is only one account, i.e. the capital account of each partner is maintained. The yearly adjustments like drawings, interest on drawings, interest on capital, salary, commission, share of profit or loss etc are recorded directly in capital account itself. As a result, the capital balance of a partner at the end of the year will be different from that at the beginning of the year. So it is called fluctuating capital method. In the absence of any instruction, the capital account should always be fluctuating.

Format: - **Capital account [Fluctuating Capital method]**

ONE

Partners' Capital Account					
Dr			Cr		
Particulars	X (₹)	Y (₹)	Particulars	X (₹)	Y (₹)
To Balance b/d (Opening debit balance)			By Balance b/d (Opening credit balance)		
To Cash/Bank A/c (Capital withdrawn)			By Cash/Bank A/c (Additional capital introduced)		
To Drawings A/c (Out of profits)			By Interest on Capital A/c		
To Profit and Loss A/c (Share in losses)			By Partners' Salary or Commission A/c		
To Balance c/d (Closing credit balance)			By Profit and Loss Appropriation A/c (Share in profits)		
			By Balance c/d (Closing debit balance)		

Items usually appears on the debit and credit side of the capital account

Debit Side	Credit Side
Drawings Interest on Drawings Share of Loss	Opening Capital Balance Additional capital introduced Interest on capital Salary to partner Commission to partner Share of profit

Difference between fixed capital method and fluctuating capital method

Basis	Fixed Capital Method	Fluctuating Capital Method
Number of Accounts	Under this method two accounts are maintained for each partner viz. capital account and current account.	Under this method there is only one account for each partner, i.e capital account.
Adjustments	All adjustments are recorded in a separate account known as current account.	All adjustments are recorded in the capital account itself.
Fixed Balance	The capital account balance remains unchanged unless there is addition to or withdrawal of capital.	The balance of the capital account fluctuates from year to year.
Credit Balance	The capital accounts always show a credit balance.	The capital account sometimes shows debit balance.
Appearance in the Balance Sheet	Both capital and current account balance will appear	Only capital account balance appears.

B. Distribution of profit/ loss among partners



In case of sole trading concern, profits or losses disclosed in the profit and loss account can be transferred to his capital account directly. But the net profit reflected in the profit and loss account of the partnership needs some adjustments. There may be some agreement between

partners with regard to interest on capital, interest on drawings, partner's salary, partners commission etc. All these adjustments/appropriations are made in a separate account known as profit and loss appropriation account.

Difference between appropriation of profit and charge against profit

Appropriation of profit	Charge against profit
1.It is the distribution of net profit to various heads like interest on capital, salary etc. 2.It can be possible only if there is profit 3. It is done after the creation of all charges against profit. 4. This will be debited to P&L Appropriation Account. 5.Eg.Interest on capital, partner's salary, partner's commission ,amount transferred to reserve etc.	1It is the deduction from revenue to calculate net profit or net loss, takes place in P & L A/C 2. It is made even if there is a loss. 3. It is done before the appropriation of profit. 4. It will be debited to profit and loss account. 5.Eg.staff salary, managers commission, interest on loan, advertisement etc

Profit and Loss Appropriation Account

In partnership it is necessary to distribute profit among partners. Profit and Loss Appropriation account is a nominal account, which is prepared to show how the net profit has been distributed among the partners. It is an extension of profit and loss account. It is opened with net profit/ net loss brought forward from profit and Loss Account. It is credited with interest on drawings and it is debited with interest on capital, partners salary, partners commission and amount transferred to reserve (if any).The net profit or net loss after making the above adjustments can be divided among the partners in their profit sharing ratio by transferring it to their capital accounts or current accounts as the case may be.

Format: -

P &L Appropriation account

Particulars	Amount	Particulars	Amount
To Partner's Salary	XXXXX	By Profit and Loss A/C	XXXXX
To Partner's Commission	XXXXX	(Net Profit)	
To Interest on capital	XXXXX	By Interest on Drawings	XXXXX
To Amount transferred to reserve(if any)	XXXXX		
To Partners capital account (b/f)	XXXXX		
<i>(Divisible Profit distributed among partners in their ratio)</i>			
	<u>XXXXX</u>		<u>XXXXX</u>

Journal Entries in connection with P & L Appropriation Account:

1. For transfer of Net profit from P & L A/C:- P & L Account Dr To P & L Appropriation A/c (Net profit transferred to P & L Appropriation Account)	XXXXX	XXXXX
2. For transfer of Net loss from P & L A/C:- P & L Appropriation A/c Dr To P & L Account (Net loss transferred to P & L Appropriation Account)	XXXXX	XXXXX
3(a). For charging interest on drawings:- Partner's Capital A/C Dr To interest on Drawings (Interest on drawings charged)	XXXXX	XXXXX
3(b). To close interest on drawings account Interest on Drawings A/C Dr To P & L appropriation A/C (Int on drawings A/C closed by transfer it to P & L Appropriation A/C)	XXXXX	XXXXX
4(a) When interest on capital due:- Interest on Capital A/C Dr To Partner's Capital A/C (Interest on capital due)	XXXXX	XXXXX
4(b) To close interest on capital account:- P & L Appropriation A/C Dr To Interest on Capital A/C (Interest on capital A/C closed by transfer it to P & L Appropriation A/C)	XXXXX	XXXXX

5 (a) When partner's salary due:- Partners's Salary A/C Dr To Partner's Capital A/C (Salary due)	XXXXXX	XXXXXX
5 (b) To close salary account P & L Appropriation A/C Dr To Partners Salary A/C (Salary account closed)	XXXXXX	XXXX
6 To transfer amount to reserve:- P & L Appropriation A/C Dr To Reserve A/C (Amount transferred to reserve)	XXXXXX	XXXXXX
7 (a) To transfer balance of P &L Appropriation account to Partner's capital account (If credit balace/Prtofit) P & L appropriation A/C Dr To Partner's Capital A/C (Divisible profit distributed among partners in their ratio)	XXXXXX	XXXXXX
7 (b) To transfer balance of P &L Appropriation account to Partner's capital account (If debit balace/loss) Partner's Capital A/C To P & L appropriation A/C Dr (Share of loss distributed among partners in their ratio)	XXXXXX	XXXXXX

Profit and Loss Account

For the year ended.....

Particulars	Amount	Particulars	Amount
Rent	2,000	Gross Profit b/d	80,000
Interest	4,000		
Stationery	3,000		
Depreciation	1,000		
Net profit c/d	70,000		
	<u>80,000</u>		<u>80,000</u>

Profit and Loss Appropriation Account

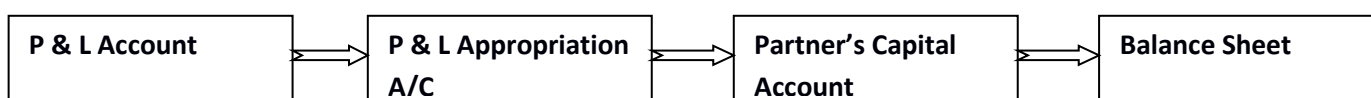
For the year ended.....

Particulars	Amount	Particulars	Amount
To Interest on Capital		Net Profit b/d(P & L A/c)	70,000
A 4000		Interest on Drawings	
		A 400	
B <u>2000</u>	6,000	B <u>200</u>	600
To Partner's Salary			
A 3,000			
To Partner's Commission			
A 1000			
B <u>2000</u>	3,000		
To A's Capital 35160			
(58600 x 3/5)			
To B's Capital <u>23440</u>	58,600		
(58600 x 2/5)			
	<u>70,600</u>		<u>70,600</u>

Partners Capital Account

Particulars	A	B	Particulars	A	B
To Drawings	20,000	10,000	By Balance b/d	2,00,000	1,00,000
To Interest on Drawings	400	200	By Interest on capital	4,000	2,000
To Balance c/d	2,22,760	1,17,240	By Salary	3,000	
			By Commission	1,000	2,000
			By P&L Appropriation	35,160	23,440
			(Closing balance of P & L Appropriation A/C)		
	2,43,160	1,27,440		2,43,160	1,27,440

Flow of Accounts in partnership:



Interest on Capital

Interest on capital is paid to partners as a compensation for their capital contribution to the firm. Interest on capital is an expense to the firm and a gain to partner's individually. No interest is allowed on partners' capital unless it is agreed between partners. Interest is generally calculated on the opening capital and is credited to capital account. If some additional capital is introduced during the year, the interest on additional amount should be calculated based on the time for which the amount remains in the business. It is an appropriation of profit and it should be noted that no interest on capital is payable if the firm is working at a loss.

Interest on capital = Capital of the partner x Rate x period for which amount remained in the business.

Calculation of interest on capital

Case-1

Calculation of Interest on Capital-When there is no Addition or Withdrawal of capital

Interest on capital = Opening capital x rate x period for which amount remained in business.

Q. Amal and Bimal entered into partnership business on 01-01-2017 by bringing in Rs.300000 and Rs.200000 respectively. They decided to share profit and losses equally and agreed that the interest on capital will be provided to the partners @ 10% per annum. There was no addition or withdrawal of capital by any partner during the year. Calculate interest on capital of Amal for the year?

Ans: Interest on capital of Amal = $3,00,000 \times 10/100 \times 12/12$

OR

= $300000 \times 10\%$

= **30000**

Case-2

Calculation of Interest on Capital-When there is additional capital introduced during the accounting year.

- a) **On opening capital** interest for **full year**
- b) **On the additional capital** interest **from the date of contribution** to the **end** of the period

Q. Anna and Maria are partners in a firm. Anna's capital account showed a balance of Rs.50,000 on 01-01-2017. During the year 2017 Anna introduced an additional capital of Rs.10,000 on 1st August 2017. The Interest on capital allowed @ 8% p.a. Accounts are closed on December 31st every year. Calculate interest on capital to be allowed to Anna during the year 2017?

Ans:

For Anna's opening capital, interest for full year, i.e. $50,000 \times 8\% = 4,000$

For Anna's additional capital, interest from the date of contribution (1-8-2017) to the end of the period (31-12-2017) 5 months, i.e. $10000 \times 8\% \times 5/12 = 333$

Total Interest on capital of Anna = $4000 + 333$

= **4333**

Case-3

Calculation of interest on capital – When there is withdrawal out of capital during the year

- i. On opening capital interest is calculated for full year **(1)**
- ii. On amount of capital withdrawn during the year, interest for the period from the date of withdrawal to the closing date and deduct it from the above **(1)**

Q. Sneha and Varsha are partners in a firm. Their capital accounts as on 1-04-2017 showed a balance of Rs.2,00,000 and Rs.3,00,000 respectively. On October 1st 2017, Sneha withdraw Rs.30,000 from her capital. Interest is allowed @8% p.a. Calculate interest on capital of Sneha for the financial year 2017-2018?

On opening capital for full year, i.e. $2,00,000 \times 8\% = 16,000$ **(1)**

Calculate interest on the amount of capital withdraw for the period from the date of withdraw to the closing date,

i.e. $30,000 \times 8\% \times 6/12 = 1200$ **(2)**

Interest on capital **(1-2)** = $16000 - 1200$

= **14,800**

Case-4**Calculation of interest on capital– When there is both addition and withdrawal of capital by partners during the year**

- i. On opening capital interest is calculated for full year **(1)**
- ii. On additional capital from the date of contribution to the end of the period **(2)**
- iii. On the amount of capital withdrawn during the year interest for the period from the date of withdrawal to the closing day and deducted from the total of the interest calculated under point **(1)** and point **(2)**.

Q. Tomy and George are partners in a firm. Their capital account balance as on 1-4-2017 showed a balance of Rs.5,00,000 and Rs.2,00,000 respectively. On June 1st, Tomy introduced additional capital of Rs.20,000. On November 1st Tomy withdraw Rs.30,000 from his capital. Interest on capital is allowed @10% p.a. Calculate interest on capital

Ans.

On opening capital (5, 00,000) Interest on capital for whole year

i.e, $5,00,000 \times 10\% = 50,000$ **(1)**

On additional capital from the date of contribution (1-6-2017) to the closing date (31-3-2018)

i.e. $20,000 \times 10\% \times 10/12 = 1667$ **(2)**

On the amount of capital withdrawn for the period from the date of withdrawal (1-11-2017) to the closing day (31-3-2018)

i.e. $30,000 \times 10\% \times 5/12 = 1250$ **(3)**

Net interest on capital = **(1) + (2) – (3)**

i.e, $50,000 + 1667 - 1250 = \underline{\underline{50417}}$

Calculation of opening capital when closing capital is given

Closing capital		XXXX
Add:		
Drawings	XXXXXX	
Interest on drawings	XXXXXX	
Share of loss(if any)	XXXXXX	XXXXXX
Less:		XXXXXX
Partners salary	XXXXXX	
Partners commission	XXXXXX	
Share of profit(if any)	XXXXXX	XXXX
Opening capital		XXXXXX

Interest on capital
is always calculated on
Opening capital

Interest on drawings

It is the amount charged by the firm on drawings made by partners. It is an income to the firm. No interest is charged on drawings if there is no agreement between partners in this regard. However, if the partnership deed so provides for it, the interest is charged at an agreed rate, for the period the money is outstanding from the partners during the accounting year.

Calculation of interest on drawings under different situation

Case1

Amount of withdrawal, rate of interest and date of withdrawal are given

Interest on drawings=amount of drawings x rate x period

Q.Johnson ,a partner withdraws Rs. 16,000 on 1st May 2017.Books of accounts are closed on 31st December every year. Calculate interest on drawings at 6% per annum.

Ans.

$$\begin{aligned}\text{Interest on drawings} &= \text{amount of drawings} \times \text{rate} \times \text{period} \\ &= 16,000 \times 6\% \times 8/12 \\ &= \mathbf{640}\end{aligned}$$

Case: 2

Date of withdrawal is not given, amount and rate of interest are given

If the date of drawings is not given, it may be assumed that drawings were made evenly throughout the year. In such a case interest should be calculated for six months on the whole amount.

Interest on drawings=amount of drawings x rate x 6/12

Q.Sachin ,a partner withdraws Rs.8,000 in a year and interest is chargeable on the drawings at 7% per annum. Calculate interest on drawings.

Ans.

Here date of drawings is not given .So interest should be calculated for six months on the whole amount.

$$\begin{aligned}\text{Interest on drawings} &= 8,000 \times 7\% \times 6/12 \\ &= \mathbf{280}\end{aligned}$$

Case: 3

Different amounts withdrawn at different intervals

When different amount withdrawn and dates of drawings are clearly stated the interest on drawings may be calculated with the help of the product method

The following procedure is adopted to calculate interest on drawings under product method.

Step-1 Calculate the time **period** between date of withdrawal and closing date

Step-2 Multiply the time period so calculated by the respective amount of drawings. This is called the **Product**.

Step-3 **Add** up the various products

Step-4 Calculate interest for **one month** on the sum of products at the rate of percentage.

Interest on Drawings = Sum of product x Rate/100 x 1/12

Q.In a partnership partners are charged interest on drawings at 10% per annum.During the year ended 31st December, 2017 a partner's drawings were as follows:

Feb-1	2000
May-1	5000
June-30	2000
Oct-31	6000
Dec-31	2000

Calculate interest on drawings chargeable to the partner?

Ans: When drawings are made in **uneven amounts at different dates**, interest on drawings can be calculated by **product method** as follows:

Date (A)	Amount (B)	No of months to closing date (C)	Product (D) (D=B x C)
Feb-1	2000	11	22000
May-1	5000	8	40000
June-30	2000	6	12000
Oct-31	6000	2	12000
Dec-31	2000	0	0
Sum of Product			<u>86000</u>

$$\text{Interest on Drawings} = \text{Sum of product} \times \text{Rate}/100 \times 1/12$$

$$= 86000 \times 10\% \times 1/12$$

$$= \underline{\underline{717}}$$

Case-4

Calculation of Interest on Drawings-When Fixed Amount withdrawn Every Month

If a partner withdraws fixed amount at regular intervals, the interest on drawings can be calculated on the basis of **average period**.

$$\text{Interest on Drawings} = \text{Total Drawings} \times \text{Rate}/100 \times \text{Average Period}$$

The calculation of average period depends upon whether the fixed amount is withdrawn on the **first day** of each month, **middle** of the month or at the **last day** of each month

Date of Withdrawal	Average Period(in months)
First day of every month	6.5
Middle of every month	6
Last day of every month	5.5

Q. Manoj, a partner withdraws a sum of Rs. 2,000 per month from the firm. Interest on drawings is to be charged @ 8% per annum. What is the interest that should be charged to partner if drawings are made:-

- (1) In the beginning of each month
- (2) In the middle of each month
- (3) In the end of each month

Ans.

Interest on Drawings = Total Drawings x Rate/100 x Average Period

Total drawings = 2000 x 12

=24,000

Ans-1- Interest on drawings when fixed amount withdrawn on the First Day of every month

Interest on Drawings is 24000 x 8/100 x **6.5/12** = **1040**

Ans-2- Interest on drawings when fixed amount withdrawn on the Middle of every month

Interest on Drawings is 24000 x 8/100 x **6/12** = **960**

Ans-3- Interest on drawings when fixed amount withdrawn on the last day of every month

Interest on Drawing is 24000 x 8/100 x **5.5/12** = **880**

Interest on Partner's Loan

If any partner, apart from his share of capital, advances a loan to the firm, he is entitled to receive interest at an agreed rate of interest. In the absence of an agreement, the Partnership Act provides, that he shall receive interest @6% per annum. Interest on Loan is a charge against profit and therefore, he is eligible to get interest even if there is loss.

Accounting treatment

Interest on partners loan is a charge against profit. Interest on partners loan account is closed by transfer it to the debit side of the P & L Account.

Journal Entry:

- 1) When interest on loan due:

Interest on partner's loan A/C	Dr	XXXX	
To Partner's Loan A/c			XXXX
(Interest due)			

- 2) To close interest on partners loan account

P & L Account	Dr	XXXX	
To Interest on Partner's Loan Account			XXXX
(Interest on partners loan account closed)			

Interest on Partner's Loan
is recorded in P & L
Account /deducted from
Net Profit and not in P & L
Appropriation Account

Guarantee of Profit

Sometimes, on admission of a new partner, an old partner or partner's may give an assurance to the new partner that, he shall be given a minimum amount of profit

irrespective the actual profit. This guaranteed profit is to be paid only if-new partner's share of profit as per the ratio is less than the guaranteed amount.

Q.Mohan and Krishnan are partners in a firm. They admit Sunny as a partner with a guarantee that his share of profits shall not be less than Rs.20,000.Profit are to be shared in the proportion of 4:3:3.The total profit for the year 2017 were Rs.50,000.Prepare P&L Appropriation A/C showing the division of profit of the year 2017.

Ans:

Here,Guaranteed partner is Sunny

Sunny's guaranteed profit = 20,000.

Profit sharing ratio between Mohan,Krishnan and Sunny = 4:3:3

Firm's profit = 50,000

Sunny's actual profit is $50,000 \times \frac{3}{10} = \text{Rs.15,000}$ i.e. Sunny's actual profit(15,000) is less than his guaranteed sum (20,000). The deficiency amount Rs.5,000 should be given to Sunny by Mohan and Krishnan in their profit sharing ratio (4:3)

Profit and Loss Appropriation Account

Particulars	Amount	Particulars	Amount
To mohans's Capital 20000		By Net profit	50,000
Less: Share of deficiency <u>2857</u>	17143		
To Krishnan capital 15000			
Less: Share of deficiency <u>2143</u>	12857		
To Sunny's capital 15000			
Add:Deficiency <u>5000</u>	20000		
(2857+2143)			
	<u>50000</u>		<u>50000</u>

Past Adjustment (To rectify errors or omission committed)

In certain cases, after the preparation of final accounts and partner's capital account, it is found that certain items are to be omitted or wrongly treated. Such errors and omissions usually relates to interest on capital, interest on drawings, wrong distribution of profit, interest on partners loan, salaries to partners etc. All such errors or omission to be adjusted to correct their impact in the capital balances of partners. Instead of altering old accounts, adjustments can be made either:-

1. Adjusted through prepare Profit and Loss Adjustment Account

2. Directly adjusted in capital account of partners in whose account is affected (Table method/Adjusted by passing a single journal entry)

Profit and Loss Adjustment Account

It is an account opened to record omitted items and rectify errors if any, after the preparation of Profit and Loss Account and Balance Sheet. If any error or omission is noticed, then these errors or omissions are adjusted by opening Profit and Loss Adjustment Account in the subsequent accounting period without altering old Profit and Loss.

Journal entries:

1. To rectify omitted items which are to be credited to partners capital account such as interest on capital, salaries, commission etc

P & L Adjustment A/C Dr	XXXX
Partners Capital (Individually)	XXXX

2. To rectify omitted items which are to be debited to partner's capital account such as interest on drawings etc.

Partners Capital Account (Individually)	XXXX
To P & L Adjustment Account	XXXX

3. Ascertain the balance in the P & L Adjustment A/C, credit balance means profit and debit balance means loss. This is to be distributed among partners in their ratio.

(a) If credit balance/profit

P & L Adjustment A/C Dr	XXXX
Partners Capital (Individually)	XXXX

(b) If debit balance/loss

Partners Capital Account (Individually)	XXXX
To P & L Adjustment Account	XXXX

Following question and solution give an idea about past adjustments and P & L Adjustment A/C

Q. On March 31st 2016, Capital accounts of A, B and C after making adjustments for profits, drawings etc were as A-Rs 8,00,000, B- Rs 6,00,000 and C Rs.4,00,000. Subsequently it was discovered that interest on capital and drawings had been omitted. The partners were entitled to interest on capital, @5% per annum. The drawings during the year were A Rs.2,00,000, B Rs.1,50,000 and C-Rs.90,000. Interest on drawings chargeable to the partners was A-Rs.5,000, B- Rs 3,600 and C Rs.2000. The net profit during the year

amounted to Rs 12,00,000 The profit sharing ratio was 3:2:1. Record necessary adjustment entries for rectifying the above errors and omissions.

1. Profit and Loss Adjustment A/C Method

Step-1

If the item of omission is interest on capital, first ascertain the opening capital. This is because interest on capital is always calculated on opening capital. If capital given is closing capital, in order to find out opening capital, following procedures should be adopted:-

Note: In this problem opening capital is not given. So we want to calculate opening capital to find out interest on capital.

Step-1

Calculate opening Capital

Particulars	A	B	c
Closing capital	800000	600000	400000
Add: Drawings	200000	150000	90000
	<u>1000000</u>	<u>750000</u>	<u>490000</u>
Less: Profit already credited	600000	400000	200000
Opening capital	<u>400000</u>	<u>350000</u>	<u>290000</u>

Interest on capital of A , $4,00,000 \times 5\% = 20000$

Interest on capital of B, $3,50,000 \times 5\% = 17500$

Interest on capital of C, $2,90,000 \times 5\% = 14,500$

Step-2

Works out the amount of omitted items which are to be credited to partner's capital account such as interest on capital, partner's salary, commission, etc. In this problem only interest on capital (credit side items) is omitted. Pass the following journal entry to rectify the omission regarding interest on capital:-

Profit and Loss Adjustment A/C Dr	52000	
To A's Capital A/C		20000
To B's Capital A/C		17500
To C's Capital A/C		14500

(Rectification entry to adjust interest on capital)

Step-3

Works out the amount of omitted items which are to be debited to partner's capital account such as interest on drawings. Pass the following journal entry for the same:

A's Capital A/C Dr	5000	
B's Capital A/C Dr	3600	
C's Capital A/C Dr	2000	
To Profit and Loss Adjustment A/C	10600	

(Rectification entry to adjust interest on drawings)

Find out the balance of Profit and Loss Adjustment A/C .The credit balance in the Profit and Loss Adjustment A/C reflects profit and debit balance reflects loss. This is to be distributes among partners in their profit sharing ratio:

Profit and Loss Adjustment A/C Dr **XXXX**
To, Partner's Capital A/C (Individually) **XXXX**
 (Transfer of balance of P & L Adjustment A/C)

Partner's Capital A/C Dr (Individually)	XXXX
To, Profit and Loss Adjustment A/C	XXXX
(Transfer of balance of P & L Adjustment A/C)	

(a) Loss distributed:

A's Capital A/C Dr	5000	
B's Capiyal A/C Dr	3600	
C's Capital A/C Dr	2000	
To Profit and Loss Adjustment A/C		10600

(Rectification entry to adjust interest on drawings)

Profit and Loss Adjustment A/C

Particulars	Amount	Particulars	Amount
To A's Capital	20000	By A's Capital	5000
To B's capital	17500	By B's Capital	3600
To C's capital	14500	By C's Capital	2000
		By A's Capital	20700
		By B's Capital	13800
		By C's Capital	6900
	<u>52000</u>		<u>52000</u>

Partner's Capital A/C

Particulars	A	B	C	Particulars	A	B	C
To P & L				By Balance b/d	800000	600000	400000
Adjustment A/C	5000	3600	2000				
To P & L				By P & L Adjustment A/C	20000	17500	14500
Adjustment A/C	20700	13800	6900				
To Balance c/d	794300	600100	405600				
	<u>820000</u>	<u>617500</u>	<u>414500</u>		<u>820000</u>	<u>617500</u>	<u>414500</u>

**Now capital A/C
shows correct balances**

**Wrong capital A/C
Balances**

2. Directly adjusted in capital account of partners/ Corrected through passing a single journal entry

Due to omission or wrong treatment the capital accounts of partners reflect wrong balances. Some partners capital account over credited (gaining partners) and some partners capital accounts under credited (sacrificing partners). In this method we need to prepare a statement to find out the net effect of omissions or commissions. Then debit the capital account of the partner whose account is over credited (gaining partner) and credit the capital account of the partner whose capital account is under credited (sacrificing partner). The adjustment journal entry is as follows:-

Gaining Partner's Capital A/C Dr	XXXX	
To, Sacrificing Partner's Capital A/C		XXXX
(Adjustment journal entry to rectify omissions and errors)		

Q Here we can solve the above problem with the help of Table method

[Q. On march 31st 2016, Capital accounts of A, B and C after making adjustments for profits, drawings etc were as A-Rs 8,00,000, B- Rs 6,00,000 and C Rs.4,00,000. Subsequently it was discovered that interest on capital and drawings had been omitted. The partners were entitled to interest on capital, @5% per annum. The drawings during the year were A Rs.2,00,000, B Rs.1,50,000 and C- Rs.90,000. Interest on drawings chargeable to the partners was A-Rs.5,000, B- Rs 3,600 and C Rs.2000. The net profit during the year amounted to Rs 12,00,000 The profit sharing ratio was 3:2:1. Record necessary adjustment entries for rectifying the above errors and omissions.]

Past Adjustment-Table Method

Particulars	Debited/credited on partners point of view			Total (On Firms point of view)
	A	B	C	
Interest on capital to be credited	20000 (Cr)	17500 (Cr)	14500 (Cr)	52000 (Dr)
Interest on drawings to be debited	5000 (Dr)	3600 (Dr)	2000 (Dr)	10600 (Cr)
Calculate Net Effect of the total column				41400 (Dr)
Amount(Net Effect 41,400) in the total column distributed among partners in their ratio3:2:1	20700 (Dr)	13800 (Dr)	6900 (Dr)	
Calculate Net Effect of the partner's column	5700 (Dr)	100 (Cr)	5600 (Cr)	

To correct capital account balance passes the following journal entry:

A's Capital A/C Dr

5700

To B's Capital A/C

100

To C's Capital A/C

5600

(Adjustment journal entry to rectify omission)

Compare capital account balance as per first method (P & L Adjustment A/C method)

Capital A/C balances before correction	A-8,00,000(Cr)	B-6,00,000(Cr)	C-4,00,000 (Cr)
Correction required as per table	A-5700 (Dr)	B-100(Cr)	C-5600(Cr)
Capital A/C balances after correction	A-7,94,300	B-6,00,100	C-4,05,600

Dear students,

Education is the passport to the future, for tomorrow belongs to those who prepare for it today.

Develop a passion for learning.....Best wishes

Binoy George,Hsst

MKNM HSS

Kumaramangalam,

Thodupuzha