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Partnership Accounts—I

The Indian Partnership Act of 1932 contains the main provisions which are applicable to partnership firms working in India. According to this Act "Partnership is the relation between persons who have agreed to share the profit of the business carried on by all or any of them acting for all". Individually the persons who work in the firm are called partners and the name with which all partners work collectively is called the firm's name. For example, A, B and C working in a firm will be called partners and 'ABC & Co.', the name with which these partners work collectively will be called firm's name.

ESSENTIAL FEATURES OF A PARTNERSHIP

The following are the essential features of a partnership firm :

- (i) *Persons*. In order to constitute a partnership firm, there must be at least two persons. The maximum number in partnership is 20 in case the firm is doing ordinary business and 10 in case the firm is engaged in banking business. This is as per Section 11 of the Companies Act, 1956.
- (ii) *Agreement*. In order to have a partnership, it is necessary that there must be an agreement between partners.
- (iii) *Sharing of profits*. It is one of the important terms to constitute a partnership firm. Generally sharing of profits (or losses) is one of the important elements to constitute a firm.
- (iv) *Business*. It includes trade, vocation and profession. The firm must be engaged in a lawful business.
- (v) *Management*. The management of the partnership firm will be done either by all the partners or any one of them on behalf of all other partners. There is mutual agency among the partners.

Partnership Deed

In the beginning all partners have mutual love and affection and they are ready to work in a team. In spite of this, it is desirable that they must have their verbal or written agreement in order to avoid the future dispute among the partners. Usually written agreement is preferred so that it can be referred to by all the partners as and when need arises. The document which contains the terms and conditions regarding the conduct of partnership business, is called partnership deed. The terms and conditions are inserted in the form of clauses in the deed. The following are the *important clauses* in a partnership deed :

1. The name of the firm.
2. The nature of the business which the firm is supposed to do.
3. The amount of capital and how it is contributed by each partner.
4. The proportion in which the partners will share profits and losses.

5. The amount of drawings which a partner can draw from the firm.
6. Whether interest on capital will be allowed? If so, then what will be the rate of interest charged on the drawings of the partners?
7. What will be the authority of each partner? Will some restrictions be imposed on the duties of the partners?
8. What will be the duration of the firm? Whether the firm will be dissolved at will or will continue for a fixed period or till the happening of a particular event or on the completion of a particular venture?
9. How the amount of the goodwill of the firm will be ascertained at the time of change in profit sharing ratio, admission, retirement or death of a partner?
10. Will some salary or remuneration or commission be allowed to any of the partners because of his working in the firm?
11. How the annual accounts of the firm will be prepared? Will the accounts be audited by an independent Chartered Accountant? How the auditor will be appointed?
12. In case of retirement or death of a partner, how the amount which is to be paid to the partner or his legal representatives is ascertained? If the partners have taken a joint life policy or individual policies, the premium of which is being charged to the Profit and Loss Account and on the death of a partner, how the amount received from the insurance company and their surrender value will be distributed among the partners.
13. If a partner has given any amount of loan besides his capital, will interest be allowed to him? If so, what will be the rate?
14. In case a partner becomes insolvent, how the accounts of the firm will be settled? Will the rule of *Garner vs. Murray* be applicable in this case?
15. The circumstances in which the firm will be dissolved and the manner, in which the accounts will be settled in case of dissolution of a firm.
16. In case some dispute arises among the partners, how will it be settled? Will it be referred to some arbitrator?
17. Any other clause on which the partners may agree at the time of agreement.

Rules Applicable in Absence of an Agreement

Under the Partnership Act, 1932 the following rules will be applicable for proper accounting of the partnership firm in absence of an agreement among the partners :

1. Profits or losses of the firm will be shared equally by the partners. (Section 13)
2. Interest on capital will not be allowed to any partner. If agreed, the interest will be allowed only out of profits of the firm, i.e., it would be an appropriation of profit payable only if profit warrants. It is chargeable only to the extent of the available profit. In case of losses no interest will be allowed. Similarly, no interest will be charged on drawings of the partners unless agreed upon. (Section 13)
3. If any partner has given a loan to the firm besides his share of capital, he will be allowed 6% interest on such loan. (Section 13)
4. No salary or remuneration will be allowed to any of the partners. In case salary is payable to the partner or partners, it would be an appropriation of profit i.e. it would be payable only if there is a profit (Section 13)
5. Every partner must take part in the management of the partnership business.
6. No person can be admitted without the consent of all existing partners.
7. The partnership books are to be kept at the place of business of the partnership and every partner may have access to and inspect and copy any of them.

Capital Accounts

Capital accounts of the partners may be fixed or fluctuating.

(i) **Fixed Capital Accounts.** When the partners agree that the amount of capital contributed by them shall remain fixed and shall not be reduced or increased during the term of the partnership except by special agreement, the capital accounts are said to be fixed. Under such circumstances, it becomes necessary to have current accounts of the partners. The usual adjustments at the end of the period in regard to interest on capital, interest on drawings, salary or commission, profit or loss will be made in the current accounts. A credit balance in current account

Partnership Accounts—II

DISSOLUTION

The Indian Partnership Act, 1932 recognises the difference between the 'dissolution of partnership' and 'dissolution of firm'. The dissolution of *partnership* between all the partners of a firm is called the dissolution of the firm. Thus, it is the complete breakdown of a partnership and partners do not continue the firm. On the other hand, dissolution of the partnership means a reconstitution of the firm due to the retirement of a partner or the insolvency of a partner or the death of a partner and the remaining partners provide for the continuance of the firm in pursuance of an express or implied agreement to that effect. On dissolution of a firm the firm's assets are realised and the liabilities are discharged because the firm is to be closed, whereas on dissolution of a partnership, the share of the outgoing partner is ascertained and the firm is not closed.

Modes of Dissolution of Firm

The various ways in which a firm may be dissolved are given as under :

(1) *Dissolution by agreement.* A firm is dissolved when all the partners agree that it should be dissolved. A partnership firm is the creation of an agreement ; similarly a firm can be dissolved by an agreement.

(2) *Dissolution on the happening of contingencies.* A firm is dissolved in any of the following ways unless there is a contract between the partners to the contrary. These are: (i) by the expiry of the term of duration of the firm, (ii) by the completion of the adventure for which the firm was constituted, (iii) by the death of a partner, and (iv) by the adjudication of a partner as insolvent.

(3) *Dissolution by notice of partnership at will.* When the partnership is at will, the firm may be dissolved at any time by any partner giving notice in writing to all the other partners of his intention to dissolve the firm.

(4) *Compulsory dissolution or dissolution by the operation of law.* A firm is compulsorily dissolved in different ways as : (i) When all the partners except one become insolvent. (ii) When all the partners become insolvent. (iii) When the business becomes illegal. (iv) Where the number of partners exceed twenty in case of ordinary business or ten in case of banking business.

(5) *Dissolution by the court.* At the suit of a partner, a court may order the dissolution of the firm in different ways as : (i) when a partner becomes of *unsound mind*, (ii) when a partner suffers from *permanent incapacity* and becomes incapable of performing his duties as a partner, (iii) when a partner is *guilty of misconduct* affecting the business of the firm, (iv) when a partner *commits wilful or persistent breaches* of agreement, (v) when a partner has *transferred the whole of his interest* in the firm to a third party or when his share has been attached under a decree or sold under process of law, (vi) when the *business of the firm cannot be carried on except at a loss*, and (vii) when the court is satisfied as to grounds which render it *just and equitable* to dissolve the firm.

Settlement of Accounts on Dissolution

The mode of settlement of accounts on a dissolution of the firm is as follows as given in Section 48 of the Indian Partnership Act, 1932.

In settling the accounts of a firm after dissolution, the following rules shall, subject to agreement by the partners, be observed—

(a) *Losses, including deficiencies of capital*, shall be paid first out of profits, next out of capital, and lastly, if necessary, by the partners individually in the proportions in which they are entitled to share profits.

(b) *The assets of the firm*, including any sums contributed by the partners to make up deficiencies of capital, shall be applied in the following manner and order :

- (i) in paying the debts of the firm to third parties ;
- (ii) in paying to each partner rateably what is due to him from the firm for advances as distinguished from capital ;
- (iii) in paying to each partner rateably what is due to him on account of capital ; and
- (iv) the residue, if any, shall be divided among the partners in the proportions in which they are entitled to share profits.

Dissolution Before Expiry of a Fixed Term (Section 50)

If a partner on his admission in the firm has paid a premium (*i.e.* goodwill) to the other partners with a stipulation that the firm will not be dissolved before the expiry of a certain period, he will be entitled to a suitable refund of the premium if the firm is dissolved before the term has expired. However, no claim in this respect will arise if :

- (i) The firm is dissolved due to the death of a partner.
- (ii) The dissolution is mainly due to the partner's (claiming refund) own misconduct.
- (iii) The dissolution is as a result of an agreement containing no provision for the return of the premium or any part of it.

The refund of the premium will be such as is reasonable having regard to the terms upon which the admission was made and to the length of the period agreed and the period expired upto the dissolution date. Any refund of premium that becomes due on the dissolution will be debited to other partners' capital accounts in their profit sharing ratio and credited to the refund claiming partner's capital account.

Firm Debts and Private Debts

Where there are partnership debts and private debts of the partners in their individual capacity, the *assets of the firm* shall be applied in the first instance in payment of the debts of the firm and surplus of assets, if any, would be paid to the partners in the proportion in which they were entitled to share profits. Similarly, the *private property of each partner* shall be applied first in the payment of his private debts, and the surplus of private assets, if any, would be handed over to the firm if the firm needs it for the payment of its debts.

Entries on Dissolution

A firm is closed on the dissolution, so books of account should also be closed. Books of account can be closed only if all the assets are realised in cash or otherwise, disposed of and all outside liabilities are paid off as also the partners' loans and capitals. The Balance Sheet of the firm is prepared on the date, the dissolution of the firm takes place to know the book value of assets and liabilities of the firm on that date. The following steps are taken to close the books of account.

1. *For Closing Assets' Accounts.* A Realisation Account is opened and all the assets at their book values (except cash and bank balances and debit balance of Profit and Loss Account) are transferred to the debit side of the Realisation Account. The entry is :

Realisation Account	Dr.
To Assets Account (individually)	
(Being transfer of various assets at book values to the Realisation Account)	