

Unit II: Accounting for Partnership

1. **Answer:** b) To establish the rights and duties of the partners

Explanation: A partnership deed is a written agreement between partners that outlines the terms and conditions governing their business relationship. The primary purpose of a partnership deed is to establish the rights, responsibilities, and duties of each partner. It includes provisions about profit sharing, capital contributions, the method of distribution of profits, the management of the firm, dispute resolution, and other important aspects such as the treatment of a partner's death or withdrawal. Having a partnership deed is crucial to avoid conflicts and to ensure smooth operation of the partnership firm.

2. **Answer:** c) It legally binds the partners to the terms agreed upon

Explanation: A partnership deed is a legally binding document that sets out the terms agreed upon by the partners. It specifies how profits and losses will be shared, the responsibilities of each partner, and other aspects like capital contributions, salary and interest, and procedures in case of disputes or a partner's exit. Having a written deed ensures that the partners are aware of their obligations and rights, and it provides a legal framework for resolving any issues that may arise during the partnership's operation.

3. **Answer:** b) The capital balance remains unchanged except for additional contributions or withdrawals

Explanation: Under the fixed capital method, each partner's capital balance remains constant, except for any additional contributions or withdrawals made during the accounting period. The profits and losses are transferred to a separate account called the "Current Account." This method ensures that each partner's capital balance is stable, making it easier to track the capital contributions of each partner. Only when new investments are made or withdrawals are taken will the capital accounts change, but they do not fluctuate with the income and expenses of the business.

4. **Answer:** a) In a separate current account

Explanation: Under the fluctuating capital method, the partner's capital account changes periodically based on the business's profits and losses, additional capital, or withdrawals. However, profits and losses are recorded in a separate current account, which keeps track of the earnings or losses that affect the partner's share in the business. The current account allows for a more flexible approach, where the capital account reflects only the original capital investment, and the current account records the ongoing changes in the partner's share of the business.

5. **Answer:** b) The way capital accounts are maintained

Explanation: The main difference between the fixed capital and fluctuating capital methods is how the capital accounts are maintained. In the fixed capital method, each partner's capital account remains unchanged, with adjustments only made for additional contributions or withdrawals. In contrast, the fluctuating capital method allows the capital account to change with the profits, losses, and withdrawals made by the partners. The fluctuating capital method

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provides more flexibility, as it allows the capital account to reflect the actual performance and financial position of each partner in the business.

6. **Answer:** d) All of the above

Explanation: In the profit and loss appropriation account, items like interest on capital, salary to partners, and commission to partners are credited. The purpose of the profit and loss appropriation account is to allocate the net profit of the partnership firm to various partners according to the agreed terms. This account is used to distribute the profits after the operational expenses have been accounted for. Each partner's share in profits, interest on capital, salary, and commission are credited from this account.

7. **Answer:** b) As per the agreement in the partnership deed

Explanation: The division of profits among partners in a partnership is typically governed by the terms outlined in the partnership deed. The deed specifies how profits (and losses) will be shared among partners, which may not always be in proportion to their capital contributions. It could be based on factors such as the amount of work put in by each partner, the time spent on business operations, or any other criteria agreed upon by the partners. Without a deed, the profits are divided equally among partners.

8. **Answer:** b) To distribute the net profit among the partners

Explanation: The main objective of preparing the profit and loss appropriation account is to distribute the net profit of the partnership firm to the partners in accordance with the partnership agreement. This account ensures that each partner receives their entitled share of profits, which may include allowances such as interest on capital, partner salaries, or commissions, before the remaining profits are distributed. It also ensures that the overall profits are appropriately allocated based on the pre-agreed terms, leading to accurate and transparent profit-sharing among the partners.

9. **Answer:** a) Limited liability

Explanation: In a partnership firm, the liability of the partners is generally unlimited, meaning they are personally liable for the debts and obligations of the business. This is in contrast to a corporation, where the liability is limited to the amount invested by shareholders. The features of a partnership firm include shared profits and losses, mutual agency (where each partner can bind the firm by their actions), and joint decision-making. The lack of limited liability is one of the distinguishing features of a partnership.

10. **Answer:** c) As a reduction in the capital account

Explanation: Drawings by partners are amounts taken out by the partners from the business for personal use. These are recorded as a reduction in the partner's capital account or current account (depending on the accounting method used). Drawings do not appear as an expense in the profit and loss account because they are not related to the business's operational costs. They are also not considered a liability for the firm but are rather a reduction in the owner's equity.

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11. **Answer:** b) It is credited to the partners' capital accounts

Explanation: Interest on capital is credited to the capital accounts of the partners as per the terms in the partnership deed. This interest is paid out of the profits of the business before the distribution of any remaining profit, and it compensates the partners for investing their capital in the firm. The rate of interest and the conditions for payment are usually stipulated in the partnership deed. Interest on capital is treated as an appropriation of profit and is not recorded as an expense in the profit and loss account.

12. **Answer:** a) Equally among the partners

Explanation: If the partnership deed does not specify how profits are to be divided, the default rule under the Indian Partnership Act, 1932, is that profits are divided equally among the partners. This applies unless the partners agree otherwise in a written deed. However, it is always advisable for partners to explicitly outline profit-sharing arrangements to avoid misunderstandings and conflicts during the business's operations.

13. **Answer:** b) The partner has invested more capital than the others

Explanation: When a partner's capital account has a credit balance, it means that the partner has contributed more capital to the partnership than the other partners. In a partnership, each partner's capital account reflects their share in the firm. If a partner's account has a credit balance, it signifies that they have invested additional funds or earned their share of profits, leading to an increase in their capital in the business. It is important to track each partner's capital contributions to ensure fairness in profit-sharing and withdrawals.

14. **Answer:** c) As an appropriation from profit in the profit and loss appropriation account

Explanation: A partner's salary is not an expense but an appropriation of the profits of the business. It is recorded in the profit and loss appropriation account after calculating the net profit. The salary is paid to the partner for their contribution to the operations of the partnership. The appropriation account ensures that the salary is distributed before the remaining profits are divided among the partners. This ensures that all agreed-upon partner compensation, such as salaries and commissions, is accounted for before the profits are shared.

15. **Answer:** c) If the partnership firm is carrying on a business that violates the law

Explanation: A partnership firm can be dissolved if it is found to be engaging in illegal activities or violating laws, as this constitutes a breach of the legal framework under which partnerships operate. If a partnership firm is carrying on an unlawful business, it is mandatory to dissolve the firm. Other circumstances for dissolution might include mutual consent among partners, the expiration of the term for which the partnership was formed, or the death or insolvency of a partner.

16. **Answer:** c) According to the partnership agreement

Explanation: A partner's share in the profit and loss appropriation account is determined according to the terms laid out in the partnership agreement. This agreement outlines how

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profits and losses are to be shared among the partners, which may or may not be proportional to their capital contributions. The agreement may specify different arrangements, such as a fixed percentage for each partner or based on the partner's role in the business. In the absence of an agreement, the default rule is to divide the profits equally.

17. **Answer:** b) It is recorded as an appropriation in the profit and loss appropriation account

Explanation: A partner's commission is considered an appropriation of the firm's profits and is recorded in the profit and loss appropriation account. It is not an expense but a payment made to the partner for services rendered. This commission is typically based on a percentage of the profits or sales, and it is paid before the final distribution of profits. Including the commission in the appropriation account ensures that the partner's compensation is accounted for before dividing the remaining profits among the partners.

18. **Answer:** d) All of the above

Explanation: In the profit and loss appropriation account, all appropriations such as interest on capital, partner's salary, and commission to partners are deducted from the net profits. These appropriations are first set aside before distributing the remaining profits or losses among the partners. These deductions are made to compensate the partners for their contributions, whether it is for investing capital, working in the business, or other services provided. This ensures that partners are fairly compensated as per the terms of the partnership agreement.

19. **Answer:** b) They must be settled before distributing any remaining assets

Explanation: When a partnership is dissolved, all liabilities of the firm must be settled before any remaining assets are distributed to the partners. The assets are first used to clear the outstanding debts and liabilities, including loans, creditors, and other obligations. After the liabilities are paid, any remaining assets can be divided among the partners according to the terms of the partnership agreement. The proper order of dissolution ensures that all external obligations are met before the partners share the remaining equity in the business.

20. **Answer:** b) It is recorded as a liability in the balance sheet

Explanation: When a partner lends money to the partnership firm, it is recorded as a liability in the firm's balance sheet. The loan amount is treated as a debt the partnership owes to the partner and is not part of their capital. If the partnership has agreed to pay interest on the loan, that interest is recorded as an expense in the profit and loss account. The repayment of the loan is handled separately from the division of profits and capital. The loan must be repaid before any remaining profits are distributed.

21. **Answer:** b) It is paid before profit distribution

Explanation: Interest on capital is paid to partners as compensation for the use of their invested capital in the business. It is treated as an appropriation of profits, which means it is paid before the remaining profits are divided among the partners. The interest on capital is calculated as a percentage of each partner's capital contribution and is paid out of the business

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profits. This ensures that the partners receive a return on their capital before any profits are distributed according to the agreed profit-sharing ratio.

22. **Answer:** d) The profit-sharing ratio cannot be altered once the partnership is formed

Explanation: The profit-sharing ratio in a partnership is not fixed permanently. It can be changed with the mutual consent of all partners. This flexibility allows partners to adjust the ratio if the business circumstances change, such as when new partners are added or when the partners agree to a different arrangement based on their roles or contributions. The ratio is usually determined in the partnership deed and can be modified as long as all partners agree to the changes.

23. **Answer:** b) The partner has withdrawn more than their capital contribution

Explanation: If a partner's capital account shows a debit balance, it means that the partner has withdrawn more from the business than their original capital contribution or their share of profits. This could happen due to excessive drawings or losses incurred by the firm, which are not accounted for. The firm may ask the partner to repay the excess amount if the firm's financial situation requires it. A debit balance in the capital account can indicate a potential liability for the partner.

24. **Answer:** b) Current accounts are settled before the capital accounts

Explanation: During the dissolution of a partnership firm, the first step is to settle the current accounts of the partners. These accounts reflect the partners' share of profits, salaries, interest on capital, and any drawings. Once the current accounts are settled, any remaining balance is transferred to the capital accounts. After this, the partnership's liabilities are cleared, and any remaining assets are distributed according to the capital accounts of the partners. This ensures that the partners' share of the firm's profits and obligations is properly addressed before final distribution.

25. **Answer:** b) Partners act on behalf of the partnership firm

Explanation: The term "mutual agency" refers to the principle that each partner in a partnership firm has the authority to act on behalf of the firm and bind it in business transactions. This means that any partner can enter into contracts or agreements that affect the firm. The actions of one partner, within the scope of the partnership's business, are considered to be actions of the entire firm. Therefore, all partners are responsible for each other's actions in the course of business.

26. **Answer:** b) If the partnership deed specifies the continuation after dissolution

Explanation: A partnership firm can continue its business if the partnership deed specifies that the firm should continue even after certain events, such as the death, withdrawal, or insolvency of a partner. In the absence of such provisions in the partnership deed, the partnership will generally be dissolved upon these events. If the partnership deed allows the firm to continue, the remaining partners can continue the business by adjusting the capital and profit-sharing ratios accordingly.

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27. **Answer:** c) It is deducted from the profits of the firm

Explanation: Interest on drawings is the interest charged on the money withdrawn by a partner for personal use. It is considered a benefit given to the partner and is therefore deducted from the firm's profits before they are distributed among the partners. The interest on drawings is a form of compensation to the firm for the funds withdrawn early, which could have been used in the business. This deduction ensures that partners do not benefit unfairly from their withdrawals, especially when the business is earning profits.

28. **Answer:** a) It is distributed among the partners

Explanation: Upon the dissolution of a partnership, the goodwill of the firm is treated as an asset that must be distributed among the partners according to the terms outlined in the partnership agreement. If the partnership agreement does not specify the treatment of goodwill, it is usually divided equally or based on the partners' capital ratios. The distribution of goodwill ensures that the partners receive their share of the value generated by the firm's reputation and customer relationships. If the firm has a positive reputation, goodwill can be a valuable asset.

29. **Answer:** a) Income and expenditure account

Explanation: The income and expenditure account is typically used for not-for-profit organizations and is not part of the final accounts of a partnership. In a partnership, the final accounts typically include the profit and loss appropriation account, the balance sheet, and the capital accounts. The profit and loss appropriation account allocates the profits or losses to the partners based on the partnership agreement, while the balance sheet provides a snapshot of the firm's assets, liabilities, and equity at the end of the accounting period. The capital accounts track each partner's contributions and share in the business.

30. **Answer:** b) It establishes clear terms for profit-sharing and other partner responsibilities

Explanation: The partnership deed is crucial for establishing clear and formal terms regarding the management of the business, profit-sharing ratios, and the rights and duties of each partner. It serves as a legal document that outlines the contributions, salaries, interest on capital, and the method of distributing profits or losses. By doing so, the partnership deed prevents disputes and ensures that all partners are on the same page regarding the firm's operation. It is highly recommended to have a deed in place to avoid misunderstandings or legal complications during the life of the partnership.

31. **Answer:** c) It is treated as an adjustment to the partner's capital account

Explanation: If a partner withdraws more than their entitled share of the profits, the excess amount is treated as an adjustment to the partner's capital account. This ensures that the partnership maintains fairness in profit-sharing and capital distribution. It is important to track withdrawals accurately to prevent discrepancies in the distribution of profits and to ensure that each partner receives their rightful share. Excess withdrawals will be deducted from the partner's capital, and the firm may require repayment if necessary.

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32. **Answer:** c) Based on their profit-sharing ratio

Explanation: Losses in a partnership firm are typically distributed among the partners based on their agreed profit-sharing ratio. This ratio is usually specified in the partnership deed and can be based on factors such as capital contribution, roles, or mutual agreements between the partners. If the profit-sharing ratio is not specified in the partnership deed, the losses are generally divided equally among the partners. The distribution of losses ensures that each partner takes on their fair share of the financial burdens of the firm.

33. **Answer:** d) When partners' capital accounts are fixed, and drawings are adjusted separately

Explanation: The fixed capital method is used when each partner's capital account remains fixed, meaning that no changes occur to the initial capital unless new capital is introduced or there are adjustments due to losses. In this method, any withdrawals or drawings by the partners are recorded in a separate drawings account, not in the capital account. The fixed capital method simplifies the capital accounts and makes it easier to track changes in the capital structure of the partnership, especially when there is no significant fluctuation in the capital invested by the partners.

34. **Answer:** b) The distribution of profits among partners

Explanation: The profit and loss appropriation account shows how the net profit (or loss) of the partnership is distributed among the partners. It includes appropriations such as interest on capital, partner salaries, and commission, before the remaining profit is divided according to the profit-sharing ratio. The appropriation account ensures that the agreed-upon amounts are allocated fairly before the final distribution of profits. It is a critical tool for understanding how profits are shared based on the terms outlined in the partnership deed.

35. **Answer:** b) The partnership deed

Explanation: In case of a dispute between partners, the partnership deed is the primary document to refer to for resolving the issues. The partnership deed outlines the terms of the partnership, including profit-sharing ratios, capital contributions, the roles of each partner, and how to handle disputes or disagreements. If the partnership deed includes provisions for dispute resolution, it helps the partners reach an amicable solution. In the absence of a partnership deed, general partnership law or the default legal provisions of the jurisdiction may apply.

36. **Answer:** b) According to their agreement in the partnership deed

Explanation: The division of profits when partners have different roles in a partnership is usually based on the terms set out in the partnership deed. This agreement may specify different profit-sharing ratios based on each partner's role, such as a higher share for a partner who is actively involved in managing the business. The partnership deed is crucial in this scenario as it outlines how profits should be shared according to the partners' responsibilities and contributions. If no specific agreement exists, the profits may be divided equally or according to capital contributions.

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37. **Answer:** b) They are settled before distributing the firm's assets

Explanation: When a partnership is dissolved, the capital accounts of the partners must be settled before any remaining assets are distributed. The first step in dissolution is to pay off all liabilities and debts of the firm, and any remaining assets are then used to settle the capital accounts of the partners. If any partner has a debit balance (i.e., has withdrawn more than their share), they are required to repay the firm. After settling the capital accounts, any remaining assets are distributed among the partners according to their respective capital balances or as specified in the partnership deed.

38. **Answer:** b) To assess the liabilities and capital of the firm

Explanation: The primary purpose of preparing a partnership's balance sheet is to assess the financial position of the firm, including the value of its assets, liabilities, and the capital invested by the partners. It provides a snapshot of the firm's resources and obligations at a given point in time. The balance sheet helps the partners understand the firm's financial stability and determine how assets should be distributed in case of dissolution. It also aids in decision-making, especially in relation to future investments, withdrawals, or any changes to the partnership structure.

39. **Answer:** c) As a reduction in the capital account

Explanation: Drawings by a partner are recorded as a reduction in their capital account. This reflects the withdrawal of funds by the partner from the partnership for personal use. Drawings are not considered an expense for the business because they do not affect the firm's profit or loss. However, they reduce the available capital for the firm and must be accounted for accurately to ensure the correct distribution of remaining profits. The drawings are adjusted periodically, and any excess withdrawal may result in adjustments to the partner's account.

40. **Answer:** c) The remaining partners' ratio may change

Explanation: When a partner retires, the profit-sharing ratio of the remaining partners may change. The retiring partner's share of profits and capital must be settled before the remaining partners can continue the business. The remaining partners may agree to redistribute the profit-sharing ratio based on their capital contributions, roles, or new agreements. In some cases, a new partner may be admitted, which could result in a new ratio being determined. It is important to establish these changes formally to avoid confusion and ensure fairness among the remaining partners.

41. **Answer:** c) It is written off to the capital accounts of the existing partners

Explanation: When a new partner is admitted to the partnership, goodwill is typically written off to the capital accounts of the existing partners in proportion to their old profit-sharing ratios. This ensures that the existing partners receive compensation for the goodwill built up during their time in the business. The new partner may contribute a certain amount towards goodwill, which is adjusted against the capital accounts of the old partners. This process ensures fairness and reflects the value of the business that the new partner is joining.

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42. **Answer:** b) To allocate the net profit to the partners based on the agreed profit-sharing ratio

Explanation: The profit and loss appropriation account is a critical part of partnership accounting. Its main role is to allocate the net profit (or loss) of the partnership to the partners based on the agreed profit-sharing ratio as stated in the partnership deed. It also accounts for various adjustments such as interest on capital, partner salaries, and other allowances, before distributing the remaining profit to the partners. The appropriations ensure that each partner's share of the firm's profits is calculated and allocated correctly.

43. **Answer:** b) The fluctuating capital method tracks changes in capital due to withdrawals and additional investments

Explanation: The main difference between the fixed and fluctuating capital methods lies in how capital accounts are managed. In the fixed capital method, the capital accounts of the partners remain fixed, with changes due only to additional investments or withdrawals that are recorded separately in a drawings or current account. In contrast, the fluctuating capital method allows for frequent changes to the capital account due to adjustments from profits, losses, interest on capital, drawings, and additional contributions. This method provides a more dynamic reflection of a partner's stake in the business.

44. **Answer:** c) It is added to the firm's cash or bank account as additional funds

Explanation: When a new partner is admitted into a partnership, the capital they introduce is added to the firm's cash or bank account as additional funds. This capital increases the firm's assets and is also recorded in the new partner's capital account. The amount of capital introduced by the new partner is often determined by their agreed share in the profits and their contribution towards goodwill. The existing partners' capital accounts may be adjusted based on the introduction of the new partner and the agreed terms in the partnership deed.

45. **Answer:** c) To provide a financial snapshot of the firm's assets and liabilities

Explanation: The purpose of preparing a balance sheet at the end of an accounting period is to provide a financial snapshot of the firm's assets and liabilities. It shows the firm's financial position at a specific point in time, detailing its resources (assets) and obligations (liabilities), as well as the capital invested by the partners. This helps partners assess the firm's financial stability and plan for future decisions, such as additional investments, withdrawals, or changes in the partnership structure. The balance sheet is an essential tool for both internal and external stakeholders.

46. **Answer:** a) Profits are shared equally among the partners

Explanation: When the profit-sharing ratio is not specified in the partnership deed, the profits are typically shared equally among all partners. In the absence of a clear agreement, this is the default arrangement according to the Indian Partnership Act of 1932 and other similar laws in many jurisdictions. The equal distribution ensures fairness among the partners if no special considerations, such as capital contributions or roles in the business, are mentioned. Partners

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are also free to modify this ratio at any time by mutual consent, provided they amend the partnership deed.

47. **Answer:** b) It is transferred to the deceased partner's heirs

Explanation: Upon the death of a partner, their share of the profits and capital is typically transferred to their heirs or legal representatives. The specific treatment of the deceased partner's share is usually outlined in the partnership deed. If the partnership deed specifies that the deceased partner's share should be transferred to their heirs, the remaining partners will pay the heirs the value of the deceased partner's share based on the firm's current valuation. If no such provisions exist, the surviving partners may negotiate an agreement for the settlement.

48. **Answer:** a) It is deducted from the firm's profits

Explanation: A partner's salary is treated as an appropriation of the profits of the firm. In the profit and loss appropriation account, it is deducted from the firm's profits before the remaining amount is divided among the partners according to the profit-sharing ratio. This ensures that the partner's salary is accounted for before the remaining profits are distributed. The salary is considered an expense for the firm, as it is a payment made for the work or services provided by the partner in managing the business.

49. **Answer:** a) It affects the accuracy of the capital accounts

Explanation: An incorrect profit-sharing ratio can significantly affect the accuracy of the capital accounts in the partnership's financial records. If the ratio is wrong, the profit allocation to each partner will be incorrect, leading to discrepancies in the capital accounts and the final distribution of profits or losses. This can result in unfair distributions among the partners and could lead to disputes. To avoid this, the profit-sharing ratio should be clearly defined in the partnership deed, and any changes should be properly documented and agreed upon by all partners.

50. **Answer:** c) The partner has contributed more capital than initially agreed

Explanation: When a partner's capital account has a credit balance, it indicates that the partner has contributed more capital to the firm than originally agreed upon or has accumulated a larger share of profits. This can happen if the partner invests additional funds into the business or if the firm generates profits that are allocated to the partner's capital account. A credit balance in the capital account signifies the partner's stake or share in the partnership, reflecting their contribution to the firm's equity.