Guarantee of Profits to a Partner:

Sometimes partners agree to guarantee minimum profit to a partner as a special privilege. There can be many reasons for granting such a privilege. Attracting a reputed individual, who is unwilling to bear the risk of income fluctuations to become a partner, is one of such reasons. The deficiency (difference between guaranteed profit and actual profit) is borne by other partner or partners' in agreed ratio. If the share of profit of the partner holding guarantee privilege comes equal or more than the guaranteed sum, that actual share will be given without any adjustments.

Guarantee may be provided by one or some or all of the partners in an existing profit-sharing ratio or in some other agreed ratio. If in any year, the actual share of profit is less than the guaranteed amount, the deficiency is borne by the guaranteeing partners in their agreed ratio.

Different Cases of Guarantee

A. **Guarantee by the Firm or by All the Partners of the Firm:** In this case, firstly the firm enters the guaranteed amount to the partner in the Profit and Loss Appropriation Account. Then, it distributes the remaining profit among the remaining partners in their remaining ratio.

For Example: Amit, Raj and Sohan are partners in a firm sharing profit and loss in the ratio 2:2:1. Amit and Raj had guaranteed that Sohan's profit in any year shall not be less than Rs.40000. The Net profit for the year ended 31st March 2018 was Rs.1.20, 000. Prepare Profit and Loss Appropriation Account.

Profit and Loss Appropriation A/c

Particulars	**Amount**	**Particulars**	**Amount**
To Amit's Capital A/c	40,000	By Net Profit (transferred from P&L A/c)	1,20,000
To Raj's Capital A/c	40,000		
To Sohan's Capital A/c	40,000		
	1,20,000		1,20,000

Working Notes: Sohan's 1/5th share of Rs.1, 20,000 is less than Rs.40000 (guarantee amount). Hence, he must be paid Rs.20000 and the remaining partners (P and Q) will share the remaining profit of Rs.40000 in their respective profit sharing ratio (2:2 or 1:1)

B. **Guarantee by One Partner Only to another Partner:** Under this case, firstly the deficiency of profit is calculated for the partner who has received the guarantee. Then, this deficiency is deducted from the share of the partner who has given the guarantee.

For Example: Now let's assume, in the first example, if only Amit gives the guarantee to Sohan then the adjustments will be like:

Profit and Loss Appropriation A/c

Particulars	Amount	Particulars	Amount
To Amit's Capital A/c	32,000	By Net Profit (transferred from P&L A/c)	1,20,000
To Raj's Capital A/c	48,000		
To Sohan's Capital A/c	40,000		
	1,20,000		1,20,000

Working Notes: Here also, Sohan's share is less than the guaranteed amount. Hence, he will get the guaranteed amount but this time there will not be any effect on the profits of Raj as the guarantee is given by Amit only. So, the adjustments (deduction) of deficiency of profit (Rs.8, 000) will be from Amit's share only.

C. **Guarantee by Other Partners but Deficiency is borne in a Specified Ratio:** Under this case, the deficiency of profit is borne by other partners in a pre-determined ratio as agreed between them not the remaining profit sharing ratio.

For Example: A and B were partners in a firm sharing profits and losses in the ratio of 3:2. They admit C for 1/6th share in profits and guaranteed that his share of profits will not be less then Rs. 25,000. Total profits of the firm were Rs. 90,000. Calculate share of profits for each partner when, Guarantee is given by A and B in ratio of 3:2.

SOLUTION:

Profit and Loss Appropriation Account
For the year ending on…………………

Particulars		Rs	Particulars	Rs
To A's Capital A/c (3/6th of Rs.90,000) Less : Deficiency Borne for C (3/5th of 10,000)	 45,000 6, 000	**39,000**	By Profit and Loss A/c (Net Profits)	90,000
To B's Capital A/c (2/6th of Rs.90,000) Less : Deficiency Borne for C (2/5th of 10,000)	 30,000 4,000	**26,000**		
To C's Capital A/c (1/6 of Rs.90,000) Add : Deficiency Recover from A Deficiency Recover from B	 15,000 6,000 4 ,000	**25,000**		
		90,000		**90,000**

Point to be remembered:

- ***Case :*** **1. When guarantee is given by FIRM (i.e., by all the Partners of the firm)**
  - *Guaranteed amount to a partner is written in Profit and Loss Appropriation A/c*
  - *Remaining profits are distributed among the remaining partners in their remaining ratio.*
- **Case 2: When guarantee is given by a partner or partners to another partner**
  - *Calculate the share in profits for the partner to whom guarantee is given*
  - *If share in profits is more than the guaranteed amount, distribute the profits as per the profit and loss sharing ratio in usual manner.*
  - *If share in profits is less than the guaranteed amount, find the difference between the share in profits and the guaranteed amount and the difference is known as Deficiency.*
    - *Deficiency is distributed among the partner or partners who guaranteed in ascertain ratio and subtracted from his or their respective shares.*

Past Adjustments: Sometimes after closing the accounts of a partnership firm for a certain period, certain omissions or errors may be discovered. For example, interest on capital or interest on drawings may have been omitted or interest has been calculated at a different rate than agreed, or profits may have been distributed in a different manner than agreed among the partners. Corrections of these errors are generally rectified in the next year by passing a single adjusting Journal entry through the Partners' Capital Accounts or Partners' Current Accounts by means of a. No attempt is made to reopen the accounts of the previous accounting period(s). Such adjustments are called **past adjustments** as these are related to past periods.

Omission of Interest on Capital / Interest on Drawings: This step is almost like rectification of errors that one a students had gone through previous year. Let us first consider omission of interest on capital. Interest on capital is taken out of the available net profit and then the balance of net profit is distributed to the partners' in the profit sharing ratio. So, when the interest on capital is omitted in the first place it means that the entire net profit is distributed incorrect.

Now how do we correct it?
Simple, take out the total amount required for paying interest on capital from the capital accounts of partners in the profit sharing ratio, and give it back to them as interest.

Omission of Outstanding Expenses and Incomes: Outstanding expenses and outstanding incomes have direct effect on the net profit. Outstanding expense is an expense in the first place and a liability as well. When it is omitted it means a higher profit is distributed to partners and a liability is not provided in the books. Outstanding income has the opposite effect. Rectification of these errors is a simple procedure.

- If the number of items is less, correct it by passing simple rectification entry, by debiting outstanding income, crediting outstanding expense and passing the difference into capital account. This way you are creating asset account in the books for the outstanding income, creating liability account for the outstanding expense, and transferring the net loss or gain into capital accounts.
- When the number of items involved is more or when it is specifically asked in the question, you should open a **profit and loss adjustment account**.
- P&L adjustment account can be safely assumed as a combined capital account of partners. When you want debit partner's capital account you can debit P&L adjustment account instead.
- When there is an outstanding expense, we usually debit capital accounts and credit outstanding expense account. Now you debit P&L adjustment account for any outstanding expense and credit it for the outstanding income.
- The net balance of profit and loss adjustment account is transferred to the capital accounts of partners in the profit sharing ratio.

Note:

- *(+) indicates amount to be Credited to Partner's Capital or Current Account AND (-) indicates Amount to be debited to Partner's Capital or Current Account.*
- *During Past adjustment it is not compulsory that capital accounts of all partners are affected. More than one partner's Capital Account may be debited or credited but **amount of debit & credit should be equal.***

JOURNAL ENTRY

Date	Particulars	L.F.	Debit Rs.	Credit Rs.
	Partner's Capital A/c (Amount to be Debited) Dr To Partners' Capital A/c (Amount to be credited) (Being adjustment entry passed………….)			

STATEMENT SHOWING ADJUSTMENT

Particulars	A Rs.	B Rs.
A. Amount to be given (CREDITED)		
* Interest on Capital (Not allowed or provided at a lower rate)		
* Partner's Salary or Commission etc. (Omitted to be recorded)		
* Actual Profits (To be distributed in correct ratio)		
TOTAL A		
B. Amount already given to be taken back now (DEBITED)		
* Interest on Capital (If given at a higher rate)		
* Interest on Drawings (if not charged)		
* Profits already distributed in wrong ratio (debited now)		
TOTAL B		
NET EFFECT (A-B)	+/-	+/-

For example: Manoj, Sahil and Dipankar are partners in a firm sharing profits and losses equally. The have omitted interest on Capital @10% per annum for three years ended on 31st March, 2019. Their fixed Capital on which interest was to be calculated throughout the year were:

- Manoj Rs.6,00,000
- Sahil Rs.4,00,000
- Dipankar Rs.2,00,000

Pass an adjustment entry and show working notes clearly.

SOLUTION:

In the Books of Manoj, Sahil and Dipankar

Date	Particulars	L.F.	Debit Rs.	Credit Rs.
	Dipankar's Current A/c Dr. To Manoj's Current A/c (Being adjustment entry passed)		30,000	30,000

STATEMENT SHOWING ADJUSTMENT

Particulars	Manoj Rs.	Sahil Rs.	Dipankar Rs.
A. Amount to be given (Credited) Interest on Capital	90,000	60,000	30,000
Total A	**90,000**	**60,000**	**30,000**
B. Amount already given to be taken back now debited:			
Excess Profit taken back from the partners in their profit sharing ratio	**60,000**	**60,000**	**60,000**
(Rs.90,000+60,000+30,000 = 1,80,000)			
Total B Net Effect (A-B)	***30,000 Credit***	***Nil***	***30,000 Debit***

NOTE: Common Error done by student-

- **Interest on Capital:** Interest is allowed on partner's capitals only if there is a specific agreement in the partnership deed. When interest is allowed on partner's capital it should be calculated on the basis of period of capital investment. Suppose a partner makes additional investment after three months from the starting of a year, interest on this additional capital is allowed for nine months only, not for the full year.
- **Commission to Partners:** Commission is allowed to a partner for his service if all partners agree to such a payment. Again, in the absence of a specific condition in the partnership deed, a partner is not entitled to any salary or commission for his service rendered to the firm.
  When commission is allowed it may be stated as 'payable on the profit **before** charging commission' or 'payable on the profit **after** charging commission'. If commission is payable on the profit before charging commission, it simply means that the commission is to be calculated at the given percent on the given amount of profit. But if it is a certain percentage after charging such commission, the amount of commission should be exactly the percentage specified on the balance of profit after deducting such commission, not the total amount.
- **Calculation of Capital Ratio:** Capital ratio should be understood as investment ratio. Money is considered an important working factor in the business. When the capital contribution of a partner is higher, it also means that his money worked more in making the profit. In calculating the capital ratio the amount and the period of investment are to be considered. Suppose A contributes 10,000 in January and B contributes the same amount on 1st July, A's capital has worked double that of B due to earlier investment, even though both the amounts are the same at the end of the year. Therefore, capital ratio should be based on the amount of capital multiplied by the number of months the investment remained with the firm.