technical

accounting for partnerships

relevant to CAT Scheme Papers 3 and 6, Professional Scheme Paper 1.1, and new ACCA Qualification Paper F3

pooling resources

Understanding business partnerships is an important element of CAT Scheme Papers 3 and 6, Professional Scheme Paper 1.1, and new ACCA Qualification Paper F3. This article looks at the ways in which partnerships are formed, structured, and accounted for.

DEFINITIONS

Partnership

A partnership is a business formed by a minimum of two people who pool their resources together towards a common goal. Partnerships are generally formed through verbal arrangements or by deed – a legally binding document, drawn up by the partners, which safeguards their interests in the case of a dispute or misunderstanding. In lieu of a deed, the partnership is governed by local law (for example, the Partnership Act 1890 in the UK). The law does not offer solutions that would be contrary to the wishes of partners. Instead, it provides a set of standard procedures which can be followed by any partnership, and are therefore not tailored to any individual partnership.

Partnership agreement

This is the agreement made among the partners – the policies, formulated by the partners, under which the partnership business will be governed. Some of the principles that might be covered under such an agreement include:

- share of profit and loss
- rate of interest on partners' capital, and on any loans or advances
- salary to be paid to partners
- interest on drawings
- working schedule and specialisation.

In the absence of a partnership agreement, local law would come into effect. As an example, in the UK, the Partnership Act of 1890 sets out the following principles:

- profit or loss should be shared equally between partners
- no salary should be paid to partners
- no interest on drawings should be charged to partners
- no interest should be credited to partners for their capital invested
- any loans and advances, apart from the capital invested by the partners, are entitled to 5% interest per annum.

ADVANTAGES AND DISADVANTAGES OF OPERATING AS A PARTNERSHIP AS OPPOSED TO A SOLE TRADER

The advantages of a partnership are as follows:

- more capital can be raised because of the number of partners
- specialised management – each partner can work in the area in which they are qualified or have expertise
- continuation of the business if one partner dies or retires
- partners can better afford to take a long break or holiday.

The disadvantages of a partnership are:

- the decision-making process can be slower due to consultation among partners
- many partnerships end in disagreement
- the profit has to be shared among partners
- there is unlimited liability if the business has to wind up. (Unless a limited liability partnership (LLP) is formed. LLPs are outside the scope of this article.)

ACCOUNTING FOR A PARTNERSHIP

Just as for a sole trader, a partnership also prepares an income statement/profit and loss account and balance sheet. The income statement/profit and loss account for a sole trader is the same as that of a partnership, as is the net assets part of the balance sheet. However, the capital part of the balance sheet is different from that of a sole trader. In order to prepare the capital part of the balance sheet for a partnership, there are three workings that must be completed:

Partners' appropriation account – this working is used to share out the profit or loss of the business between the partners.
Partners' current account – this working is done to show how much money is owed to the partners by the partnership business, or how much money is owed to the partnership business by the partners.
Partners' capital account – this working is drawn up to check how much money is invested in the business by the partners.

TABLE 1: ABC PARTNERSHIP APPROPRIATION ACCOUNT FOR THE YEAR ENDED 31 DECEMBER 2005

	A	B	C	Total
	$	$	$	$
Net profit for the year				x
Add interest on drawings	(x)	(x)	(x)	x
Less interest on partners' capital	x	X	x	(x)
Less partners' salary	x	X	x	(x)
Profit to be shared				**x**
Share of profit	x	X	x	(x)
	x	**X**	**x**	**0**

TABLE 2: ABC PARTNERSHIP CURRENT ACCOUNT AS AT 31 DECEMBER 2005

	A	B	C		A	B	C
	$	$	$		$	$	$
				Balance b/f	x	x	x
Drawings	x	x	x	Interest on capital	x	x	x
Interest on drawings	x	x	x	Partners' salary	x	x	x
Share of loss	x	x	x	Share of profit	x	x	x
Balance c/f	x	x	x				
	X	**X**	X		**X**	**X**	**X**
				Balance b/f	**x**	**x**	**x**

TABLE 3: ABC PARTNERSHIP CAPITAL ACCOUNT AS AT 31 DECEMBER 2005

	A	B	C		A	B	C
	$	$	$		$	$	$
Elimination of goodwill using the new profit sharing ratio (PSR)	x	x	x	Balance b/f	x	x	
				Capital introduced			x
				Introduction of goodwill using old PSR	x	x	x
Balance c/f	x	x	x				
	X	**X**	**X**		**X**	**X**	**X**
				Balance b/f	**x**	**x**	**x**

EXAMPLE 1

ABC Partnership

Table 1 shows the appropriation account for the year ended 31 December 2005. In an exam, the examiner might include the partners' salary as wages and salaries in the income statement/profit and loss account. This would mean that the net profit would need adjusting, which would involve adding the partners' salary to the net profit given in the question.

EXAMPLE 2

ABC Partnership

Table 2 shows the current account as at 31 December 2005.

EXAMPLE 3

ABC Partnership

Table 3 shows the capital account as at 31 December 2005.

EXAMPLE 4

Here is an illustrated example of the workings of a partnership business, and the treatment of goodwill on the admission of a new partner.

Jess and Tash are in partnership and share profits and losses in the ratio of 6:4 respectively. Jess is allowed an annual salary of $28,000 and Tash is allowed an annual salary of $25,000. The partners prepare their accounts annually at 31 December. The balances on the partners' current and capital accounts at 1 January 2005 are as follows:

Partners	Current account	Capital account
	$	**$**
Jess	20,000 CR	250,000 CR
Tash	30,000 CR	400,000 CR

Due to the expansion and success of the business, the partners admitted Sash into the partnership on 1 April 2005. Sash introduced $500,000 as capital. On that date, the partners valued the goodwill as $200,000. After the admission of Sash, the partnership arrangements are as follows:

- Profit and losses will be shared as follows:
  - Jess: 50%
  - Tash: 30%
  - Sash: 20%
- Partners will be credited with 5% of the interest on their capital balance at the start of the year
- Interest on drawings will be charged at 8% per annum
- The partners' drawings during the year are as follows:
  - Jess: $40,000 to 31 March and $60,000 to 31 December
  - Tash: $30,000 to 31 March and $50,000 to 31 December
  - Sash: $50,000 to 31 December
- Sash will be allowed an annual salary of $20,000. Jess and Tash will continue to receive their annual salary
- The goodwill must be eliminated from the records
- During the year ended 31 December 2005, the partnership reported a profit of $526,000 after writing off a bad debt of $6,000 on 31 March 2006
- The partners' annual salary was deducted as an expense in the income statement/profit and loss account under wages and salaries.

Requirement

Prepare the following:

(a) Partners' capital accounts as at 31 March 2005
(b) Partners' appropriation account for the year ended 31 December 2005
(c) Partners' current accounts as at 31 December 2005
(d) Balance sheet extract (Capital) as at 31 December 2005.

Answer

(a) Jess, Tash and Sash Partnership

Table 4 on page 65 shows the capital account as at 31 March 2005.

Goodwill is the excess market value of the business over its book value. It is only fair that the partners who created this goodwill – Jess and Tash – should benefit from it, due to the hard work they have put into the business to get it up and running. If a partner joins the business when such surplus is present, then it is only fair that Sash pays for that benefit. The accounting entries are:

Dr Partners' capital account using new profit sharing ratio (PSR)
Cr Partners' capital account using old profit sharing ratio (PSR).

(b) Jess, Tash and Sash

Table 5 on page 65 shows the appropriation account for the year ended 31 December 2005.

Calculating the profit

	$
Net profit as per question	526,000
Add bad debt written off (this should be written off in the period that it relates to)	6,000
Partners' salary should be treated in the appropriation account and not the income statement/profit and loss account	68,000
Net profit before appropriation	**600,000**
For the first three months to 31 March 2005, the net profit would be: ($600,000 x 3/12) = $150,000 - $6,000	**144,000**
For the next nine months to 31 December 2005, the net profit would be: ($600,000 x 9/12) = $450,000	**450,000**

(c) Jess, Tash and Sash

Table 6 on page 65 shows the current account as at 31 December 2005.

(d) Balance sheet extract

	$	$
Capital account		
Jess		270,000
Tash		420,000
Sash		460,000
		1,150,000
Current account		
Jess	212,128	
Tash	150,277	
Sash	51,595	**414,000**
		1,564,000

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In order to prepare the capital part of the balance sheet for a partnership, there are three workings that must be completed: partners' appropriation account, partners' current account, and partners' capital account.

TABLE 4: JESS, TASH AND SASH PARTNERSHIP CAPITAL ACCOUNTS AS AT 31 MARCH 2005

	Jess	Tash	Sash		Jess	Tash	Sash
	$	$	$		$	$	$
Goodwill new PSR	100,000	60,000	40,000	**Balance b/f**	**250,000**	**400,000**	
				Bank (capital introduced)			500,000
Balance b/f	270,000	420,000	460,000	Goodwill old PSR	120,000	80,000	
	370,000	**480,000**	**500,000**		**370,000**	**480,000**	**500,000**
				Balance b/f	**270,000**	**420,000**	**460,000**

TABLE 5: JESS, TASH AND SASH PARTNERSHIP APPROPRIATION ACCOUNT FOR YEAR ENDED 31 DECEMBER 2005

	Period to 31 March (3 months)		Period to 31 Dec (9 months)	
	$	$	$	$
Net profit		**144,000**		**450,000**
Add interest on drawings				
Jess (40,000 x 8% x 3/12): (60,000 x 8% x 9/12)	800		3,600	
Tash (30,000 x 8% x 3/12): (50,000 x 8% x 9/12)	600		3,000	
Sash (50,000 x 8% x 9/12)	-	1,400	3,000	9,600
		145,400		**459,600**
Less interest on partners' capital				
Jess (250,000 x 5% x 3/12): (270,000 x 5% x 9/12)	(3,125)		(10,125)	
Tash (400,000 x 5% x 3/12): (420,000 x 5% x 9/12)	(5,000)		(15,750)	
Sash (460,000 x 5% x 9/12)	-	(8,125)	(17,250)	(43,125)
Less partners' salary				
Jess (28,000 x 3/12): (28,000 x 9/12)	(7,000)		(21,000)	
Tash (25,000 x 3/12): (25,000 x 9/12)	(6,250)		(18,750)	
Sash (20,000 x 9/12)	-	(13,250)	(15,000)	(54,750)
Profit to be shared		**124,025**		**361,725**
Share of profit				
Jess (124,025 x 60%): (361,725 x 50%)	(74,415)		(180,863)	
Tash (124,025 x 40%): (361,725 x 30%)	(49,610)		(108,517)	
Sash (361,725 x 20%)	-	**(124,025)**	(72,345)	**(361,725)**
		Nil		**Nil**

TABLE 6: JESS, TASH AND SASH PARTNERSHIP CURRENT ACCOUNTS AS AT 31 DECEMBER 2005

	Jess	Tash	Sash		Jess	Tash	Sash
	$	$	$		$	$	$
Drawings	100,000	80,000	50,000	**Balance b/f**	**20,000**	**30,000**	-
Interest on drawings	4,400	3,600	3,000	Interest on capital	13,250	20,750	17,250
				Partners' salary	28,000	25,000	15,000
Balance b/f	212,128	150,277	51,595	Share of profit	255,278	158,127	72,345
	316,528	**233,877**	**104,595**		**316,528**	**233,877**	**104,595**
				Balance b/f	**212,128**	**150,277**	**56,595**