PARTNERSHIP ACCOUNTS

Partnership

There are a number of ways in which a partnership may be defined, but there are four key elements.

Two or more individuals

A partnership includes at least two individuals (partners). In certain jurisdictions, there may be an upper limit to the number of partners but, as that is a legal point, it is not part of the FA2 syllabus.

Business arrangement

A partnership exists to carry on a business.

Profit motive

As it is a business, the partners seek to generate a profit.

Unincorporated business entity

A partnership is an unincorporated business entity. That means:

- The reporting entity (business entity) principle applies to a partnership, so for accounting purposes, the partnership is a separate entity from the partners
- The partners have unlimited liability, and
- If the partnership is unable to pay its liabilities, the partners may be called upon to use their personal assets to clear unpaid liabilities of the partnership.

Partnership Controlled

It is good practice to set out the terms agreed by the partners in a partnership agreement. While this is not mandatory, it can reduce the possibility of expensive and acrimonious disputes in the future. As a formal agreement is not mandatory, there is no definitive list of what it should contain, but FA2 exams will not go beyond the following:

Share of residual profit

The FA2 Study Guide defines this as ‘the amount of profit available to be shared between the partners in the profit and loss sharing ratio, after all other appropriations have been made’.

Therefore, candidates need to be aware that there is a distinction to be made between the profit for the year (income minus expenses), which is calculated in exactly the same way as for a sole trader and residual profit (the remaining profit after profit for the year has been adjusted by the appropriations in accordance with the partnership agreement).

It’s worth pointing out that when a question states the profit or loss sharing ratio, that the proportions are always applied to the residual profit – not the profit for the year.

Appropriations of profit

As there is no requirement for all of the appropriations considered below to be included by a specific partnership, exam questions may only include some of them. That means that you only need to deal with the appropriations referred to in the question.

Another point to remember is that the Appropriation Account is an additional accounting statement that is required for a partnership. For a sole trader, the profit for the year is simply transferred to the credit side of the proprietor's capital account (the double entry is completed by a debit entry in the income statement, resulting in a nil balance on that statement). In the case of a partnership, the income statement will still be debited, but the profit will be credited to the appropriation account, rather than the capital account. As each appropriation is dealt with, the double entry is completed through entries in both the appropriation account and the partner's current account (if current accounts are not maintained by the partnership, the entries will be made in the capital accounts).

Partners' salaries

In some ways, the term 'salaries' is a misleading description. The salaries of employees are business expenses that are written off to the income statement, thereby reducing profit for the year. However, as partners are the owners of the business, any amounts that are paid to them under the partnership agreement are part of their share of the profit. As the amount is guaranteed, it must be dealt with through a credit entry in the partner's account (usually the current account) before the residual profit is shared.

The double entry is completed by a debit entry in the Appropriation Account.

Interest on capital

Almost always, interest on capital will be paid on partners' capital balances only – although the balances on the current accounts are actually part of the total capital balance, it is normal to exclude them from the value of capital on which interest is paid.

Paying interest on capital is a means of rewarding partners for investing funds in the partnership as opposed to alternative investments. As such, it reduces the amount of profit available for sharing in the profit and loss sharing ratio. This means that a debit entry is needed in the Appropriation Account. The double entry is completed by a credit entry in the current account of the partner to whom the salary is paid.

Interest on drawings

Charging interest on drawings is a means of discouraging partners from withdrawing excessive amounts from the business. From this, it follows that interest on drawings is a debit entry in the partners' current accounts and a credit entry in the Appropriation Account.

Depending on what the question is testing, it will either provide the amounts of interest on capital and drawings or give details of how to calculate the amounts.

Remember to deal with each of these appropriations before sharing the residual profit between the partners.

A final point in this context is that, if the total of the appropriations is greater than the profit for the year, the amount to be shared between the partners will be a loss. This will mean that the entries for the share of the residual profit will be a credit in the Appropriation Account (thus resulting in a nil balance) and debits in the partners' current accounts.

What is the difference between capital and current accounts?

In one sense, there is no difference. A partner's total capital is the sum of the balances on their capital account and their current account.

In practice, however, it is convenient to separate the amount invested by the partner (the capital account) from the amount they have earned through the trading activities of the partnership (the current account). Therefore, the capital account is usually fixed, while the current account is the current total of appropriations and the share of residual profit/loss, less drawings.

Remember that a partner's drawings will be a debit entry in the partner's current account.

What happens when there is a new partner?

When a new partner is admitted to the partnership, the new partners effectively buy the assets of the old partnership from the old partners.

The admission of a new partner will also mean that the profit/loss sharing ratio will change.

How does goodwill arise, and how is it treated?

Goodwill is defined as the amount by which the fair value of the net assets of the business exceeds the book value of the net assets. It arises due to factors such as the reputation, location, customer base, expertise or market position of the business. (In simple terms, 'fair value' can be thought of as being the same as 'market value'.)

In the FA2 exam, the following points will not be examined:

- The reasons for goodwill
- The calculation of goodwill
- The definition of fair value
- The calculation of fair value.

The question will provide either the value of goodwill, or information to allow it to be calculated without much difficulty (see Example (ii)).

The first step is to create the asset of goodwill. This is a debit entry for the value of the goodwill in the goodwill account. The double entry is completed with credit entries in the old partners' capital accounts. The value of each entry is calculated by sharing the value of the goodwill between the partners in the old profit and loss sharing ratio.

If goodwill is to be retained in the partnership (sometimes referred to as 'carried in the books') no further entries are required.

If goodwill is not to be carried in the books, it is eliminated by a credit entry in the goodwill account. The double entry is completed with debit entries in the partners' capital accounts. The

value of each entry is calculated by sharing the value of the goodwill between the new partners in the new profit and loss sharing ratio.

If a partner is contributing (or withdrawing) capital, the relevant amount will be recorded in both the partner's capital account and the bank account. A contribution will be a credit entry in the capital account and a debit entry in the bank account, and a withdrawal will be a debit entry in the capital account and a credit entry in the bank account.

How are loans from partners treated?

A loan is not part of the partner's capital, and the loan is treated is the same way as a loan from a third party. The liability of the partnership will be recorded by the creation of a liability, resulting in a credit balance for the amount of the loan. The debit entry will depend on how the loan was made. If the partner deposited cash in the bank account, the debit entry will be in the bank account. If the loan was created by converting a proportion of the partner's capital into a loan, the debit entry will be in the capital account.

The interest on the loan will be a business expense and should therefore be debited to the income statement.

Examples

(i) – Appropriations of profit

Based on the following information:

- Prepare the Partnership Appropriation Account
- Calculate each partner's share of the residual profit and total profit share
- Prepare the partners' current accounts

Amit and Burton are in partnership sharing profits in the ratio 3:2. The partnership's profit for the year was $65,460. The partnership agreement provides for:

- Interest to be paid on the partners' opening capital balances at a rate of 5% per annum
- Interest on drawings at a rate of 8% per annum on all drawings during the year
- Partners' salaries of Amit, $9,000; Burton, $5,000.

At the beginning of the year, the partners' capital and current account balances were:

What is the Admission of a Partner?

A business firm seeks new partners with business expansion being one of the driving motives. As per the Partnership Act, 1932, a new partner can be admitted into the firm with the consent of all the existing partners, unless otherwise agreed upon.

With the admission of a new partner, there is a reconstitution of the partnership firm and all the partners get into a new agreement for carrying out the business of the firm.

The following conditions led to the addition of a new partner:

1. When the firm is in an expansion mode and requires fresh capital.
2. When the new partners possesses expertise which can be beneficial for the business expansion of the firm.

3. When the partner in question is a person of reputation and adds goodwill to the firm.

Also Read: Basic Concepts of Accounting for Partnership

The following adjustments need to be made at the time of admission of a new partner

1. Calculating the new profit sharing ratio along with the sacrificing ratio.
2. Accounting for goodwill.
3. Revaluation of assets and liabilities.
4. Adjustment of capital as per new profit sharing ratio.

With the admission of a new associate, the partnership enterprise is restructured and a new agreement is entered into; to carry on the trading concern of the enterprise. A newly added partner obtains 2 primary rights in the enterprise :

- Right to share the assets of the partnership firm
- Right to share the profits of the partnership firm

Must Read: What is Goodwill?

Treatment of Goodwill in the Admission of a Partner

A new partner is entitled to be a part of the future profits of the firm upon being added to the firm. The act of admitting new partner also leads to the reduction in the future profit sharing ratio of the existing partners. For this reason a new partner has to bring extra value apart from capital, this is known as Premium for Goodwill.

Treatment of goodwill on admission of a new partner will be based on the following conditions:

1. When the amount for goodwill is paid privately
2. When the amount necessary for paying the share of goodwill is brought as cash.
3. When share of goodwill is not brought as cash.

Adjustment of Capital and Change in Profit Sharing Ratio Among Existing Partners

Few significant points which require observation during the admission of a new partner are mentioned below:

- Sacrificing ratio
- New profit sharing ratio
- Revaluation of assets and Reassessment of liabilities
- Valuation and adjustment of goodwill
- Adjustment of partners' capitals
- Distribution of accumulated profits (reserves)

K.M. SHIBHATHULLAH

PG DEPARTMENT OF COMMERCE WITH (C.A)