Partnerships

Theory

1. An agreement between two or more people to carry on a business in order to make a profit.

2. Advantages:

    a. Raise more capital
    b. More skills & knowledge
    c. Share the work

3. Disadvantages

    a. Profits must now be shared
    b. Disagreements can occur
    c. Partners cannot act independently

4. According to the Partnership Act 1890, in the ***absence*** of a partnership agreement:

    a. All partners contribute equal capital
    b. Partners are not entitled to interest on capital or salaries
    c. Partners will not be charged interest on drawings
    d. Profits or losses will be shared equally
    e. Partners are entitled to 5% interest on a loan they make to the partnership

Special accounts for partnerships

1. APPROPRIATION ACCOUNT

    - Continues from the Profit and Loss Account and shows how the profit or loss will be treated between the partners.

    - Items under the Appropriation Account:

        i. Partners' SALARIES
        ii. INTEREST ON CAPITAL
        iii. INTEREST ON DRAWINGS
        iv. SHARE OF THE REMAINING PROFIT

Example:

Trading and Profit and Loss and Appropriation Account

Net Profit			*20 000*
ADD Interest on Drawings	: Abrahams	2 000	
	: Peterson	3 000	5 000
			25 000
LESS Interest on Capital	: Abrahams	4 000	
	: Peterson	2 000	
		6 000	
LESS Salaries	: Abrahams	9 000	15 000
			10 000
Share of Profit	:Abrahams(1/2)	5 000	
	: Peterson (1/2)	5 000	10 000

2. DRAWINGS

   - Each partner has their own Drawings account.

3. CAPITAL ACCOUNTS

- Each of the partners will have their own Capital accounts
- The capital accounts may either be:
  - *Fluctuating Capital Accounts* – all the items in the Appropriation account are entered into the Capital accounts of the partners; the Drawings account of each partner is closed off to the partners Capital accounts.

  - *Fixed Capital Accounts* – The capital account balances do not change unless a partner contributes more capital. The items in the Appropriation account now get entered into the *partners' Current Accounts.*

4. CURRENT ACCOUNTS

- Each partner has their own Current Account *if the Capital accounts are fixed*.
- These accounts are used to complete the double entry from the Appropriation account (salaries, interest on capital, interest on drawings, profit share).
- The drawings account of each partner is closed off to the partners' Current account.
- The current account may also be credited with any interest on a loan made by the partner to the business. BE CAREFUL! The *interest on a loan* made by a partner to the business appears as a *normal expense in Profit and Loss.*

Example:

Current account: Abrahams

Dec 31	Interest on Drawings	2 000	Jan 1	Balance b/d	6 000
	Drawings	8 000	Dec 31	Interest on Capital	4 000
				Salary: Abrahams	9 000
				Share of Profit	5 000
				Interest on Loan	*3 000*

<u>Partnership Changes</u>

What is a change?

- When a new partner joins the business
- When an existing partner leaves the business
- When partners agree to change the profit sharing ratio

IMPORTANT:
When a change occurs, a Trading and Profit and Loss account must be drawn up on the same date for the OLD partnership (before the change). A Trading and Profit and Loss account will be drawn up at the end of the year for the NEW partnership (after the change). Most examination questions will therefore consist of <u>two</u> Trading and Profit and Loss accounts next to each other.

<u>REVALUATION OF ASSETS (unrealized Profit)</u>

When one of the above changes occur, the Partners; Capital accounts should show the real net worth of their business.
The real net worth depends on a realistic valuation of the businesses' Assets. Therefore, it is usual to get all assets valued upon a change in the partnership.

A **<u>REVALUATION account</u>** is opened in the ledger for this purpose.

Journal Entries:

Step one: *Transfer any Provisions for depreciation to the Revaluation account:*
DEBIT Provision for Depreciation
CREDIT Revaluation

Step two: *If an assets value is increasing* ***(important : NEW VALUE – COST PRICE)***
DEBIT the asset (eg Vehicles)
CREDIT Revaluation

If an assets value is decreasing ***(important: COST PRICE – NEW VALUE)***
DEBIT Revaluation
CREDIT the asset (eg Vehicles)

Step three: *Adjust Provision for Bad Debts (if required)*

- *Increasing*: DEBIT Revaluation
  CREDIT Provision for Bad Debts

- *Decreasing*: DEBIT Provision for Bad Debts
  CREDIT Revaluation

Step four: *Close off the Revaluation account to the Partners Capital accounts(profit ratio)*

GOODWILL

What is Goodwill?

- an intangible asset representing the value added to a business (over and above the value of net assets) by factors such as:

- a loyal customer base,
- good management,
- good reputation,
- good supplier contacts,
- well known brand names
- good location

Goodwill is usually valued when a change in the partnership occurs.

How to account for Goodwill?

Partners may choose to keep a Goodwill account in the books or not.

1. If a Goodwill account is to be kept in the books:

OLD PARTNERS OLD RATIO

DEBIT Goodwill
CREDIT the (old) Partners' Capital accounts

2. If a Goodwill account is <u>NOT</u> to be kept in the books:

OLD PARTNERS OLD RATIO

DEBIT Goodwill
CREDIT the (old) Partners’ Capital accounts

Then

NEW PARTNERS NEW RATIO

DEBIT the (new) Partners Capital accounts
CREDIT Goodwill

Partnership Dissolution

When a partnership business ceases to exist.

Reasons

- The business is no longer profitable
- Partners simply agree to do so for any personal reasons eg ill health

What happens upon dissolution?

1. the assets are all sold off or they may be taken over by a partner
2. the liabilities are all paid
3. the partners are paid the balances of their capital accounts

A **REALISATION account** is opened in the ledger for this purpose

Journal Entries:

1. Close the Provisions for Depreciation and Provision for Bad debts to the Asset account
   DEBIT Provision for Depreciation (on vehicles)
   CREDIT Vehicles

2. Close the Asset accounts to the Realisation account
   DEBIT Realisation
   CREDIT Vehicles

3. Record the money received from the sale of assets and from debtors
   DEBIT Bank
   CREDIT Realisation

4. Record the assets taken over by the partners (without payment)
   DEBIT Partners Capital account
   CREDIT Realisation

5. Payment of liabilities
   DEBIT liability (eg creditors)
   CREDIT Bank

6. Discounts received from creditors
   DEBIT the creditor
   CREDIT Realisation

7. Payment of costs of dissolution
   DEBIT Realisation
   CREDIT Bank

8. Close the Realisation account to the partners Capital accounts (profit ratio)
   If a profit was made: DEBIT Realisation
   CREDIT Partners Capital accounts
   Opposite if a loss was made

9. Close the partners Current accounts to the Capital accounts
   DEBIT Current account: Peters
   CREDIT Capital : Peters

   OR

   DEBIT Capital : Peters
   CREDIT Current account: Peters

10. Partners get paid out their Capital account balances
    DEBIT Capital: Peters
    CREDIT Bank

    OR

    The partners must pay in if their Capital accounts have a debit balance
    DEBIT Bank
    CREDIT Capital: Peters

    GARNER versus MURRAY
    If a partner cannot pay in the amount of their Debit balance in their Capital account, then the remaining partners must pay the amount into the Bank account of the business. The remaining partners share the payment according to their last capital balances on the last balance sheet.

What Happens if the Partnership is SOLD? (eg pg 133 – 135)

Most questions involve the partnership being sold to a <u>Limited Company.</u>

Journal Entries:

1. Close the Provisions for Depreciation and Provision for Bad debts to the Asset account

    DEBIT Provision for Depreciation (on vehicles)
    CREDIT Vehicles

2. Close the Asset accounts to the Realisation account

    DEBIT Realisation
    CREDIT Vehicles

3. Taking over of liabilities

    DEBIT liability (eg creditors)
    CREDIT Realisation

4. Record the selling price of the partnership

    DEBIT ABC Linited
    CREDIT Realisation

5. Close the Realisation account to the partners Capital accounts (profit ratio)

    If a profit was made: DEBIT Realisation
    CREDIT Partners Capital accounts
    Opposite if a loss was made

6. Close the partners Current accounts to the Capital accounts

    DEBIT Current account: Peters
    CREDIT Capital : Peters

    OR

    DEBIT Capital : Peters
    CREDIT Current account: Peters

7. Close the ABC Limited account to the Ordinary Shares account (and or preference shares and debentures)

DEBIT Ordinary Shares (and or Preference shares; Debentures)
CREDIT ABC Limited

8. Close the Ordinary Shares (and or Preference Shares; Debentures) to the Capital accounts

DEBIT Partners Capital accounts
CREDIT Ordinary Shares (and or Preference Shares; Debentures)