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
 : Peterson (1/2) 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:**

<table>
<thead>
<tr>
<th>Current account: Abrahams</th>
</tr>
</thead>
<tbody>
<tr>
<td>Dec 31 Interest on Drawings</td>
</tr>
<tr>
<td>Drawings</td>
</tr>
<tr>
<td></td>
</tr>
<tr>
<td>Jan 1 Balance b/d</td>
</tr>
<tr>
<td>Dec 31 Interest on Capital</td>
</tr>
<tr>
<td>Salary: Abrahams</td>
</tr>
<tr>
<td>Share of Profit</td>
</tr>
<tr>
<td>Interest on Loan</td>
</tr>
</tbody>
</table>
Partnership Changes

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 two Trading and Profit and Loss accounts next to each other.

REVALUATION OF ASSETS (unrealized Profit)

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 REVALUATION account 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 **NOT** 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 **Limited Company**.

**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 Limited
   - **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)