Accounting for partnerships
The launch of the syllabus for Foundations in Accountancy provides a good opportunity to revisit the topic of accounting for partnerships. The syllabus for Paper FA2, *Maintaining Financial Records* contains an additional outcome that was not in the Syllabus for CAT Paper 3 (Section H3 – Change in partnership). Also, a recurring feature of performance in CAT Paper 3 exams was that a disappointingly low number of candidates performed well on questions that examined the topic of partnerships.

The purpose of this article is to assist candidates to develop their understanding of the topic of accounting for partnerships. As such, it covers all of the outcomes in Section H of the Study Guide for Paper FA2. It also provides underpinning knowledge for candidates studying Papers FFA and F3, *Financial Accounting* but it is not intended to comprehensively cover the Study Guides for those papers.

What is a 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 Paper 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.

How is a 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 Paper FA2 exams will not go beyond the following:

Share of residual profit
The Paper 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 Paper 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:

<table>
<thead>
<tr>
<th></th>
<th>Capital</th>
<th>Current</th>
</tr>
</thead>
<tbody>
<tr>
<td>Amit</td>
<td>$120,000</td>
<td>$15,655</td>
</tr>
<tr>
<td>Burton</td>
<td>$80,000</td>
<td>$4,137</td>
</tr>
</tbody>
</table>

During the year, Amit’s drawings were $18,000 and Burton’s drawings were $31,000.

Solution

<table>
<thead>
<tr>
<th>Memo</th>
<th>Appropriation Account</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>A</td>
</tr>
<tr>
<td>Profit for year</td>
<td>$65,460</td>
</tr>
<tr>
<td>Salaries</td>
<td>9,000</td>
</tr>
<tr>
<td>Interest on capital (W1)</td>
<td>6,000</td>
</tr>
<tr>
<td>Interest on drawings (W2)</td>
<td>(1,440)</td>
</tr>
<tr>
<td></td>
<td>12,560</td>
</tr>
<tr>
<td>Residual profit (W3)</td>
<td>27,228</td>
</tr>
<tr>
<td></td>
<td>40,788</td>
</tr>
</tbody>
</table>

W1 A $120,000 x 5% = $6,000
B $80,000 x 5% = $4,000

W2 A $18,000 x 8% = $1,440
B $31,000 x 8% = $2,480

W3 Profit for year $65,460
Less: Salaries $14,000
Interest on capital $10,000 $24,000 $41,460
Add: Interest on drawings $3,920
Residual profit $45,380
Shared A x 3/5 $27,228
B x 2/5 $18,152

Current account – Amit

<table>
<thead>
<tr>
<th></th>
<th>$</th>
</tr>
</thead>
<tbody>
<tr>
<td>Drawings</td>
<td>18,000</td>
</tr>
<tr>
<td>Closing balance</td>
<td>38,443</td>
</tr>
<tr>
<td></td>
<td>56,443</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>$</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Opening balance</td>
<td>15,655</td>
</tr>
<tr>
<td>Total share</td>
<td>40,788</td>
</tr>
<tr>
<td></td>
<td>56,443</td>
</tr>
</tbody>
</table>
ACCOUNTING FOR PARTNERSHIPS

AUGUST 2011

<table>
<thead>
<tr>
<th>Current account – Burton</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
</tr>
<tr>
<td>Opening balance</td>
</tr>
<tr>
<td>Drawings</td>
</tr>
<tr>
<td></td>
</tr>
</tbody>
</table>

The closing balances are thus

Amit $38,443 Cr
Burton $10,465 Dr

(ii) – Change in partnership

Amit and Binta have been in partnership, sharing profits and losses in the ratio 4:3. They agreed to admit Chen to the partnership, with profits and losses being shared between Amit, Binta and Chen in the ratio 3:2:1. On the date of the change in partnership, the partners’ capital and current account balances were:

<table>
<thead>
<tr>
<th>Capital</th>
<th>Current</th>
</tr>
</thead>
<tbody>
<tr>
<td>Amit $60,000 Cr</td>
<td>$12,800 Cr</td>
</tr>
<tr>
<td>Binta $40,000 Cr</td>
<td>$9,500 Cr</td>
</tr>
</tbody>
</table>

It was agreed that, at the date of Chen’s admission, the partnership was to be valued at $164,300.

Step 1 – Calculate goodwill

The total book value of the partnership is equal to the combined value of the partners’ capital and current accounts, or $122,300 ($60,000 + $12,800 + $40,000 + $9,500).

The partnership is valued at $164,300.

Therefore, the goodwill is valued at $42,000 ($164,300 – $122,300).

Step 2 – Create goodwill asset in books

The goodwill account is created by a debit entry of $42,000. This value is credited to the old partners in the old profit and loss sharing ratio – ie 4/7 (or $24,000) to Amit and 3/7 (or $18,000) to Binta.

Thus, the new capital balances are:

Amit $84,000 Cr ($60,000 Cr and $24,000 Cr)
Binta $58,000 Cr ($40,000 Cr and $18,000 Cr)

If goodwill is to be carried in the books, no further entries are needed, as the only change is that a new asset of goodwill has been created, and the capital balances of the old partners have increased by the same value.
Step 3 – Eliminate goodwill (if required by question)
If goodwill is not to be carried in the books, it is eliminated by a credit entry in the goodwill account, and debit entries in the partners’ capital accounts, based in the new profit and loss sharing ratio:

- Amit $21,000 ($42,000 x 3/6)
- Binta $14,000 ($42,000 x 2/6)
- Chen $7,000 ($42,000 x 1/6)

As a result, the new capital balances are:

- Amit $63,000 Cr ($84,000 Cr and $21,000 Dr)
- Binta $44,000 Cr ($58,000 Cr and 14,000 Dr)
- Chen $7,000 Dr (share of goodwill eliminated)

Step 4 – Contribution of capital by new partner (if required by question)
If the question requires a contribution by any of the partners (or a repayment of capital) we simply need to follow the normal principles of double-entry bookkeeping.

For example, the question may require the new partner to contribute cash so that the opening capital balance is nil.

In this case, a credit of $7,000 is needed in Chen’s capital account, so this is the amount of cash that must be contributed.

The entries will therefore be:

- Debit Bank $7,000
- Credit Capital – Chen $7,000
### Table 1 – Summary of entries

<table>
<thead>
<tr>
<th>Entry</th>
<th>Debit Description</th>
<th>Credit Description</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Profit for year</strong></td>
<td>Income statement</td>
<td>Appropriation account</td>
</tr>
<tr>
<td><strong>Partners’ salaries</strong></td>
<td>Appropriation account</td>
<td>Partners’ Current Accounts</td>
</tr>
<tr>
<td><strong>Interest on capital</strong></td>
<td>Appropriation account</td>
<td>Partners’ Current Accounts</td>
</tr>
<tr>
<td><strong>Interest on drawings</strong></td>
<td>Partners’ Current Accounts</td>
<td>Appropriation account</td>
</tr>
<tr>
<td><strong>Residual profit</strong></td>
<td>Appropriation account</td>
<td>Partners’ Current Accounts</td>
</tr>
<tr>
<td></td>
<td>if profit is greater than total of appropriations:</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Debit Description</td>
<td>Credit Description</td>
</tr>
<tr>
<td><strong>Interest on loan from partner</strong></td>
<td>Income statement</td>
<td>Bank account* or Accrued expenses**</td>
</tr>
<tr>
<td><strong>Loan made by partner</strong></td>
<td>Bank account† or Capital account‡</td>
<td>Loan account</td>
</tr>
</tbody>
</table>

* if the interest has been paid to the partner
** if the interest remains unpaid
† if funds were deposited in the partnership bank account
‡ if capital was converted into a loan

Ronnie Patton is examiner for Foundations in Accountancy Paper FA2