

RELEVANT TO FOUNDATIONS IN ACCOUNTANCY PAPER FA2

Partnerships

This article considers partnerships and the calculations that would be needed to attempt the relevant questions in the CAT Paper FA2.

A partnership is where two or more individuals are in business together making and sharing the profits. In the CAT papers, although more than two individuals can be a partnership, it will usually be two individuals you are being asked to deal with.

The partnership will set up an agreement which states the terms for each partner such as any salary they are entitled to, if interest will be payable for capital invested and what the profit sharing ratio is. However, before we get to deal with this we need to know the net profit for the period – this is calculated exactly the same as for a sole trader. However, you do need to be careful with partner's salaries – these are not an expense to be deducted from the profits; instead they are just an appropriation of profit.

Once we have found the net profit, or have been given it in the question, we then need to share this out among the partners per the terms of the partnership agreement. The easiest way is to set up an appropriation statement and then allocate the profits as follows:

1. Allocate any salaries
2. Allocate any interest on capital
3. Allocate the remaining profit in the profit sharing ratio (PSR)

This remaining profit may be referred to as the *residual profit* – therefore if a question asks for a partner's share of the residual profit, it is asking for the share of the remaining profit after all other allocations.

So if Alan and Betty are in partnership, both having invested \$20,000, with a partnership agreement that states interest on capital is 5% pa, Alan gets a salary of \$6,000 and the residual profit is allocated 60:40. If the total profit for the period is \$22,400 the appropriation would be as follows:

	Alan	Betty	Total
	\$	\$	\$
Salaries	6,000		6,000
Interest on capital	1,000	1,000	2,000
PSR 60:40	8,640	5,760	14,400
	<u>15,640</u>	<u>6,760</u>	<u>22,400</u>

The final item that could be in the appropriation statement is interest on any drawings made by the partners; these are owed by the partners into the partnership and are showing as negative figures within the appropriation statement. So if we add in drawings of \$9,000 and \$5,000 for Alan and Betty respectively, and interest on drawings of 3%, the appropriation statement would be as follows:

PARTNERSHIPS

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	Alan	Betty	Total
	\$	\$	\$
Salaries	6,000		6,000
Interest on capital	1,000	1,000	2,000
Interest on drawings	(270)	(150)	(420)
PSR 60:40	8,892	5,928	14,820
	<u>15,622</u>	<u>6,778</u>	<u>22,400</u>

The questions may ask for any part of the appropriation statement, and can be for one or both partners. Alternatively, the questions may ask for figures from the statement of financial position.

The partners each have two accounts in the statement of financial position, the capital account which is the fixed amount of capital invested by the partner – this rarely changes within questions. They also have a current account, which shows the accumulated profits less drawings for each partner and the balance of which is frequently asked for in exam questions. The easiest way to calculate the current accounts is through using a T account.

If we continue with Alan and Betty, and they have current account balances brought forward of \$17,300 and \$2,100 respectively, then the T account would be as follows:

Current accounts					
	Alan	Betty		Alan	Betty
	\$	\$		\$	\$
Drawings	9,000	5,000	Balance b/f	17,300	2,100
Balance c/f	23,922	3,878	Profit allocated	15,622	6,778
	<u>32,922</u>	<u>8,878</u>		<u>32,922</u>	<u>8,878</u>
			Balance b/f	23,922	3,878

The balance b/f along with the balance on the capital accounts will be included together in the capital section of the statement of financial position.

With multiple choice questions, only certain figures will be asked for so full workings are not required. However, taking short cuts will often result in errors, so the key is to know the appropriation statement and the current account T account thoroughly – these can then be produced as quick workings and hopefully the correct answer can be quickly established. Lots of question practice will also help.

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