Partnership accounts

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This article concentrates on the preparation of partnership financial statements.

There are no material differences between UK and international practice in partnership accounts apart from minor variations in terminology and format. This article uses international terminology. For students taking the UK paper the conversion is:

International term	UK equivalent
Income statement	Profit and loss account
Statement of division of profit	Appropriation account

Differences between sole traders' accounts and partnership accounts

If you can handle the financial statements of sole traders, with adjustments for accruals, prepayments, depreciation and the like, it is an easy matter to add the requirements for partnership accounts. The differences are:

1. Balance sheet
    a. there is a separate capital account for each partner instead of just the one required for a sole trader
    b. we often maintain a separate current account for each partner, recording drawings and profit shares. If this is done, the capital account is only used for 'capital' transactions such as the introduction of extra long-term capital by partners.
2. Income statement - the division of the net profit among the partners has to be shown. There are several possibilities:
    a. profit is shared in agreed proportions
    b. as (a), but partners are credited with a 'salary' to allow for the work they put into the partnership
    c. as (a) or (b), but partners are credited with 'interest on capital' to allow for differences in the amounts of fixed capital partners have contributed.

It is important to note that partners' salaries and interest on capital are not charges in the main part of the Income statement. They are simply part of the process of dividing up the profit among the partners. The division is shown in the statement of division of profit. This may be presented in a tabular format as shown in the next section.

Preparing partnership financial statements

Income statement

The main part of the income statement is prepared *exactly* as for a sole trader. Points to watch:

a. *Do not* put partners' salaries or interest on capital into the main income statement. They belong only in the division of profit statement section.
b. *Do not* include drawings anywhere in the income statement or statement of division of profit. Drawings are debited to partners' current accounts.

Statement of division of profit

The easiest format to adopt here is a simple columnar presentation. See Figure 1 below (figures invented). Points to watch:

a. One partner may guarantee that another partner's total profit share is not less than a certain minimum amount. To deal with this, make a transfer from one column to another in the tabulated statement.
b. Changes to the profit-sharing arrangements or changes in partnership personnel part way through the year. You have to divide the profit on a time basis between the periods, then apply the details given to the apportioned profits. Remember to take half a year's salary for a half-year period. Your table then shows the total profit shares for the year calculated for the two periods involved.
c. Change in partnership personnel part way through the year, with an agreement that certain expenses charged in the income statement relate to one part of the year only. This is a variation on (b) above and always causes problems for candidates. What you have to realise is that for the partners not bearing the expense, the profit is that shown by the income statement plus the special expense. You have to split that increased profit among the partners, then deduct the special expense from the partners who are to bear it.

Figure 1: statement of division of profit

	A	**B**	**C**	**Total**
	$	**$**	**$**	**$**
Salaries	20,000	15,000	-	35,000
Interest on capital	4,000	3,000	2,000	9,000
Share of balance 3:2:1	90,000	60,000	30,000	180,000
	114,000	78,000	32,000	224,000

P, after having been a sole trader for some years, entered into partnership with Q on 1 July 20X2, sharing profits equally. The business profit for the year ended 31 December 20X2 was $340,000, accruing evenly over the year apart from a charge of $20,000 for a bad debt relating to trading before 1 July 20X2, which it was agreed P should bear entirely.

How is the profit for the year to be divided between P and Q?

	P $000	Q $000
A	245	95
B	250	90
C	270	90
D	255	85

Decide what you think the answer should be, and then read on.

Discussion
A little clear thinking is required. The profit *excluding* the $20,000 is to be used, then $20,000 deducted from P's share.Thus we have:

	P $000	Q $000
6 months to 30 June 20X2	180	
6 months to 31 December 20X2	90	90
	270	90
less: bad debt	20	
	250	90

The answer is B. If you didn't get it right, re-read note (c).

d the question states that there is no partnership agreement and tells you nothing about profit shares. In this case, assume the following (Partnership Act 1890 provisions):

i. no partnership salaries
ii. no interest on capital
iii. profit shared equally among the partners
but
iv. if any partner has loaned money to the partnership (as opposed to introducing capital), the loan carries interest at 5 per cent per year, charged in the income statement. Questions rarely bring in this point, because it makes the question easier.
e Interest on drawings - partners sometimes agree that interest should be charged on drawings made. In reality, partners will agree the amount of drawings the business can stand rather than charge interest. If the point should come up, calculate the total interest due from all partners and add that to the net profit in the statement of division of profit. Then deduct each partner's interest charge from the individual shares at the end of the statement.

Balance sheet
Each partner has to have a capital account and, probably, a current account in the balance sheet. The easiest way to present these is to use columns. See Figure 2 (figures invented).

Figure 2

Capital accounts

	A	B	C	
	$	$	$	
Balance at 1 January	40,000	30,000	20,000	
Capital introduced	20,000	10,000	-	
Balance at 31 December	60,000	40,000	20,000	120,000

	A	B	C	
	$	$	$	
Balance at 1 January	14,800	16,100	12,400	
Profit share (the total from the division of profit statement)	68,000	49,000	46,000	
	82,800	65,100	58,400	
Drawings	(70,000)	(60,000)	(60,000)	
Balance at 31 December	12,800	5,100	(1,600)	16,300

If a partner has a debit balance, as does C here, it is easy to include it in the tabulation as shown. There is no need to complicate matters by putting C's account on the assets side of the balance sheet.

A practice question
Here is a practice question to test your understanding. Try to complete it for yourself, then take a look at the discussion and answer below.

Alamute and Brador have been in partnership for several years, compiling their financial statements for the year ended 31 March and sharing profits in the ratio 60:40 after allowing for interest on capital account balances at 5 per cent per year. Extracts from their trial balance at 31 March 20X3 are given in Figure 3.

Figure 3: extract from Alamute and Brador trial balance

		Reference to notes	$
Capital accounts:	Alamute		50,000
	Brador		50,000
Current accounts	Alamute		3,800 credit
	Brador		2,600 debit
Drawings:	Alamute		48,400
	Brador		36,900

Office equipment	cost	1	48,300
	accumulated depreciation, 1 April 20X2		12,800
Inventory, 1 April 20X2		2	15,600
Trade receivables		3	68,400
Allowances for receivables, 1 April 20X2		3	3,800
Sales revenue			448,700
Purchases			184,600
Rent paid		4	30,000
Salaries			88,000
Insurance		5	4,000
Sundry expenses			39,400

Notes to Figure 3

1. Office equipment should be depreciated at 20% per year on the reducing balance basis.
2. Closing inventory amounted to $21,400.
3. Debts of $2,400 are to be written off, and the allowance for receivables is to be adjusted to 5% of trade receivables.
4. Rent paid of $30,000 is the amount for the nine months to 31 December 20X2. From that date the rent was increased by 10%.
5. Insurance paid in advance amounted to $1,500.

Required:

a. Prepare the partnership's trading and income statement and statement of division of profit for the year ended 31 March 20X3 (9 marks)
b. Write up the partners' current accounts for the year ended 31 March 20X3 (3 marks) (12 marks in total).

Discussion
This is quite a simple question, but care is needed on several points:

1. The drawings figures are given. They go into the current accounts and do not appear in theincome statement or statement of division of profit.
2. Note 3 gives details of receivables. The charge in the income statement is:

	$	**$**
Debts written off		2,400
Movement in allowance		
Original allowance	3,800	
New allowance required	3,300	(500)

5% x (68,400 - 2,400)

1,900

3. Note 4 explains the rent. $30,000 is the cost for nine months. That means $10,000 per quarter. The fourth quarter must therefore be $11,000, giving a total of $41,000.

a Alumute and Brador

Income statement for the year ended 31 March 20X3

		$	$
Sales revenue			448,700
Cost of sales:	opening inventory	15,600	
	purchases	184,600	
		200,200	
	less: closing inventory	21,400	(178,800)
Gross profit			269,900
Less:	expenses		
	salaries	88,000	
	rent (30,000 + 11,000)	41,000	
	insurance (4,000 + 1,500)	2,500	
	sundry expenses	39,400	
	depreciation (35,500 x 20%)	7,100	
	receivables expense (2,400 - 500)	1,900	
		____	(179,900)
Net profit			90,000

Statement of division of profit

	Alumute	**Brador**	**Total**
	$	**$**	**$**
Net profit			90,000
Interest on capital	2,500	2,500	(5,000)
			85,000
Balance of profit 60:40	51,000	34,000	(85,000)
	53,500	36,500	-

b Current accounts

	Alamute	Brador		Alamute	Brador
	$	**$**		**$**	**$**
Balance	-	2,600	Balance	3,800	-
Drawings	48,400	36,900	Share of profit	53,500	36,500
Balance	8,900	-	Balance	-	3,000
	57,300	39,500		57,300	39,500

Neil Stein is former examiner for Paper 1.1