PARTNERSHIP ACCOUNTS

2015

Introduction to Partnership

A partnership is defined as the relationship that subsists between two or more persons who come together in view of profits. The ownership of the business is shared between two or more persons. The partner (owner) must make an agreement about the composition of ownership, their respective rights and obligations, the contribution of capital and the profit (or loss) sharing.

Characteristics of partnerships:-

1. Partnerships have a limited life.
2. Partners have unlimited personal liability (unless they are silent partners in a limited partnership in which case their liability is limited to the amount of their investment).
3. All full partners have the right to use partnership property.
4. All full partners are bound by contracts entered into on behalf of the partnership by other partners.
5. All partners share in profits and losses.

Partnership Agreements

A partnership is formed on the basis of mutual agreement between the partners. The relationship among the partners in a partnership is set up in a partnership agreement known as partnership deed. In the absence of a deed the relationship may be deduced from either the Partnership Act or from consistent behaviour of the partners.

A Partnership Act is an Act of Parliament that describes how partners would relate in their partnership. In the absence of any agreement the partnership Act is the basis of the relationship among partners. A partnership deed is an agreement in writing made by the partners describing the manner of relationship. The deed contains a number of agreements, which may include:

i. Capital contribution.
ii. Business management.
iii. Share of profits, including interest on capital and partners salaries.
iv. Drawing and interest charges.
v. Change of constitution.
vi. Admissions and retirements.

In the absence of an agreement, the Partnership Act requires that profits be shared equally among the partners. The partnership deed may provide for a different profit sharing ratio so as to compensate the partners for their respective contribution. In the absence of a partnership deed and where the Act is silent, then the partners' behaviour may be deemed to be implies relationship. Behaviour means a consistent pattern of actions among the partners.

Appropriation of Profit

Unlike a sole-proprietor, profits of a partnership must be shared among the partners. Partnership accounts need to include a statement that shows how the profit or loss for the year is shared among the partners. This statement is called the profit and loss appropriation account. Unless the partnership is operating in accordance with the Partnership Act, the partners will have to agree on how the profits and losses will be shared among themselves, i.e., they must agree on a profit sharing ratio. The profit sharing ration will depend on a number of factors such as the:

i. Amount of capital introduced by the partners;
ii. Amount of time each partner devotes to the business;
iii. Special skills and experience of the partners.

Some partnership agreements attempt to take specific account of these factors by using a profit sharing approach that incorporates all these factors. This involves considerations of the following factors:

i. Interest on capital account balance.
ii. Partners salaries.
iii. Share of the balance.

Interest on Capital

A partnership may have unequal capital contribution. The partner with more capital should take home a higher share of profit. This is normally paid to partners at a rate of interest on capital. This is intended to compensate partners in proportion to the amount of capital they have contributed. The partners may also agree to give interest on current account credit balances. The qualifying balance in this case may be either an average of credit balances over the year or the credit balance at the year end. This will be particularly appropriate when there are large credit balances and when they differ substantially between partners.

Salaries

Some partners may contribute more time and skills in the business than others. They need to be compensated for the extra effort. One way of compensating for time and skill is paying a salary. A salary paid to a partner is not charged against the profit and loss account, but against partnership profits and loss appropriation account. Using a salary component in a profit sharing arrangement is a good way of rewarding partners who provide more valuable services to the partnership either through the amount of time they spend on the business or because of their particular skills.

Distribution by Profit Sharing Ratio

The profit that remains after interest on partners' capital and partners' salaries is distributed to all the partners in the profit sharing ratio.

Drawings

Partners take out their profits share by way of drawings. The drawing may be in form of cash or by taking an asset such as stock. Either way, the drawing is charged to the respective partner. The partnership agreement may provide for the restriction of drawings to avoid reduction in working capital. One way of restricting drawing is to charge interest on the amounts drawn. The interest charged is credited in the partners profit and loss appropriation account. Partners take out their profits share by way of drawings. The drawing may be in form of cash or by taking an asset such as stock. Either way, the drawing is charged to the respective partner. The partnership agreement may provide for the restriction of drawings to avoid reduction in working capital. One way of restricting drawing is to charge interest on the amounts drawn. The interest charged is credited in the partners profit and loss appropriation account.

Entries for income appropriation account

Net profit		xxx
interest on drawings		
A		xxx
B		xxx
		xxx
Interest on capital		
A	xxx	
B	xxx	
Salary		
A	xxx	
B	xxx	
profit/loss share		
A	xxx	
B	xxx	
		xxx

Personal Account

The transactions of a partner with the partnership are best captured in the form of personal accounts. The personal account will describe transactions such as, capital contributions, share of profit including interest and salaries as well as drawing and interest thereon. The structure of personal account may be the subject of the partnership agreement. In most cases it involves two accounts for every partner.

(i) Partners' capital account.
(ii) Partners' current account.

The capital account captures transactions of a long-term nature. In particular, it captures the capital contributed. Revaluation gains and losses are best passed in this account. If there is any interest on capital, then such interest is calculated on the basis of the balance in the partner's capital account.

Current account captures transactions of a short-term nature. This includes distribution of profits, interest on capital and partners salaries. It also captures drawings by the partner and any interest charged on the drawings.

The balance at the end of the year in the partner's capital and current account forms the aggregate capital in the balance sheet. Partners may choose to have one personal account instead of two in which case there is no split between transactions of long-term and short-term nature.

Partners' Loan Account

Sometimes partners make advances to the partnership in addition to their capital contributions. In these circumstances the partners' loan is treated the same way as any other loan to the business and is kept separate from the partners' capital and current accounts. If the partnership were dissolved for any reason, the partnership loan would be paid before the partners' capital, but would rank after the amounts due to other liabilities.

Entries for current account

		Bal b/f	xxx
Interest on drawings	xxx	Interest on capital	xxx
Drawings	xxx	Salary	xxx
Bal c/f	xxx	Profit	xxx
	xxx		**xxx**

Or

Interest on drawings	xxx	Bal b/f	xxx
Drawings	xxx	Interest on capital	xxx
Loss	xxx	Salary	xxx
Bal c/f	xxx		
	xxx		**xxx**

Financial Statements of a Partnership

Accounting for partnerships is similar to that of other forms of business organization. The same accounts are used, with the exception of profit appropriation accounts and the personal accounts aforementioned. The profit of the partnership is distributed through a profit and loss appropriation account. This is an account drawn after the profit and loss account and shows the distribution of profits in the profit sharing pattern adopted by the partnership.

Exercise

Question One

The trial balance of A and B partnership as at 31st December 2002 is as follows:-

		Dr. Sh. '000'	Cr Sh. '000'
Land and buildings		3, 000	
Motor vehicles		2, 000	
Furniture		1, 500	
Capital	A		4, 000
	B		3, 000
Current	A		500
	B		1, 000
Drawings	A	500	
	B	500	
Sales			10, 000
Purchase		6, 000	
Stock		1, 000	
Debtors		3, 000	
Bank		2, 000	
Expenses		2, 000	
Creditors			3, 000
		21, 500	21, 500

Additional Information:

A and B share profits in the ratio 2:1 respectively after charging interest on capital for 10%, partners drawings at the rate of 6% and partners salary at Sh. 100, 000 and Sh. 80, 000 per annum respectively. Closing stock amount to Sh. 3, 000, 000. Depreciation is charged at the rate of 2.5% on land and buildings, 10% on motor vehicle and 15% on furniture as at 31st December 2002.

Required

(a) Trading, profit and loss account for year ended 31st December 2002.

(b) Appropriation account.

(c) Partners current accounts.

(d) Balance sheet as at 31st December 2002.

Question two

Kimani and Rotich are in partnership managing a small wholesale business, sharing profits and losses at 3:2 respectively after providing for a salary of Sh. 200, 000 and 150, 000 respectively and 10% interests on capital. Drawings attract an interest of 5% per annum.

Their trial balance extracted at 31st July 2004 was as follows:

	Sh.	Sh.
Capital:		
Kimani		700, 000
Rotich		400, 000
Current Account:		
Kimani		101, 000
Rotich		10, 000
Drawings:		
Kimani	55, 000	
Rotich	45, 000	
Freehold shop premises	500, 000	
Pick-ups (at written down value)	210, 000	
Buildings	300, 000	
Purchases	1, 680, 000	
Stock 1 August 2003	170, 000	
Sales		2, 000, 000
Wages	132, 250	
General expenses	11, 500	
Rates	25, 000	
Water and electricity	20, 000	
Advertising	12, 500	
Accounts receivable and payable	90, 000	95,000
Bad debts	4, 750	
Cash in hand	5, 000	
Cash at bank	47, 500	
Provision for doubtful debts		2, 500
	3, 308, 500	**3, 308, 500**

Additional Relevant Information:

(i) Stock as at 31st July 2004 was Sh. 300, 000.
(ii) Wages owing at 31st July 2004 amounted to Sh. 1, 250.
(iii) Advertising pre-paid at 31st July 2004 totaled Sh.500.
(iv) The provision for doubtful debts is to be increased to 5% of the accounts receivable.
(v) Pick-ups are to be depreciated at 10% of the written down value.

Required

(a) Trading, profit and loss account for the year ended 31st July 2004.

(b) The partners' current accounts for the year ended 31st July 2004.

(c) Balance sheet as at that date.