Paul Robbins training and consultancy

Final Accounts Preparation

Lesson 3 – Partnership Financial Statements

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What is a Partnership?

- ***'The relation which subsists between persons carrying on a business in common with a view to profit'*** (Partnership Act 1890)
- Usually between two and twenty partners – however some large partnerships such as the major accountancy firms can have many partners
- Often professional firms such as accountants, solicitors, architects, doctors and dentists but also builders, plumbers, scaffolders, etc.
- May be formed as either a new venture or two or more sole traders combining their businesses

Advantages and Disadvantages

- ***Advantages***
- Cheap, quick and easy to set up
- More capital available as partners can pool their resources
- Partners can specialise in their own area of expertise within the business (e.g. tax or insolvency)
- Partnerships better able to cover for holidays and sickness absences than sole traders

- ***Disadvantages***
- Decisions may take longer as all partners need to be consulted
- Partners may disagree about how the business should be managed
- Liability is still unlimited – but now each partner is responsible for the debts of the whole partnership
- Retirement of one partner could affect the future of the partnership

Rules of Partnerships

- Partners have two choices in respect of the rules for running their partnership:
- ***To follow the rules of the Partnership Act 1890***
- ***To agree on their own set of rules – this will be done through creating a Partnership Agreement***
- It is normal these days for a partnership to create a Partnership Agreement
- If no Partnership Agreement exists, the rules of the Partnership Act 1890 will automatically apply

Rules of the Partnership Act 1890

- Profits and losses are to be shared equally between the partners
- No partner is entitled to receive a salary
- Partners are not entitled to receive interest on their capital
- Interest is not to be charged on partners’ drawings
- When a partner contributes more capital than agreed, they are entitled to receive interest at five percent per annum on the excess amount

Partnership Agreements

- Must be agreed by all partners of the business and will usually include:
- How profits and losses will be shared between the partners
- Whether partners will be entitled to receive a salary – and if so, which partners and how much?
- Whether interest is to be allowed on partners' capital – and if so, how much?
- Whether interest is to be charged on partners' drawings – and if so, how much?

Sharing Profits and Losses

- Partners take their share of the profits out of the business as **drawings**
- In many cases the profits and losses of a partnership are <u>not</u> shared out equally
- This may be because one partner has put more capital into the business or does the most work in the business – often profits and losses are shared in the same proportion as capital is invested
- ***In your exam you will normally be told how profits and losses should be shared – if not, you should assume that partners share profits and losses equally***

Partners' Salaries

- Many Partnership Agreements include provision for partners to receive a salary
- Often partners who receive a salary spend more time working in the business than the other partners
- Salaries paid to partners are <u>not</u> an expense of the business but are an ***appropriation of profits***
- Professional partnerships may have junior partners who receive a salary for working in the business full time. However, many junior partners will not have yet paid any capital into the business and will not receive a share of the profits.

Partnership Financial Statements

- Financial Statements for partnerships are broadly the same as those for sole traders – Statement of Profit or Loss and Statement of Financial Position
- Just below the Statement of Profit or Loss there is a section for the appropriation of profits called the ***Partnership Appropriation Account***
- This sets out how the profits and losses are shared out amongst the partners

Interest on Capital Balances

- Often Partnership Agreements allow for interest to be paid on partners' capital
- The rate of interest payable should also be stated
- Interest is paid to compensate partners for the use of their capital, which could be invested elsewhere for a return
- Often interest is paid on capital balances where partners share profits equally but where different amounts of capital are invested in the business
- ***In your exam you will be given the amount of interest payable on partners' capital – you will <u>not</u> need to calculate this***

Interest on Drawings

- A partnership might not want its partners drawing too much money out of the business as this may result in a cash shortage and liquidity problems
- To deter partners from doing this, the Partnership Agreement may state that interest is to be charged on partners’ drawings, and at what rate
- Any interest charged on drawings should be shown in the ***Appropriation Account*** where it ***increases*** the profit to be shared amongst the partners
- ***In your exam you will be given the amount of interest charged – you will <u>not</u> need to calculate this***

Capital and Current Accounts

- All partners have both a ***Capital Account*** and a ***Current Account***
- The balance on the Capital Account is usually fixed and only changes when there is a permanent change in capital contributed by a partner – for instance when a partner leaves or retires from the business
- The balance on the Current Account constantly changes and includes:
- Share of profit or loss and salary
- Interest allowed on capital balances and interest charged on drawings
- Drawings and goods taken for own use

Partners' Current Accounts

- ***Debit***
- Drawings and goods for own use
- Interest charged on drawings
- Share of losses
- Balance c/d (normally)

- ***Credit***
- Balance b/d (normally)
- Partner's salary
- Interest paid on capital balances
- Share of profits

Statement of Financial Position

- The SoFP must show the year end balances on each partner’s Capital Account and Current Account and the totals for the partnership
- The overall total for the partnership should agree with the ‘Net Assets’ of the business and show how the business is financed
- The other sections of the SoFP are exactly the same as for sole traders – the only difference is that partners’ Current and Capital Accounts are included in the SoFP in place of the Owner’s Capital Account

Statement of Financial Position

Dr Allen and Dr Khan Doctors' Surgery Partnership Statement of Financial Position as at 30 November 2016			
Financed By:	Dr Allen	Dr Khan	Total
	(£)	(£)	(£)
Capital Account	65,000	80,000	145,000
Current Account	13,700	11,400	25,100
	78,700	91,400	170,100

Changes in Partnerships

- We will now look at some more complex aspects of partnership accounts involving changes in partnerships:
- Accounting for goodwill
- Admission of a new partner
- Retirement of a partner
- Changes in profit sharing ratio

Accounting for Goodwill

- ***Goodwill is the difference between what a business is ‘worth’ as whole and what it is ‘worth’ on paper – the value of its net assets***
- The actual value of a business – what it is ‘worth’ as a whole – is usually higher than the net asset value shown in the SoFP as this cannot include the ***intangible non current asset*** of goodwill
- Goodwill is very difficult to value as it is subject to differing perceptions of what the business is actually worth
- ***Where changes to partnerships take place (e.g. admission or retirement of a partner) a valuation has to be placed on goodwill***

Goodwill for Partnerships

- Upon the admission or retirement of a partner a value is agreed for goodwill which is then ***temporarily debited*** to the ***Goodwill Account*** and ***credited*** to the individual partners' ***Capital Accounts*** in line with their profit sharing ratio

- After accounting for the admission or retirement of a partner, the goodwill should be eliminated by ***crediting*** the ***Goodwill Account*** and ***debiting*** the individual partners' ***Capital Accounts*** in line with their profit sharing ratio

- ***The balance on the Goodwill Account after the change in partnership has occurred should be nil***

Admission of a New Partner

- A new partner can only be admitted with the consent of all existing partners and will normally be charged a premium for the existing goodwill of the business
- This is because the new partner will benefit from the goodwill that the existing partners have built up over the years as soon as they join the partnership
- If the business was sold shortly after the admission of the new partner, all of the partners would benefit from the goodwill of the business
- ***The new partner is effectively buying some of the goodwill from the existing partners***

Admission of a New Partner

- ***<u>Creation of Goodwill (existing partners)</u>***
- Debit – Goodwill Account
- Credit – Partners’ Capital Accounts (in the old profit sharing ratio)
- ***<u>Elimination of Goodwill (existing and new partners)</u>***
- Debit – Partners’ Capital Accounts (in the new profit sharing ratio)
- Credit – Goodwill Account
- ***This effectively charges the new partner for their share of the goodwill***

Admission of a New Partner

- George and Sanjay are partners in an existing business and they share profits and losses equally
- At 30 June 2016 George's Capital Account is £60,000 and Sanjay's Capital Account is £75,000
- On 1 July 2016 the two partners agree to admit Alan to the partnership and on that date goodwill is valued at £50,000
- Alan pays £40,000 into the business and it is agreed that the new profit sharing ratio will be George 40% Sanjay 40% and Alan 20%
- ***Calculate the updated Capital Accounts for the three partners***

Admission of a New Partner

- ***<u>Creation of Goodwill (existing partners)</u>***
- Debit – Goodwill Account (George) £25,000
- Debit – Goodwill Account (Sanjay) £25,000
- Credit – Capital Account (George) £25,000
- Credit – Capital Account (Sanjay) £25,000

- ***<u>Elimination of Goodwill (existing and new partners)</u>***
- Debit – Capital Account (George) £20,000
- Debit – Capital Account (Sanjay) £20,000
- Debit – Capital Account (Alan) £10,000
- Credit – Goodwill Account (George) £20,000
- Credit – Goodwill Account (Sanjay) £20,000
- Credit – Goodwill Account (Alan) £10,000

Admission of a New Partner

The updated Capital Account balances will therefore be:

	George	Sanjay	Alan
	(£)	(£)	(£)
Opening Capital	60,000	75,000	---
Capital Introduced	---	---	40,000
Goodwill Created	25,000	25,000	---
Goodwill Eliminated	(20,000)	(20,000)	(10,000)
Closing Capital	65,000	80,000	30,000

Retirement of a Partner

- When a partner retires you will need to calculate money due to them from the partnership – this requires the creation and elimination of goodwill
- This enables the retiring partner to receive the amount of goodwill which they have built up over their time as a partner of the business
- The retiring partner's share of goodwill plus the balance on their Capital Account and Current Account will be paid to them upon their retirement
- Sometimes a partner will leave some of their capital in the business as a loan which will be repaid over a period of time

Retirement of a Partner

- ***<u>Creation of Goodwill (existing partners)</u>***
- Debit – Goodwill Account
- Credit – Partners’ Capital Accounts (in the old profit sharing ratio)
- ***<u>Elimination of Goodwill (remaining partners)</u>***
- Debit – Partners’ Capital Accounts (in the new profit sharing ratio)
- Credit – Goodwill Account
- ***The remaining partners are effectively buying the retiring partner’s goodwill from them***

Retirement of a Partner

- Peter, Samuel and Dwaine are in partnership together
- The profits and losses are shared: Peter 40%, Samuel 30% and Dwaine 30%
- Peter has decided to retire and the Capital Account balances at the point of his retirement are: Peter £80,000, Samuel £60,000 and Dwaine £50,000
- Goodwill at the point of Peter's retirement has been valued at £100,000
- Samuel and Dwaine will continue in partnership together and will now share profits and losses equally
- ***Calculate the updated Capital Accounts for the three partners***

Retirement of a Partner

- ***Creation of Goodwill (existing partners)***
- Debit – Goodwill Account (Peter) £40,000
- Debit – Goodwill Account (Samuel) £30,000
- Debit – Goodwill Account (Dwaine) £30,000
- Credit – Capital Account (Peter) £40,000
- Credit – Capital Account (Samuel) £30,000
- Credit – Capital Account (Dwaine) £30,000

- ***Elimination of Goodwill (remaining partners)***
- Debit – Capital Account (Samuel) £50,000
- Debit – Capital Account (Dwaine) £50,000
- Credit – Goodwill Account (Samuel) £50,000
- Credit – Goodwill Account (Dwaine) £50,000

Retirement of a Partner

The updated Capital Account balances will therefore be:

	Peter	Samuel	Dwaine
	(£)	(£)	(£)
Opening Capital	80,000	60,000	50,000
Capital Introduced	---	---	---
Goodwill Created	40,000	30,000	30,000
Goodwill Eliminated	---	(50,000)	(50,000)
Closing Capital	120,000	40,000	30,000

Changes in Profit Sharing Ratio

- Partners may decide to change the profit sharing ratio of their business
- This may be due to one or more partners investing additional capital into the business or taking a greater role in the running of the business
- It could also be due to one or more partners withdrawing some of their capital from the business or spending less time working for the business
- ***When the profit sharing ratio changes, goodwill should be created and allocated to partners at the existing profit sharing ratio and then eliminated at the new profit sharing ratio***

Changes in Profit Sharing Ratio

- John and Anna are in partnership together sharing profits and losses equally
- The balance on John’s Capital Account is £80,000 and the balance on Anna’s Capital Account is £70,000
- John has decided to reduce his working week to four days and both partners have decided to share future profits and losses John 40% and Anna 60%
- John and Anna have agreed that the goodwill in the business at the point of change is £50,000
- ***Calculate the updated Capital Accounts for the two partners***

Changes in Profit Sharing Ratio

- ***Creation of Goodwill (existing profit sharing ratio)***

Debit – Goodwill Account (John)	£25,000
Debit – Goodwill Account (Anna)	£25,000
Credit – Capital Account (John)	£25,000
Credit – Capital Account (Anna)	£25,000

- ***Elimination of Goodwill (new profit sharing ratio)***

Debit – Capital Account (John)	£20,000
Debit – Capital Account (Anna)	£30,000
Credit – Goodwill Account (John)	£20,000
Credit – Goodwill Account (Anna)	£30,000

Changes in Profit Sharing Ratio

The updated Capital Account balances will therefore be:

	John	Anna
	(£)	(£)
Opening Capital	80,000	70,000
Capital Introduced	---	---
Goodwill Created	25,000	25,000
Goodwill Eliminated	(20,000)	(30,000)
Closing Capital	85,000	65,000