

# **Study Unit 2**

## **Establishment and Financial Statements of a Partnership**

# **i) Theory and Introduction to Partnerships**

Study Unit 2: Establishment and Financial Statements of a Partnership  
i) Theory and Introduction to Partnerships

# **INTRODUCING PARTNERSHIPS**

# Introduction

- Sole Proprietor is a business form that consists of one owner that is not legally separate from the business.
- Partnership:
  - when two or more persons start a business
  - NOT a separate legal entity
  - Definition:
    - Legal relationship created by agreement between two or more (maximum twenty) natural persons.
    - Each partner must contribute assets or expertise to the enterprise
    - Goal to make profit which will be shared between the partners (either per agreed ratios or common law = capital ratios)

# Reasons for forming a partnership

1. Increased capital
2. Reduce competition
3. Combine capital and technical expertise  
(intellectual property or skills)
4. Retain skills and expertise

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i) Theory and Introduction to Partnerships

## **LEGAL ASPECTS OF A PARTNERSHIP**

# Legal overview

- No specific legislation in South Africa
  - refer to common law principles
- No legal entity (juristic person) for a partnership
- Partners are held **JOINTLY & SEVERALLY LIABLE** for obligations of the partnership
- Not a separate tax entity
  - Partners pay tax in their personal names on their share of the profits from the partnership

# Establishment of a Partnership

Two principle ways of establishing a partnership:

## 1. ACTION

- Tacit agreement
- Implied by conduct (actions) of the partners

## 2. AGREEMENT

- People agree in words (verbal or written)
- Only requires agreement on general requirements:
  - Contribution of money / assets / labour
  - Intention to make a profit and how to divide the profit



# The Partnership Agreement

- Not a legal requirement, but recommended that the agreement be in writing.
- Where the agreement is silent, common law principles apply.
- Common law (unless the agreement says otherwise):
  - Partners have equal rights in management of the partnership;
  - Ownership of partnership in same ratio as they share profits or losses
  - Profits will be shared in the same ratio as their capital contributions

# Essential matters to include in the agreement (READ only)

- Name, purpose, nature and scope of partnership
- Address where business will be conducted
- Names of the partners entering into agreement
- Date of commencement
- Duration of agreement
- Contribution of each partner
- Rights, powers and duties of each partner
- Date of financial year end
- Who is responsible for keeping financial records
- Profit or loss distribution ratio
- Interest rate on current account / capital account etc
- Salaries and bonuses due to partners for services rendered
- Process for retirement / admission / death of partners
- Insurance (key man and life insurance)
- Process and formula for valuation of assets including Goodwill

# Dissolution (Termination)

Partnership has a limited lifespan as it is not a juristic person. Dissolution of a partnership can be caused by the following:

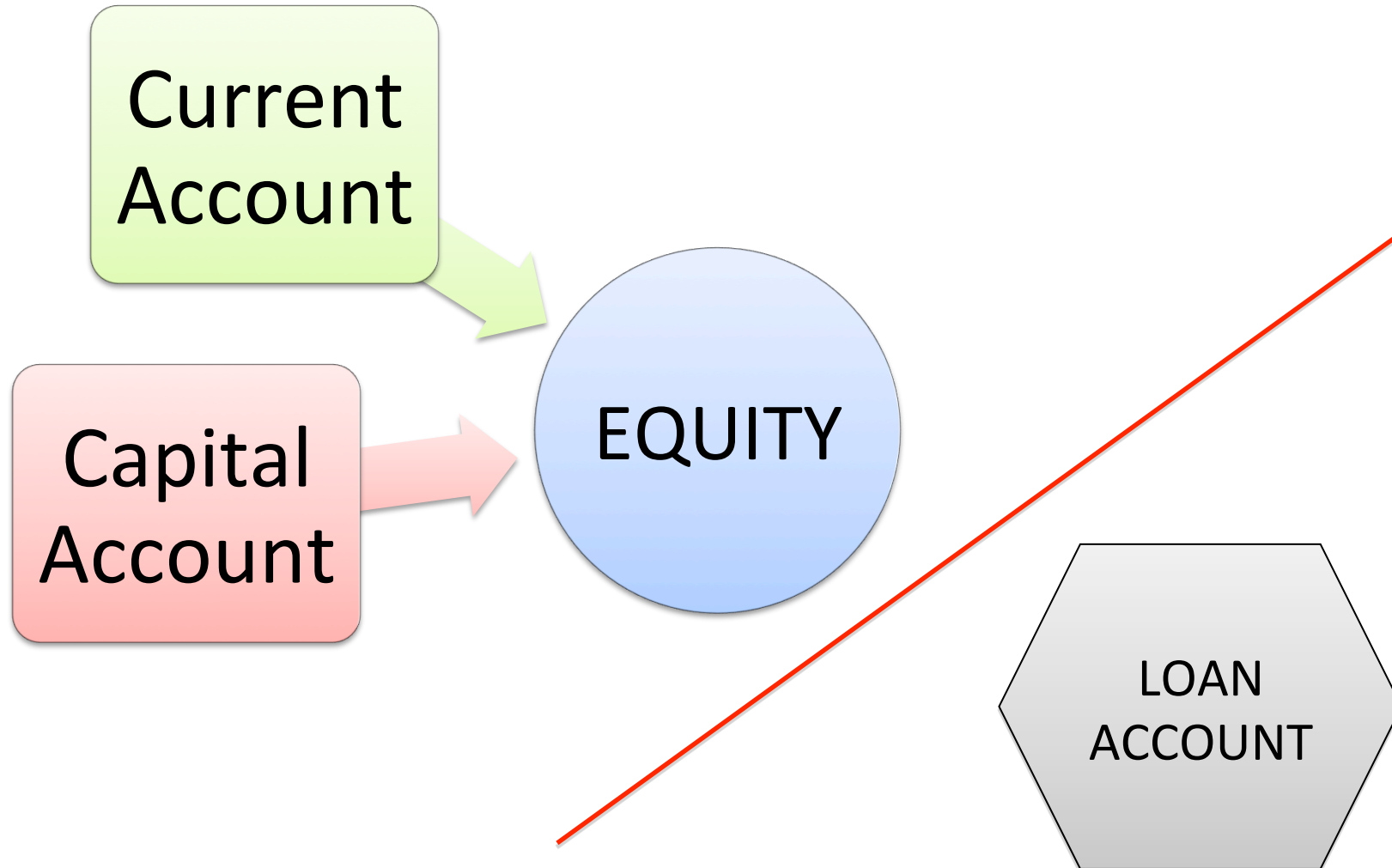
- Mutual agreement
- Fulfillment of purpose for which partnership was formed
- Passage of time (when formed for a specific time period)
- Change in partners (business continues but with new partners)
  - Death
  - Retirement
  - Admission of new partner
- Insolvency (partnership or one of the partners)
- Unilateral action of one partner (may be liable for breach of contract)
- Unlawful actions of a partner
- Number of partners exceeds 20 (automatic dissolution)

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# **CAPITAL ACCOUNT VS CURRENT ACCOUNT VS LOAN ACCOUNT**

$$E = A - L$$



## **ii) Accounting Procedures and Specialised Accounts**

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## **RECORDING OF EQUITY**

### ***CAPITAL ACCOUNTS***

# Capital Account Journals

**Partner Capital Contributions**

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**Partner Capital Withdrawals**

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# General Ledger – Capital Account

<i>Debit</i>	<b>Capital Account – Partner A</b>		<i>Credit</i>
Bank (Withdrawal)	X	Bank (Contribution)	X
		Building (PPE) (Contribution)	X
<i>Balance</i>	X		
	<hr/> XX		<hr/> XX
		Closing Balance	X

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## **RECORDING OF EQUITY**

### ***CURRENT ACCOUNTS***

# Appropriation Account

- Will be dealt with again for closing entries
- New account – not seen in FAC1502 for Sole Proprietors
- Appropriation Account:
  - Final account used to “appropriate” the profits of the partnership at the end of the year
  - Remember that Partners remuneration (interest, salaries, bonuses etc) do not go to normal profit or loss account but to the appropriation account

# Current Account Journals

## Interest on capital account

*(Balance X given %)*

*Capital account = credit balance*

Interest on Capital (Appropriation)	X	
Current Account: A		X

## Interest on drawings account

*(Balance X given %)*

*Drawings account = debit balance*

Current Account: A	X	
Interest on Drawings (Appropriation)		X

# Current Account Journals

## Interest on current account

*(Balance X given %)*

*Current account = debit OR credit balance*

If Credit Balance:

Interest on Current Account (Appropriation)	X		(expense)
Current Account: A		X	

If Debit Balance:

Current Account: A	X		
Interest on Current Account (Appropriation)		X	(income)

# Current Account Journals

## Salaries and Bonuses

**Partner salaries – ignore the cash payment and refer to the agreement**

Partner A Salaries (Appropriation)	X	
Current Account: A		X

**Partner bonus / commission or other remuneration - ignore cash**

Partner A Bonus (Appropriation)	X	
Current Account: A		X

# General Ledger – Current Account

## *CREDIT BALANCE*

<i>Debit</i>	<b>Current Account – Partner A</b>		<i>Credit</i>
		Opening Balance	X
Interest on Drawings (Appropriation)	X	Interest on Capital (Appropriation)	X
		Interest on Curr Acc (Appropriation)	X
		Partner A Salaries (Appropriation)	X
		Partner A Bonus (Appropriation)	X
<i>Balance</i>	X		
	<hr/> XX <hr/>		<hr/> XX <hr/>
		Closing Balance	X

# General Ledger – Current Account

## *DEBIT BALANCE*

<i>Debit</i>	<b>Current Account – Partner A</b>		<i>Credit</i>
Opening Balance	X		
Interest on Drawings (Appropriation)	X		
Interest on Curr Acc (Appropriation)	X		
		Interest on Capital (Appropriation)	X
		Partner A Salaries (Appropriation)	X
		Partner A Bonus (Appropriation)	X
		<i>Balance</i>	<i>X</i>
	<hr/> XX <hr/>		<hr/> XX <hr/>
Closing Balance	X		



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## **RECORDING OF EQUITY**

### ***DRAWINGS ACCOUNT***

# Drawings Journals

***Whatever the Partner draws (takes out) from the business***

Doesn't matter if it is cash, assets such as inventory, or expenses of the partner paid by the partnership

**INTEREST ON LOAN ACCOUNTS IS NOT INCLUDED IN DRAWINGS**

Drawings: A	X	
Bank		X
Inventory		X
Assets		X
Entertainment expense		X
Stationery expense		X

# General Ledger – Drawings Account

<i>Debit</i>	<b>Drawings Account – Partner A</b>		<i>Credit</i>
Bank	X		
Inventory	X		
Assets	X		
Entertainment expense	X		
Stationery expense	X	<i>Balance</i>	<u>X</u>
	<u>XX</u>		<u>XX</u>
Closing Balance	X		

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## **RECORDING OF LOAN ACCOUNTS**

# What are loan accounts?

- Sometimes partners loan money to the partnership or borrow money from the partnership
- This is separate from the current or capital accounts
- Loan will usually have repayment terms
  - Fixed payment period (*principle and interest*)
  - Interest rate
    - Interest expense / income (*not part of appropriation account*)

# Journals - Liability

**Partner grants loan to Partnership (obligation = liability)**

Bank	X	
Liability: Loan from Partner A		X

**Interest expense on loan (part of finance cost in profit or loss)**

Interest expense (finance cost)	X	
Liability: Accrued interest / Bank		X

# Journals - Liability

## Payment of accrued interest

Liability: Accrued interest (if interest not paid)	X	
Bank		X

## Settlement of loan by Partnership (repayment of principle)

Liability: Loan from Partner A	X	
Bank		X

# General Ledger – Loan Account

## *PARTNERSHIP LIABILITY*

<i>Debit</i>	<b>Liability Loan Account – Partner A</b>		<i>Credit</i>	
Bank (loan repaid)	X		Bank (loan granted)	X
<i>Balance</i>	X			
	<hr/>			<hr/>
	XX			XX
	<hr/>			<hr/>
			Closing Balance	X

<i>Debit</i>	<b>Liability Interest Accrual – Partner A</b>		<i>Credit</i>	
Bank (Interest paid)	X		Interest expense (finance cost)	X
<i>Balance</i>	X			
	<hr/>			<hr/>
	XX			XX
	<hr/>			<hr/>
			Closing Balance	X



# Journals - Asset

**Partnership grants loan to Partner (receivable = benefit = asset)**

Asset: Loan to Partner B	X	
Bank		X

**Interest income on loan (part of finance cost in profit or loss**

Asset: Interest receivable / Bank	X	
Interest income (other income)		X

# Journals - Asset

## Interest received by Partnership from Partner

Bank	X	
Asset: Interest receivable (if interest not paid)		X

## Receipt of principle by Partnership from Partner

Bank	X	
Asset: Loan to Partner B		X

# General Ledger – Loan Account

## *PARTNERSHIP ASSET*

<i>Debit</i>	<b>Asset Loan Account – Partner B</b>		<i>Credit</i>	
Bank (loan granted)	X		Bank (loan repaid)	X
			<i>Balance</i>	X
	<hr/>			<hr/>
	XX			XX
	<hr/>			<hr/>
Closing Balance	X			

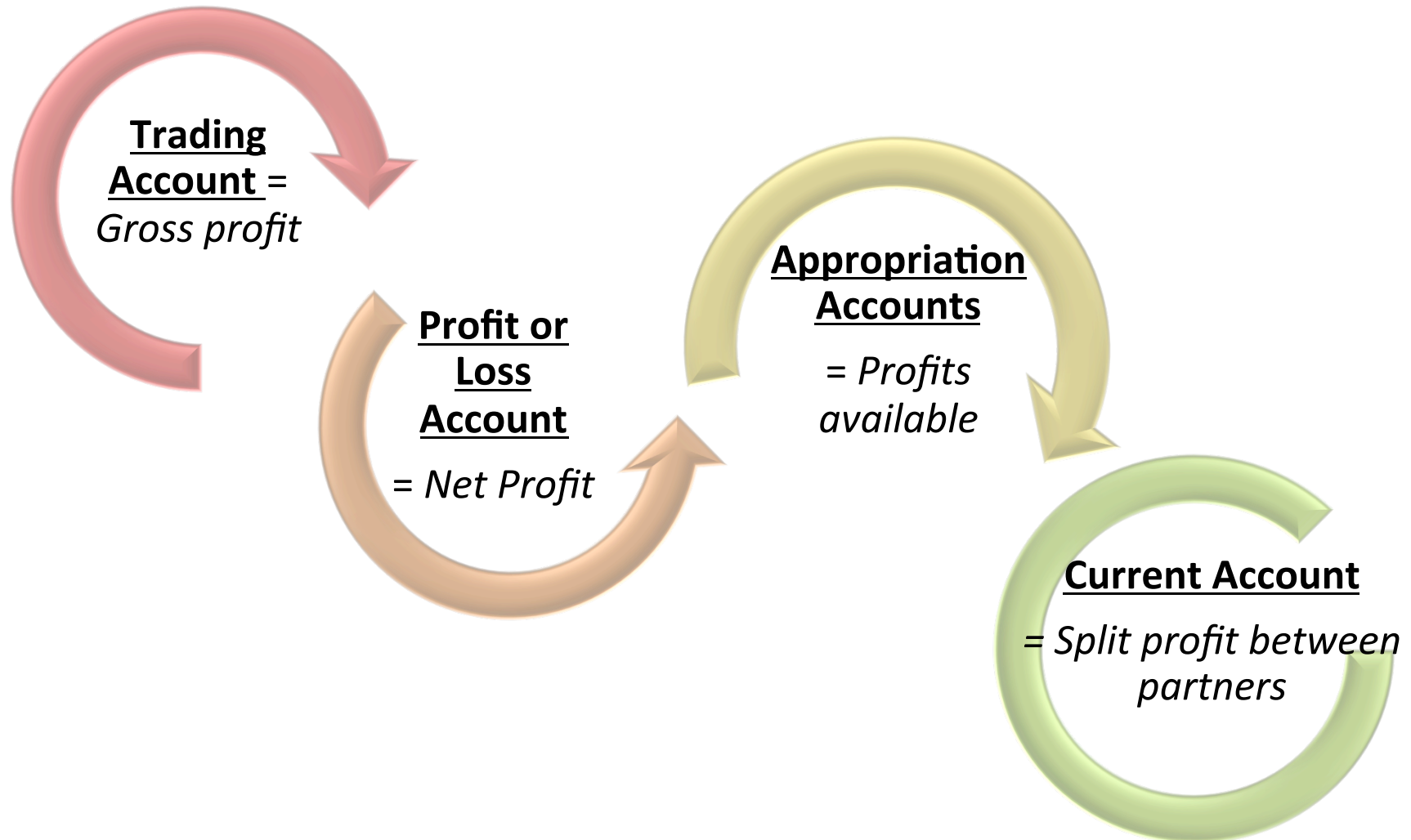
<i>Debit</i>	<b>Asset Interest Receivable – Partner B</b>		<i>Credit</i>	
Interest income (other income)	X		Bank (Interest received)	X
			<i>Balance</i>	X
	<hr/>			<hr/>
	XX			XX
	<hr/>			<hr/>
Closing Balance	X			

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ii) Accounting Procedures and Specialised Accounts

## **Year end closing entries and transfers**

### ***OVERVIEW***

# Year end closing transfers



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ii) Accounting Procedures and Specialised Accounts

## **Year end closing entries and transfers**

### ***TRADING ACCOUNT***

# Trading Account - refresher

- Trading account is used at year end to close out gross profit to the “Profit or Loss Account”
  - Remember  $\text{Gross Profit} = \text{Sales} - \text{Cost of Sales}$
- Close out sales (revenue) and cost of sales accounts arising from transactions during the year.
- Remember, the cost of sales is different depending on the type of inventory accounting system being used (Periodic vs Perpetual)

# Trading Account Closing Journals

## Transfer Sales (revenue) account to Trading Account

Sales	X	
Settlement / cash / volume discount given		X
Sales returns		X
Trading account (sales – discounts – returns)		X

*Note: You do not have to do the journal in the exam, you can take directly to the general ledger of financial statements.*

*The journal is used to teach you how to think about one component or step at a time and to give you a structure to work with.*



# Trading Account Closing Journals

## PERIODIC INVENTORY SYSTEM

Transfer Cost of Sales (Purchases and Inventory Accounts O/B & C/B) to Trading Account

Trading account	X	
<i>(purchases + delivery – discounts – returns)</i>		
Purchases		X
Transport and delivery expenses		X
Settlement / cash / volume discount received	X	
Purchases returns	X	

Inventory (Closing balance)	X	
Trading account		X

Trading account	X	
Inventory (Opening balance)		X

# Trading Account Closing Journals

## PERPETUAL INVENTORY SYSTEM Transfer Cost of Sales to Trading Account

Trading account	X	
<i>(cost of sales – discounts)</i>		
Cost of Sales		X
Settlement / cash / volume discount received	X	

*Note:*

*Under the perpetual system there is no separate account for purchases, delivery costs etc. They all form part of the cost of sales account*

# General Ledger – Trading Account

## *PERIODIC INVENTORY SYSTEM*

<i>Debit</i>	<b>TRADING ACCOUNT (Periodic)</b>		<i>Credit</i>
Settlement discount given	X	Sales	X
Sales returns	X		
Purchases	X	Settlement discount received	X
Transport / delivery expenses	X	Purchases returns	X
Inventory (Opening balance)	X	Inventory (Closing balance)	X
<i>Profit or loss account</i>	<i>X</i>		
<i>(Balance = Gross Profit)</i>	<hr/> <i>XX</i> <hr/>		<hr/> <i>XX</i> <hr/>
		Closing Balance	R Nil

# General Ledger – Trading Account

## *PERPETUAL INVENTORY SYSTEM*

<i>Debit</i>	<b>TRADING ACCOUNT (Perpetual)</b>		<i>Credit</i>
Settlement discount given	X	Sales	X
Sales returns	X		
Cost of Sales	X	Settlement discount received	X
<i>Profit or loss account</i> <i>(Balance = Gross Profit)</i>	X		
	<hr/> <b>XX</b> <hr/>		<hr/> <b>XX</b> <hr/>
		Closing Balance	R Nil

# Trading Account Closing Transfer

**CLOSE OFF (TRANSFER) THE BALANCE ON THE TRADING ACCOUNT (= GROSS PROFIT) TO PROFIT OR LOSS ACCOUNT**

Trading account	X	
Profit or Loss Account		X

*Note:*

*This journal closes of the balance on the Trading Account to the Profit or Loss Account.*

*The balance on the trading account is equal to the Gross Profit (Sales – Cost of Sales)*

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ii) Accounting Procedures and Specialised Accounts

## **Year end closing entries and transfers**

### ***PROFIT OR LOSS ACCOUNT***

# Profit or Loss Account - refresher

- Profit or Loss Account is used at year end to close out profit (or potentially loss) to the Appropriation Account (different to Sole Proprietors)
  - Remember we have already closed out the Trading Account (Gross Profit) to the Profit or Loss Account
- Close out all other income accounts to Profit or Loss Account
  - (rental income, interest income on loan receivables, commission income etc)
- Close out all selling, distribution, administration and other expenses to the Profit or Loss Account
  - Rental expense, entertainment expense, water and electricity, stationery, salaries (non partners)

# Remember GP transferred...

## CLOSE OFF GROSS PROFIT TO PROFIT OR LOSS ACCOUNT

*We have already done this journal as part of the closing off procedure for the Trading account (just here for revision)*

Trading account	X	
Profit or Loss Account		X



# P/L Account Closing Journals

## Transfer Other Income accounts to P/L Account

Rental income	X	
Interest income on loans	X	
Other income account 1, 2 etc	X	
Profit or Loss Account		X

# P/L Account Closing Journals

## Transfer Selling, Distribution, Administration and Other Expenses accounts to P/L Account

Profit or Loss Account	X	
Rental expense		X
Salary (non partner) expense		X
Interest expense on loan (finance costs)		X
Other expense 1, 2 ,etc		X

# General Ledger – Profit or Loss Account

<i>Debit</i>	<b>PROFIT OR LOSS ACCOUNT</b>		<i>Credit</i>
Rental expense	X	Rental income	X
Salary (non partner) expense	X	Interest income on loans	X
Interest expense on loan	X	Other income account 1, 2 etc	X
Other expense 1, 2 ,etc	X	<i>Trading Account (Gross Profit)</i>	<i>X</i>
<i>Appropriation Account</i>	<i>X</i>		
<i>(Balance = Net Profit)</i>	<hr/> <i>XX</i> <hr/>		<hr/> <i>XX</i> <hr/>
		Closing Balance	R Nil

# P/L Account Closing Transfer

**CLOSE OFF (TRANSFER) THE BALANCE ON THE PROFIT OR LOSS ACCOUNT(= NET PROFIT) TO THE APPROPRIATION ACCOUNT**

Profit or Loss Account	X	
Appropriation Account		X

*Note:*

*This journal closes of the balance on the Profit or Loss Account to the Appropriation Account.*

*The balance on the Profit or Loss Account being transferred is equal to the Net Profit (if profit then a Credit balance and you must debit in order to close off and transfer). Remember that the Profit or Loss Account (Net Profit) may be in a Debit balance if there is a Net Loss.*

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ii) Accounting Procedures and Specialised Accounts

## **Year end closing entries and transfers**

### ***APPROPRIATION ACCOUNT***

# Appropriation Account - New

- We use the Appropriation Account to Collect all the transactions with partners and transfers to other reserves,
- We then transfer the balance for the year to each partners Current Account.
- The Appropriation Account is only shown in the Statement of Changes in Equity and will always balance to a R Nil balance at the end of the year as any balance must be transferred to the respective Current Accounts.
  - The Appropriation Account is a clearing account to close off at the end of the year and therefore must balance to Zero.

# Appropriation Account P/L Account Closing Transfer

*Journal repeated from last section*

**CLOSE OFF (TRANSFER) THE BALANCE ON THE PROFIT OR LOSS  
ACCOUNT(= NET PROFIT) TO THE APPROPRIATION ACCOUNT**

Profit or Loss Account	X	
Appropriation Account		X

**Note:**

*Repeat of the same journal from the Profit or Loss Account section  
Included for completeness sake only and does not need to be  
journalised a second time.*

# Appropriation Account Closing Journals

## CLOSE OFF (TRANSFER) ACCOUNTS TO THE APPROPRIATION ACCOUNT

*Refer to the journals under the current account for initial reference*

### Closing transfer - Interest on capital account

Appropriation Account	X	
Interest on Capital Account (Appropriation)		X

### Closing transfer - Interest on drawings account

Interest on Drawings (Appropriation)	X	
Appropriation Account		X



# Appropriation Account Closing Journals

**Closing transfer - Interest on current account (*if credit balance*)**

Appropriation Account	X	
Interest on Current Account (Appropriation)		X

**OR**

**Closing transfer - Interest on current account (*if debit balance*)**

Interest on Current Account (Appropriation)	X	
Appropriation Account		X

# Appropriation Account Closing Journals

## Closing transfer – Partner Salaries

Appropriation Account	X	
Partner A Salaries (Appropriation)		X

## Closing transfer – Partner Bonus

Appropriation Account	X	
Partner A Bonus (Appropriation)		X

# Appropriation Account Closing Journals

Transfers to other reserve accounts  
(most common = Asset Replacement Reserve)

Appropriation Account	X	
Asset Replacement Reserve		X

Appropriation Account	X	
Reserve 1		X

# General Ledger – Appropriation Account

<i>Debit</i>	<b>APPROPRIATION ACCOUNT</b>		<i>Credit</i>
			<i>P/L Account (Net Profit)</i> X
Interest on Capital Account	X		Interest on Drawings Account      X
Interest on Current Account <i>(if current acc was a credit bal)</i>	X		Interest on Current Account      X <i>(if current acc was a debit bal)</i>
Partner A Salaries	X		
Partner B Salaries	X		
Partner A Bonus	X		
Asset Replacement Reserve	X		
<i>Balance</i>	<i>X</i>		
<i>-Current Account: Partner A</i>	<i>X</i>		
<i>-Current Account: Partner B</i>	<i>X</i>		
	<hr/> XX		<hr/> XX
		Closing Balance	R Nil

# Appropriation Account

## Current Account Closing Transfer

**CLOSE OFF (TRANSFER) THE BALANCE ON THE APPROPRIATION ACCOUNT TO EACH OF THE PARTNERS CURRENT ACCOUNTS**

Appropriation Account	X	
Current Account: Partner A		X
Current Account: Partner B		X

**Note:**

*The ratio of this split will be governed by the Partnership Agreement, or if that is silent it will be done in the ratio of capital contribution by each partner.*

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ii) Accounting Procedures and Specialised Accounts

## **Year end closing entries and transfers**

### ***DRAWINGS ACCOUNT***

# General Ledger – Drawings Account

<i>Debit</i>	<b>Drawings Account – Partner A</b>		<i>Credit</i>
Bank	X		
Inventory	X		
Assets	X		
Entertainment expense	X		
Stationery expense	X	<i>Balance</i>	<u>X</u>
	<u>XX</u>		<u>XX</u>
Closing Balance	X		

# General Ledger – Drawings Account

<i>Debit</i>	<b>Drawings Account – Partner A</b>		<i>Credit</i>
Bank	X		
Inventory	X		
Assets	X		
Entertainment expense	X		
Stationery expense	X	<i>Current Account: A</i>	<i>X</i>
	<hr/> XX		<hr/> XX
Closing Balance	R Nil		



# Close off the Drawings Account

Close off the Drawings Accounts by transferring  
to the Current Account

Current Account: Partner A	X	
Drawings Account: Partner A		X

Current Account: Partner B	X	
Drawings Account: Partner B		X

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ii) Accounting Procedures and Specialised Accounts

## **Year end closing entries and transfers**

### ***CURRENT ACCOUNT REVIEW***

# **Quick review of what has happened.....**

**A review of where we left the Current Accounts  
before doing year end closing and transfers**

# General Ledger – Current Account

## *CREDIT BALANCE*

<i>Debit</i>	<b>Current Account – Partner A</b>		<i>Credit</i>
		Opening Balance	X
Interest on Drawings (Appropriation)	X	Interest on Capital (Appropriation)	X
		Interest on Curr Acc (Appropriation)	X
		Partner A Salaries (Appropriation)	X
		Partner A Bonus (Appropriation)	X
<i>Balance</i>	X		
	<hr/>		
	XX		<hr/>
	<hr/>		XX
		Closing Balance	X

# General Ledger – Current Account

## *DEBIT BALANCE*

<i>Debit</i>	<b>Current Account – Partner A</b>		<i>Credit</i>
Opening Balance	X		
Interest on Drawings (Appropriation)	X	Interest on Capital (Appropriation)	X
Interest on Curr Acc (Appropriation)	X	Partner A Salaries (Appropriation)	X
		Partner A Bonus (Appropriation)	X
		<i>Balance</i>	<i>X</i>
	<hr/> XX <hr/>		<hr/> XX <hr/>
Closing Balance	X		

# Closing transfers.....

## Partners incomes before profit shares:

- Interest on Capital Account
- Interest on Current Account
- Less interest on Drawings Account
- Partner salaries / bonus

Trading Account (Gross Profit) to Profit or Loss Account (Net Profit) to...

Appropriation Account

Current Account

Drawings Account

# Appropriation Account

## Current Account Closing Transfer

**CLOSE OFF (TRANSFER) THE BALANCE ON THE APPROPRIATION ACCOUNT TO EACH OF THE PARTNERS CURRENT ACCOUNTS**

Appropriation Account	X	
Current Account: Partner A		X
Current Account: Partner B		X

**Note:**

*The ratio of this split will be governed by the Partnership Agreement, or if that is silent it will be done in the ratio of capital contribution by each partner.*

# Close off the Drawings Account

Close off the Drawings Accounts by transferring  
to the Current Account

Current Account: Partner A	X	
Drawings Account: Partner A		X

Current Account: Partner B	X	
Drawings Account: Partner B		X



# General Ledger – Current Account

## *CREDIT BALANCE*

<i>Debit</i>	<b>Current Account – Partner A</b>		<i>Credit</i>
		Opening Balance b/d	X
Interest on Drawings (Appropriation)	X	Interest on Capital (Appropriation)	X
		Interest on Curr Acc (Appropriation)	X
		Partner A Salaries (Appropriation)	X
		Partner A Bonus (Appropriation)	X
Drawings Account: Partner A	X	Appropriation Account <i>(share of available profit)</i>	X
<i>Balance c/d</i>	X		
	<hr/> XX		<hr/> XX
		Balance b/d	<hr/> X

# General Ledger – Current Account

## *DEBIT BALANCE*

<i>Debit</i>	<b>Current Account – Partner B</b>		<i>Credit</i>
Opening Balance b/d	X		
Interest on Drawings (Appropriation)	X	Interest on Capital (Appropriation)	X
Interest on Curr Acc (Appropriation)	X	Partner A Salaries (Appropriation)	X
		Partner A Bonus (Appropriation)	X
Drawings Account: Partner B	X	Appropriation Account <i>(share of available profit)</i>	X
		<i>Balance c/d</i>	<u>X</u>
	<u>XX</u>		<u>XX</u>
Balance b/d	X		