ACCOUNTING AND FINANCE FOR BUSINESS

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number of people who own it. The main choice for sole proprietorships wishing to convert to or form multi-ownership enterprises is between a partnership and a limited company.

Scan the following QR code with your QR reader to take you to the website of the Department for Business Innovation and Skills

Did you know?

A UK Department for Business, Innovation and Skills statistical survey, *Business Population Estimates for the UK and Regions 2011,* found that there were an estimated 4.5 million private-sector businesses in the UK at the start of 2011 employing an estimated 23.4 million people with an estimated combined annual turnover of £3,100 billion. 62.4% of these businesses were sole proprietorships, 27.7% were limited companies and 9.8% were partnerships. Scan the QR code to take you to the website for full details.

6.3 Partnerships

A *partnership* is defined in the UK's Partnership Act of 1890 as:

> The relation which subsists between persons carrying on a business in common with a view of profit.

Partnerships are often formed by professional practices such as architects, accountants and solicitors. In fact, for many years, the rules of these professions prevented them from forming limited liability companies. Whilst the minimum number of partners is two, there is no maximum number, so major professional partnerships might have hundreds or even thousands of partners. The simplest partnership is two people setting up a business together, sharing profits or losses on a 50/50 basis, each contributing the same equity and effort. However, often one of the partners has more cash, time or experience than the other, so the partners agree perhaps a 60/40 split to recognise this. Partners can decide whatever arrangements they wish, provided they are legal, and it is important that all partners sign a formal partnership agreement (covering such matters as profit shares, partners' salaries and equity contributions) so that future disagreements are avoided.

Stop and think

A classic example of a partnership *disagreement* was the 1998 case of *Joyce v Morrisey and Others,* which related to a dispute regarding the profit sharing ratio of a successful rock band, 'The Smiths'. The band had four members including Mike Joyce, the drummer. The two lead members of the group, Morrisey and Johnny Marr, had allocated profits to themselves of 40% each and only 10% each to Mike Joyce and Andy Rourke (the remaining band member). Joyce and Rourke took legal action – though Rourke subsequently withdrew from the action – claiming that the profits should have been shared *equally* amongst all four members. There had been no written partnership agreement. After listening to all the arguments, the judge found in favour of the drummer, and required the band's profits to be split equally.

Did you know?

The accounting firm PricewaterhouseCoopers has approximately 9,000 partners worldwide.

The advantages of partnership include the following:

- The problems and pleasures of running the business are shared.
- There is access to greater expertise and financial input.
- Losses as well as profits are shared.
- The financial results do not have to be made public (unless it is a *limited liability partnership* – see section 6.3.5).
- Few legal formalities are involved, though a partnership agreement should be drawn up to avoid misunderstandings.
- The partnership can have a continuing existence (subject to the partnership agreement) even on the death of a partner in a two-partner firm if a suitable replacement partner can be found.

Disadvantages include the following:

- Personality clashes may threaten the business and ultimately cause the break-up of the partnership.
- In the vast majority of partnerships, there is no restriction on the personal liability of partners for the debts of the business (but see section 6.3.5).
- Generally, a partnership has less access to funding for expansion than a limited company.

The main sources of finance for a partnership are:

- Equity introduced by the partners
- Loans from friends and family of partners
- Bank borrowings, through overdrafts or loans, secured either on the partnership's assets or on the personal assets of individual partners
- Profits ploughed back into the business.

6.3.1 Accounting requirements of partnerships

In nearly all respects, partnership accounting is identical to that of a sole proprietorship. The only difference is that separate accounts *must* be opened for each partner showing the financial implications of the partnership agreement. These include details of:

- Shares of profits and losses
- Equity introduced and withdrawn by each partner
- Drawings made by each partner
- Whether any partners are to receive a guaranteed salary (for example, if only one partner works full-time for the partnership)
- Interest charged on drawings (to discourage individual partners from drawing excessive amounts)
- Interest allowed on equity balances (to reward those partners who have invested more than others).

6.3.2 Partnership accounts

As stated above, within the partnership, it is essential to have separate accounts (usually known as partners' capital accounts) for each partner to record their respective financial stake in the business. Starting with any initial equity contribution, this will increase over time due to profit allocations and decrease when the partner draws value out of the partnership. If these separate accounts were not maintained, it could cause severe problems if a partner died, retired or otherwise left the partnership, as it would be difficult, if not impossible, to establish the amount to be repaid to the partner or the deceased partner's family in such circumstances.

6.3.3 Partnership income statements

When preparing a partnership's financial summaries, the income statement will be produced in exactly the same way as that for a sole proprietorship. The only additional information comes in a separate section (often referred to as an *appropriation account*) after the operating profit or loss has been determined, as the profit or loss has to be divided between the partners according to their partnership agreement. If partners have also decided to pay themselves salaries or charge interest on drawings or allow interest on partners' equity, these items are also shown in this section.

Activity 6.1

Gilbert and Bufton are partners sharing profits and losses in the ratio 3:2. The operating profit for the year ended 31 December 2013 was £60,000. As Gilbert worked full-time whilst Bufton worked part-time for the partnership, Gilbert was allowed a salary of £12,000 p.a.

Show the 'appropriation account' section of the income statement for the year.

Answer

	£	£
Operating profit for the year		60,000
Divided as follows:		
Gilbert: fixed salary		(12,000)
		48,000
Gilbert: share of remaining profit (60% × £48,000)	28,800	
Bufton: share of remaining profit (40% × £48,000)	19,200	
		48,000

Stop and think

Gilbert's salary is not deducted as an 'expense' in arriving at the operating profit figure, unlike employees' salaries. It is part of the way in which the partners have decided to share the profit, so is shown as an 'appropriation'.

6.3.4 Partnership statement of financial position

The top part of the statement of financial position, showing non-current and current assets and liabilities, is identical to that of a sole proprietorship. However, the sole proprietor's equity account is replaced by details of each of the partners' capital accounts.

Activity 6.2

Assume that Gilbert and Bufton (see Activity 6.1) started the year with capital account balances of £25,900 and £15,750 respectively. During the year, Gilbert drew out £35,000 from the partnership and Bufton took £17,000.

Show the relevant extract from the partnership's statement of financial position as at 31 December 2013.

Answer

	£	£
Total net assets *(details would be provided)*		49,650
Gilbert's capital account		
Opening balance, 1 January 2013	25,900	
Add Salary	12,000	
Share of profit	28,800	
	66,700	
Less Drawings	(35,000)	
Closing capital balance, 31 December 2013		31,700
Bufton's capital account		
Opening balance, 1 January 2013	15,750	
Add Share of profit	19,200	
	34,950	
Less Drawings	(17,000)	
Closing capital balance, 31 December 2013		17,950
		49,650

An alternative way of showing the same information is to adopt a 'columnar' format, as follows:

	£	£	£
Total net assets *(details would be provided)*			49,650
Capital accounts	**Gilbert**	**Bufton**	
Opening balances	25,900	15,750	
Add Fixed salary to Gilbert	12,000	–	
Shares of profit	28,800	19,200	
	66,700	34,950	
Less Drawings	(35,000)	(17,000)	
Closing balances	31,700	17,950	49,650

Stop and think

No additional information is given in this format, but it looks a lot neater!

6.3.5 Limited liability partnerships

The vast majority of partnerships are referred to as 'general' or 'conventional' partnerships, to distinguish them from a relatively new form of business organisation, the *limited liability partnership* (or LLP). The LLP combines the organisational flexibility of a general partnership with the great advantage of limited liability. The owners of a LLP are (officially) referred to as 'members' rather than partners, and limited liability gives the members protection in the event of the LLP failing. Creditors of the LLP cannot require the members to use their personal assets to pay the LLP's debts. This is very similar to the advantage enjoyed by the shareholders of a limited liability *company*, which is referred to in section 6.5 below.

The accounting requirements for an LLP are virtually identical to that of a general partnership, but one major difference between the two types of organisation is that an LLP must *publish* its financial statements (though large LLPs publish more information than smaller ones). In the UK, this is achieved by submitting them annually to *Companies House*, which is the UK government's database of information maintained for every LLP and limited company on its register. Members of the public can gain access to this information through its website. Scan the QR code to take you to the website of Companies House (or see the reference at the end of this chapter).

Scan the following QR code with your QR reader to take you to the website of Companies House

Since the Limited Liability Partnerships Act was passed in 2000, many professional firms such as chartered surveyors, accountants and lawyers have converted their business organisation from that of a general partnership to a limited liability partnership. There are no taxation advantages or disadvantages that are relevant when making this change – the critical difference is the advantage that limited liability brings to the owners.

Did you know?

In February 2012, there were 51,000 limited liability partnerships registered with Companies House (out of 2.8 million businesses on its database).

6.4 Limited liability companies

Although there are many advantages in running a business as a sole proprietorship or a conventional partnership, these can be outweighed by the fact that the owner or partners have personal responsibility for meeting all the debts of their business. Whilst this may be of little concern to the proprietors of healthy, profitable enterprises, it can have a devastating effect on the fortunes of owners of failing or loss-making businesses, as they must meet the claims of creditors from their personal assets – possibly having to sell their homes – if the value of the business's assets are insufficient.

Another major disadvantage for ambitious business owners is the restricted scope they have for raising funds for expansion. To overcome these, many businesses are organised as limited liability companies (usually shortened to 'limited companies').

Their main features are:

- They are separate legal entities, able to trade, own assets and owe liabilities (including tax on their profit) in their own right independently from their owners.
- Ownership is (with rare exceptions) divided into shares ('the share capital') which can be bought and sold.
- The owners (known as shareholders or members) have limited liability for the debts of the company, so even if the company fails with considerable debts, their loss is restricted to the value of their part of the share capital.
- Management is in the hands of directors, who might own only a small part of the share capital. They are elected by the shareholders.
- Public limited companies (plc's) are allowed to sell their shares to the general public, which enables them to have access to virtually unlimited funds for expansion. Private limited companies (Ltd) cannot sell their shares to the public.
- Limited companies can raise money by issuing corporate bonds (also known as 'debentures'), being fixed interest loans usually secured on the company's assets, or by issuing convertible loan stock, meaning loans which can be converted into shares at a later date. *Neither of these are part of a company's share capital.*
- Employees can be offered shares in the company as an incentive to increasing their contribution towards increased profits.
- The company has perpetual existence, so even if an individual shareholder dies, the company continues.
- There may be tax advantages, particularly for highly profitable businesses, in structuring as limited liability companies.

Did you know?

In 2012, the directors of Tesco plc, one of the world's largest supermarket companies, owned just 8.4 million out of 8 billion shares issued by the company.

Limited companies do have a number of *disadvantages* when compared with other forms of business organisations:

- Lack of secrecy, as companies have to publish financial information, though large companies have to disclose more than small ones (see the previous reference to Companies House).
- Extra costs of complying with legislation: - for large companies this includes a requirement to appoint an auditor who is an independent qualified accountant responsible for reporting whether the published financial information shows a faithful representation of the financial situation.
- More formality – shareholders' meetings must be held to agree important issues, annual returns have to be completed and sent to the government, etc.
- Some shareholders might have no part in the day-to-day management of the company, yet will seek to exercise influence on the company and put pressure on the