**PARTNERSHIP**

The Uniform Partnership Act, which has been adopted by most states, defines a **partnership** as “an association of two or more persons to carry on as co-owners of a business for profit.” Partnerships are treated as separate entities in accounting, but legally there is no economic separation between them and their owners. They differ in many ways from the other forms of business. Here we describe some of their important characteristics.

**Characteristics of Partnerships**

A partnership is a voluntary association of individuals rather than a legal entity in itself. Therefore, a partner is responsible under the law for his or her partners’ actions within the scope of the business. A partner also has unlimited liability for the debts of the partnership. Because of these potential liabilities, a partner must be allowed to choose the people who join the partnership. A person should select as partners individuals who share his or her business objectives.

**Partnership Agreement** A partnership is easy to form. Two or more competent people simply agree to be partners in a common business purpose. Their agreement is known as a **partnership agreement.** The partnership agreement does not have to be in writing. However, good business practice calls for a written document that clearly states the details of the arrangement, including the name, location, and purpose of the business; the names of the partners and their respective duties; the investments of each partner; the method of distributing income and losses; and the procedures for the admission and withdrawal of partners, the withdrawal of assets allowed each partner, and the liquidation (termination) of the business.

**Limited Life** Because a partnership is formed by an agreement between partners, it has a **limited life.** It may be dissolved when a new partner is admitted; when a partner withdraws, goes bankrupt, is incapacitated (to the point that he or she cannot perform as obligated), retires, or dies; or when the terms of the partnership agreement are met (e.g., when the project for which the partnership was formed is completed). However, if the partners want the partnership to continue legally, the partnership agreement can be written to cover each of these situations. For example, the partnership agreement can state that if a partner dies, the remaining partner or partners must purchase the deceased partner’s capital at book value from the heirs.

**Mutual Agency** Each partner is an agent of the partnership within the scope of the business. Because of this **mutual agency,** any partner can bind the partnership to a business agreement as long as he or she acts within the scope of the company’s normal operations. For example, a partner in a used-car business can bind the partnership through the purchase or sale of used cars. But this partner cannot bind the partnership to a contract to buy men’s clothing or any other goods that are not related to the used-car business. Because of mutual agency, it is very important for an individual to choose business partners who have integrity and who share his or her business objectives.

**Unlimited Liability** All partners have **unlimited liability** for their company’s debt, which means that each partner is personally liable for all the debts of the partnership. If a partnership cannot pay its debts, creditors must first satisfy their claims from the assets of the business. If these assets are not enough to pay all debts, the creditors can seek payment from the personal assets of each partner. If one partner’s personal assets are used up before the debts are paid, the creditors can claim additional assets from the remaining partners who are able to pay. Each partner, then, can be required by law to pay all the debts of the partnership.

**Co-Ownership of Partnership Property** When individuals invest property in a partnership, they give up the right to their separate use of the property. The property becomes an asset of the partnership and is owned jointly by the partners.

**Participation in Partnership Income** Each partner has the right to share in the company’s income and the responsibility to share in its losses. The partnership agreement should state the method of distributing income and losses to each partner. If the agreement describes how income should be shared but does not mention losses, losses are distributed in the same way as income. If the agreement does not describe the method of income and loss distribution, the partners must by law share income and losses equally.

**Advantages and Disadvantages of Partnerships**

Partnerships have both advantages and disadvantages. One advantage is that a partnership is easy to form, change, and dissolve. Also, a partnership facilitates the pooling of capital resources and individual talents; it has no corporate tax burden (because a partnership is not a legal entity for tax purposes, it does not have to pay income tax, as do corporations, but must file an informational return); and it gives the partners a certain amount of freedom and flexibility. On the other hand, partnerships have the following disadvantages: the life of a partnership is limited; one partner can bind the partnership to a contract (mutual agency); the partners have unlimited personal liability; and it is more difficult for a partnership to raise large amounts of capital and to transfer ownership interests than it is for a corporation.

**Limited Partnerships and Joint Ventures**

Two other common forms of association that are a type of partnership or similar to a partnership are limited partnerships and joint ventures that, like corporations, confines the limited partner’s potential loss to the amount of his or her investment. Under this type of partnership the unlimited liability disadvantage of a partnership can be overcome. Usually, the limited partnership has a general partner who has unlimited liability but allows other partners to limit their potential loss. The potential loss of all partners in an ordinary partnership is limited only by personal bankruptcy laws.

**Joint Ventures** In today’s global environment, more companies are looking to form alliances similar to partnerships, called *joint ventures,* with other companies rather than to venture out on their own. A **joint venture** is an association of two or more entities for the purpose of achieving a specific goal, such as the manufacture of a product in a new market. Many joint ventures have an agreed-upon limited life. The entities forming joint ventures usually involve companies but can sometimes involve governments, especially in emerging economies. A joint venture brings together the resources, technical skills, political ties, and other assets of each of the parties for a common goal. Profits and losses are shared on an agreed-upon basis.

**ACCOUNTING FOR PARTNERS EQUITY**

Although accounting for a partnership is very similar to accounting for a sole proprietorship, there are differences. One is that the owner’s equity in a partnership is called **partners’ equity**. In accounting for partners’ equity, it is necessary to maintain separate Capital and Withdrawals accounts for each partner and to divide the income and losses of the company among the partners.

Each partner invests cash, other assets, or both in the partnership according to the partnership agreement. Noncash assets should be valued at their fair market value on the date they are transferred to the partnership. The assets invested by a partner are debited to the proper account, and the total amount is credited to the partner’s Capital account.

To show how partners’ investments are recorded, let’s assume that Jerry and Rose have agreed to combine their capital and equipment in a partnership to operate a jewellery store. According to their partnership agreement, Adcock will invest Ksh.28, 000 in cash and Ksh.37, 000 worth of furniture and displays, and Villa will invest Ksh.40, 000 in cash and Ksh.30, 000 worth of equipment. Related to the equipment is a note payable for Ksh.10, 000, which the partnership assumes. Record the transactions in a journal.

On June 1, Sarah and Alma form a partnership to operate a fitness center. Sara contributes cash of Ksh.24, 000, and Alma contributes exercise equipment that cost Ksh.20, 000 but is valued at Ksh.16, 000. Prepare the entry in journal form to record the partners’ initial investments.

**FIXED/ FLUCTUATING CAPITAL ACCOUNTS**

There are two choices open to partnerships: **fixed capital accounts** plus current accounts, and **fluctuating capital accounts**.

**1 Fixed capital accounts plus current accounts**

The capital account for each partner remains year by year at the figure of capital put into the firm by the partners. The profits, interest on capital and the salaries to which the partner may be entitled are then credited to a separate current account for the partner, and the drawings and the interest on drawings are debited to it. The balance of the current account at the end of each financial year will then represent the amount of undrawn (or withdrawn) profits. A credit balance will be undrawn profits, while a debit balance will be drawings in excess of the profits to which the partner was entitled.

In the fixed capital account, you enter the amount of fixed capital agreed upon by partners.

The current account will contain the drawings by partners, profit/ loss shares, interest on drawings, interest on capital.