Student 1: Excellence

NZQA Intended for teacher use only

The following aspects of evidence have been omitted from this exemplar:

- *formation entries for both partners*
- *profit distribution statement*
- *capital account for Sam*
- *capital and current accounts for Alex*
- *discussion on the purpose and consequences of the salary clause of the partnership agreement*

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Current: Sam					
Date		Dr	Cr	Bal	Dr/Cr
1/1/14	Balance			9,000	Dr
31/12/14	Salary		8,000	1,000	Dr
	Interest on capital		4,000	3,000	Cr
	Interest on drawings	1800		1200	Cr
	Interest on current	360		840	Cr
	Profit distribution		36,360	37,200	Cr
	Drawings	3,800		33,400	Cr

Mighty Mini Golf Statement of Financial Position (extract) as at 31 December 2014			
Equity	4		
Capital		140,000	
Current		48,700	$188,700

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Notes to the Statement of Financial Position

4 Equity

	Capital	Current	Total
Alex	50,000	15,300	65,300
Sam	90,000	33,400	123,400
	$140,000	$48,700	$188,700

Goodwill represents the additional intangible assets that Sam is bringing to the partnership from his sole trader business. Apart from tangible assets he is contributing the reputation, established client base and location associated with his former business as it is being taken over by the partnership as a going concern. The goodwill from Sam's existing business will bring immediate economic benefit to Mighty Mini Golf as the existing customers are likely to support the new entity, bringing in sales revenue from the start. 3

In the absence of a partnership agreement, profits would be equally distributed between Sam and Alex in accordance with the Partnership Act 1908. This Act does not allow any other profit distributions like interest on capital, interest on drawings and interest on current accounts.

The 3:2 profit share ratio in their partnership agreement is fairer than sharing profits equally. Sam has invested a larger amount into the business, taking more of a risk than Alex. The biggest risk for the partners is that they have unlimited liability meaning they can be held personally liable for debts that Mighty Mini Golf cannot pay. They are potentially risking their personal assets by entering into the partnership. The imbalance in capital contributions is reflected in the profit sharing ratio which provides Sam with a greater reward to offset his risk. 4
If Sam was not rewarded for his greater capital contribution he might be inclined to reduce his capital to the level of Alex's. This may mean the entity lacks the capital needed to continue to operate the business effectively. 3

Mighty Mini Golf needs to keep sufficient money in its bank account to be able to pay expenses and debts as they fall due. If partners' drawings are high the bank balance might fall so low that an overdraft has to be taken out. The interest on the overdraft would decrease Mighty Mini Golf's profit. So that this doesn't happen, Sam and Alex are charged 10% interest on drawings over $20,000 to discourage them from taking excessive drawings from the business. 3

Sam and Alex earn 5% per annum on the balance of their capital accounts. This clause is used to compensate partners for the loss of use of their capital, i.e. the funds are not available for Sam to Alex to use for an alternative investment. The interest encourages the partners to keep or increase their investment in Mighty Mini Golf by paying them with an interest rate that is about the same as they would earn on a term deposit at a bank. 4
The interest is likely to mean that Sam and Alex are more willing to invest in the partnership which will lead to Mighty Mini Golf having more funds at its disposal to use on expanding their customer base, increasing its advertising, replacing equipment or other actions that could increase future sales and profits. 3
The interest is credited to partners' current accounts only if the partnership makes a profit for the period and it reduces the amount of profit available for sharing in the profit sharing ratio. 2

Mighty Mini Golf has a clause in the partnership agreement which states that each partner will be charged or credited 4% interest on their closing current account balances. This clause is a disincentive for partners to take more drawings earned in profit share. A current account with a credit balance earns the partner interest to encourage them to retain some of their profit in the business, rather than investing it elsewhere such as a bank where they would receive a similar interest rate. 4
It is of benefit to Mighty Mini Golf to have access to funds for growth and expansion, which will have positive long-term impacts on revenue and profit figures. 3