CHAPTER

12

Partnerships

CHAPTER OBJECTIVES

After studying this chapter, you should be able to

1. Identify the characteristics of a partnership
2. Account for partners' initial investments in a partnership
3. Allocate profits and losses to the partners by different methods
4. Account for the admission of a new partner to the business
5. Account for the withdrawal of a partner from the business
6. Account for the liquidation of a partnership
7. Prepare partnership financial statements

Bruce Dunn is a chartered accountant in Vancouver. He received his designaton as a Chartered Accountant in 1982 after articling with one of the larger firms in Canada. Shortly after, he decided to open his own proprietorship. Initially, he specialized in accounting and tax services for small- and medium-sized businesses. His business grew quickly through the 1980s and 1990s. Bruce found that as his practice matured, he became much more of a tax specialist to his long-time clients.

"With the advent of computer accounting software packages, more of my clients were able to perform basic accounting duties and the skill they wanted me to provide the most was in the area of taxation," Dunn said. "The problem became that as my clients grew larger, they needed some other services, such as information systems consulting and treasury management consulting, that I could not provide. I was starting to lose clients to larger, full-service firms, and my practice was stagnant."

Bruce learned of another sole proprietorship, Wayne Grieve, a chartered accountant who specialized in information systems consulting and advisory services. After several meetings, the two CAs decided to merge their businesses and formed a partnership.

"The partnership has been in business for only eighteen months," Bruce said recently, "but we can already identify benefits. We are able to offer a full range of services to our clients, which allows us to compete for clients big and small. We have both noticed that our office operates more efficiently and we have seen some cost savings from that. An added benefit that I had not anticipated is that we can 'sound ideas off each other.' With the complexities that exist today in the business world, the ability to discuss alternatives with a partner is almost a necessity. Forming this partnership was the best thing that could have happened to my business."

THINKING IT OVER

What are some reasons that Dunn and Grieve might form a partnership?

A: To raise more capital; to use the talents of both partners; to expand the business. Additional answers are possible.

THE PARTNERSHIP

The partnership form of business introduces some complexities that proprietorship avoids. How much cash should a new partner contribute to the business? How should the partners divide profits and losses? How should a partner who leaves the firm be compensated for her or his share of the business?

A **partnership** is an association of two or more persons who co-own a business for profit. This definition is common to the various provincial partnership acts, which tend to prescribe similar rules with respect to the organization and operation of partnerships in their jurisdiction.

Forming a partnership is easy. It requires no permission from government authorities and involves no legal procedures, with the exception that most provinces require most partnerships to register information such as the name of the partners and the name under which the business will be carried on.[1] When two persons decide to go into business together, a partnership is automatically formed.

A partnership brings together the assets, talents, and experience of the partners. Business opportunities closed to an individual may open up to a partnership. Suppose neither Dunn nor Grieve has enough capital individually to buy a small building for an office. They may be able to afford it together in a partnership. They pool their talents and know-how. Their partnership thus offers clients a fuller range of services than either person can offer alone.

Partnerships come in all sizes. Many partnerships have fewer than ten partners. Some medical practices may have ten or more partners while some of the largest law firms in Canada have more than 130 partners. The largest accounting firms in

[1] Smyth, J.E., D.A. Soberman, and A.J. Easson, *The Law and Business Administration in Canada*, Ninth edition (Toronto: Pearson Education Canada Inc., 2001), pp. 580–585.

Rank 1999	Firm	Revenue (Millions)	Number of Partners/ Principals
1	PricewaterhouseCoopers LLP (June 1999)*	$845	534
2	Deloitte & Touche LLP (August 1999)	750	522
3	KPMG LLP (September 1999)	735	548
4	Ernst & Young LLP (September 1999)	616	412
5	Grant Thornton Canada (Decemb er 1999)	228	368
6	Arthur Andersen LLP (August 1999)	203	155
7	BDO Dunwoody LLP (December 1999)	172	287
8	Collins Barow/Mintz & Partners (January 2000)**	56	119
9	Richter Usher & Vineberg (February 2000)	54	55
10	HLB/Schwartz Levitsky Feldman (January 2000)	38	62

Source: "Canada Largest Corporations," *National Post Business*, June 2000, p. 164.
* Formed by the combination of Price Waterhouse and Coopers & Lybrand in fiscal 1999.
** Mintz & Partners joined Collins Barrow in July 1999.

EXHIBIT 12-1

The Ten Largest Accounting Partnerships in Canada (data given are as of the date shown in brackets)

Canada have from 150 to more than 500 partners.[2] Exhibit 12-1 lists the 10 largest public accounting firms in Canada.

PricewaterhouseCoopers LLP
www.pwcglobal.com

Deloitte & Touche LLP
www.deloitte.ca

KPMG LLP
www.kpmg.ca

Ernst & Young LLP
www.eycan.com

Grant Thornton Canada
www.grantthornton.ca

Arthur Andersen LLP
www.arthurandersen.ca

BDO Dunwoody LLP
www.bdo.ca

Collins Barrow/Mintz & Partners
www.collinsbarrow.com

Richter, Usher & Vineberg LLP
www.richter.ca

HLB/Schwartz Levitsky Feldman LLP
www.slf.ca

Characteristics of a Partnership

Starting a partnership is voluntary. A person cannot be forced to join a partnership, and partners cannot be forced to accept another person as a partner. Although the partnership agreement may be oral, a written agreement between the partners reduces the chance of a misunderstanding. The following characteristics distinguish partnerships from sole proprietorships and from corporations.

The Written Partnership Agreement

OBJECTIVE 1
Identify the characteristics of a partnership

A business partnership is like a marriage. To be successful, the partners must cooperate. However, business partners do not vow to remain together for life. To make certain that each partner fully understands how the partnership operates and to lower the chances that any partner might misunderstand how the business is run, partners may draw up a **partnership agreement**. This agreement is a contract between the partners, so transactions under the agreement are governed by contract law. The provincial legislatures in Canada have passed their respective versions of a partnership act, the terms of which apply in the absence of a partnership agreement or in the absence of particular matters in the partnership agreement.[3]

The partnership agreement should make the following points clear:

1. Name, location, and nature of the business
2. Name, capital investment, and duties of each partner
3. Method of sharing profits and losses among the partners
4. Withdrawals of assets allowed to the partners
5. Procedures for settling disputes among the partners
6. Procedures for admitting new partners
7. Procedures for settling with a partner who withdraws from the business
8. Procedures for removing a partner who will not withdraw or retire from the partnership voluntarily
9. Procedures for liquidating the partnership—selling the assets, paying the liabilities, and disbursing any remaining cash to the partners

KEY POINT

A partnership is not required to have a formal written agreement. But a written agreement prevents confusion as to the sharing of profits and losses, partners' responsibilities, admission of new partners, how the partnership will be liquidated, and so on. A written agreement does not preclude discord, however.

[2] "Canada's Largest Corporations," *National Post Business*, June 2000, p. 164.
[3] Smyth, J.E., D.A. Soberman, and A.J. Easson, *The Law and Business Administration in Canada*, Ninth edition. (Toronto: Pearson Education Canada Inc., 2001), pp. 590–597.

LEARNING TIP

Note that when a partner leaves a partnership, it dissolves and its books are closed. If the remaining partners want to continue as partners, they form a new partnership with a new set of books. Dissolution does not require liquidation; that is, the assets need not be sold to outside parties.

As partners enter and leave the business, the old partnership is dissolved and a new partnership is formed. Drawing up a new agreement for each new partnership may be expensive and time-consuming.

Limited Life

A partnership has a life limited by the length of time that all partners continue to own the business. If Bruce Dunn of the chapter-opening story withdraws from the business, the partnership of Dunn & Grieve will cease to exist. A new partnership may emerge to continue the same business, but the old partnership will have been dissolved. **Dissolution** is the ending of a partnership. The addition of a new partner dissolves the old partnership and creates a new partnership. Large parnterships such as PricewaterhouseCoopers retain the firm name even after partners resign from the firm.

Mutual Agency

Mutual agency in a partnership means that every partner can bind the business to a contract within the scope of the partnership's regular business operations. If Bruce Dunn enters into a contract with a person or another business to provide service, then the firm of Dunn & Grieve—not only Dunn—is bound to provide that service. If Dunn signs a contract to purchase lawn services for his home, however, the partnership would not be bound to pay because the lawn service is a personal matter for Dunn. It is not a regular business operation of the partnership.

KEY POINT

Since all partners are personally liable for any debt of the business, it is extremely important to choose a partner carefully. This is one reason some investors/partners prefer the *limited partnership* form of business organization.

Unlimited Liability

Each partner has an **unlimited personal liability** for the debts of the partnership. When a partnership cannot pay its debts with business assets, the partners must use their personal assets to meet the debt. Proprietors also have unlimited personal liability for the debts of their business.

Suppose the Dunn & Grieve firm had an unsuccessful year, and the partnership's liabilities exceed its assets by $20,000. Dunn and Grieve must pay this amount with their personal assets. Because each partner has *unlimited liability*, if a partner is unable to pay his or her part of the debt, the other partner (or partners) must make payment. If Grieve can pay only $5,000 of the liability, Dunn must pay $15,000.

Unlimited liability and mutual agency are closely related. A dishonest partner or a partner with poor judgment may commit the partnership to a contract under which the business loses money. In turn, creditors may force *all* the partners to pay the debt from their personal assets. Hence, a business partner should be chosen with great care.

Partners can avoid unlimited personal liability for partnership obligations by forming a *limited partnership*. In this form of business organization, one or more of the general partners assumes the unlimited liability for business debts. In addition, there is another class of owners, limited partners, who can lose only as much as their investment in the business. In this sense, limited partners have limited liability similar to the limited liability that shareholders in a corporation have.

KEY POINT

A personal investment of assets in a partnership becomes the joint property of all the partners.

Co-ownership of Property

Any asset—cash, inventory, machinery, and so on—that a partner invests into the partnership becomes the joint property of all the partners. Also, each partner has a claim to his or her share of the business's profits.

No Partnership Income Taxes

A partnership pays no income tax on its business income. Instead, the net income of the partnership is divided, and becomes the taxable income of the partners. Suppose Dunn & Grieve earned net income of $150,000, shared equally by partners

Dunn and Grieve. Dunn & Grieve would pay no income tax *as a business entity*. However, Dunn and Grieve would pay income tax as individuals on their $75,000 shares of partnership income.

Partners' Owner's Equity Accounts

Recall from Chapter 1, page 12, that owner's equity for a proprietorship has only one account, entitled "Capital." For example, when Bruce Dunn had his own saccounting practice, owner's equity would have been the single account Bruce Dunn, Capital.

Accounting for a partnership is much like accounting for a proprietorship. We record buying and selling goods and services, collecting, and paying cash for a partnership just as we do for a proprietorship. But, because a partnership has more than one owner, the partnership must have more than one owner's equity account. Every partner in the business—whether the firm has two or two hundred partners—has an individual owner's equity account. Often these accounts carry the name of the particular partner and the word *capital*. For example, the owner's equity account for Bruce Dunn would read "Bruce Dunn, Capital." Just as a sole proprietor has a drawings or withdrawal account (a temporary account), each partner in a partnership has a withdrawal account. If the number of partners is large, the general ledger may contain the single account Partners' Capital or Owners' Equity. A subsidiary ledger can be used for individual partner accounts.

Exhibit 12-2 lists the advantages and disadvantages of partnerships (compared to proprietorships and corporations).

LEARNING TIP

A partnership is really a "multiple proprietorship." Most features of a proprietorship also apply to a partnership—in particular, limited life and unlimited liability.

Types of Partnerships

There are two basic types of partnerships: general and limited.

General Partnerships

A **general partnership** is the basic form of partnership organization. Each partnership is an owner of the business with all the privileges and risks of ownership. The general partners share the profits, losses, and the risks of the business. The partnership *reports* its income to governmental tax authorities (C anada Customs and Revenue Agency, or CCRA), but the partnership pays *no* income tax. The profits and losses of the partnership pass through the business to the partners, who then pay personal income tax on their income.

EXHIBIT 12-2

Advantages and Disadvantages of Partnerships

Partnership Advantages	Partnership Disadvantages
Versus Proprietorships: 1. Can raise more capital. 2. Brings together the expertise of more than one person 3. 1+1>2 in a good partnership. If the partners work well together, they can achieve more than by working alone. ***Versus Corporations:*** 4. Less expensive to organize than a corporation, which requires articles of incorporation from a province or the federal government. 5. Fewer governmental regulations and restrictions than a corporation.	1. Partnership agreement may be difficult to formulate. Each time a new partner is admitted or a partner leaves the partnership, the business needs a new partnership agreement. 2. Relationships among partners may be fragile. 3. Mutual agency and unlimited personal liability create personal obligations for each partner.

Limited Partnerships

A **limited partnership** has at least two classes of partners. There must be at least one *general partner*, who takes primary responsibility for the management of the business. The general partner also takes the bulk of the risk of failure in the event of the partnership goes bankrupt (liabilities exceed assets). In some limited partnerships, such as real-estate limited partnerships, the general partner often invests little cash in the business. Instead, the general partner's contribution is her or his skill in managing the organization. Usually, the general partner is the last owner to receive a share of partnership profits and losses. But the general partner may earn all excess profits after satisfying the limited partners' demands for income.

The *limited partners* are so named because their personal obligation for the partnership's liabilities is limited to the amount they have invested in the business. Usually, the limited partners have invested the bulk of the partnership's asset and capital. They therefore usually have the first claim to partnership profits and losses, but only up to a specified limit. In exchange for their limited liability, their potential for profits usually has a limit as well.

Most of the large public accounting firms in Canada are now organized as **limited liability partnerships** (LLPs), which means that each partner's personal liability for the business's debts is limited to a certain dollar amount. An example is PricewaterhouseCoopers LLP. The LLP must carry an adequate amount of malpractice insurance to protect the public.

OBJECTIVE 2
Account for partners' initial investment in a partnership

Initial Investments by Partners

Let's examine the start up of a partnership. We will see how to account for the multiple owner's equity accounts of the partners and learn how they appear on the balance sheet.

Partners in a new partnership may invest assets and their related liabilities in the business. These contributions are entered in the books by recording the assets and liabilities, in the same way as proprietorships record them, at their agreed-upon values. Each person's net contribution (assets minus liabilities) is credited to the owner's equity account for that person. Often the partners hire an independent firm to appraise their assets and liabilities at current market value at the time a partnership is formed. This outside evaluation assures an objective valuation for what each partner brings into the business.

Assume Karen Edwards and Linda McLean form a partnership to develop and sell computer software. The partners agree on the following values based on an independent appraisal:

Edwards' contributions

- Cash, $20,000; inventory, $140,000; and accounts payable, $170,000 (The appraiser believes that the current market values for these items equal Edwards' book values.)
- Accounts receivable, $60,000, less allowance for doubtful accounts of $10,000
- Computer equipment: cost, $800,000; accumulated amortization, $200,000; current market value, $450,000

McLean's contributions

- Cash, $10,000
- Computer software: cost, $36,000; current market value, $200,000

The partnership records receipts of the partners' initial investments at the current market values of the assets and liabilities because, in effect, the partnership is buying the assets and assuming the liabilities at their current market values. The partnership entries are as follows:

Edwards' investment

2003			
June 1	Cash	20,000	
	Accounts Receivable	60,000	
	Inventory	140,000	
	Computer Equipment	450,000	
	Allowance for Doubtful Accounts		10,000
	Accounts Payable		170,000
	Karen Edwards, Capital		490,000
	To record Edwards' investment in the partnership ($670,000 – $180,000).		

McLean's investment

2003			
June 1	Cash	10,000	
	Computer Software	200,000	
	Linda McLean, Capital		210,000
	To record McLean's investment in the partnership.		

The initial partnership balance sheet reports these amounts as shown in Exhibit 12-3. Note that the asset and liability sections on the balance sheet are the same for a proprietorship and a partnership.

KEY POINT

The major difference in accounting for a proprietorship versus a partnership is the number of capital and drawing accounts. The partnership balance sheet shows a separate capital account for each partner, and there is a separate drawing account for each partner. The asset and liability sections on the balance sheet and the income statement are the same for a proprietorship and a partnership.

EXHIBIT 12-3

Partnership Balance Sheet

EDWARDS AND McLEAN
Balance Sheet
June 1, 2003

Assets			Liabilities	
Cash		$ 30,000	Accounts payable	$170,000
Accounts receivable	$60,000			
Less: Allowance for doubtful accounts	10,000	50,000	**Capital**	
Inventory		140,000	Karen Edwards, capital	490,000
Computer equipment		450,000	Linda McLean, capital	210,000
Computer software		200,000	Total capital	700,000
			Total liabilities	
Total assets		$870,000	and capital	$870,000

STOP & THINK

How could a partner allow the partnership to use a personal asset, such as a car or money, without losing his or her claim to that asset?

Answer: The partner could lease the car to the partnership. If the partnership were liquidated, the car would have to be returned to its owner. The partner could also lend money to the partnership instead of investing it. Upon liquidation, the partnership would have to repay the loan to the lending partner before any distribution of capital to the partners.

Accounting and the e-World

The Lively Life of a Dot.com Partnership

Founding partners say that starting up a business is *the* life. Sleep is scant and cash is low, but hopes and energy run high. Some Internet businesses have started with nothing more than enthusiastic partners and a winning idea.

The story of **Yahoo!** founders Jerry Yang and David Filo is now legend. In 1994, the two Stanford University graduate students created a way to categorize Web sites. Their guide, names Yahoo!, was the first place for Web browsers to find sites easily. Now Yahoo! is a global Internet communications, commerce, and media company with over 2,000 employees. Yahoo! has a global Web network of 21 properties and offices in the United States, Canada, Europe, Asia, and Latin America.

Founded in 1999 by 19-year-old Shawn Fanning and 20-year-old Sean Parker, **Napster**, created software that lets people trade music files on the Internet for free. In almost no time, the company turned the music industry upside down. Twenty million users downloaded the free software in just seven months, and *Fortune* magazine commended the company for pioneering one of the hottest business concepts of our time: peer-to-peer information sharing. Napster is so successful that some members of the music industry have effectively put the organization out of business.

In 1994, Todd Krizelman and Stephen Paternot, both 25 and at Cornell University, created an online community where participants could go to find news, discussion forums, and products, called **theglobe.com**. Krizelman and Paternot drained their bank accounts and lived off credit cards, and recruited employees in the student lounge, paying them with Domino pizza. Four years later, theglobe.com brought in $27 million in an initial public stock offering, and the former dorm buddies are now joint Chief Executive Officers (CEOs).

Based on: [Yahoo!] Information from http://join.yahoo.com/cheif.html and http://join.yahoo.com/overview.html. [Napster] Chuck Phillips, "Company Town; THE BIZ Q & A; Humming a Hopeful Tune at Napster," *The Lost Angeles Times,* July 19, 2000, p. 1. Amy Kover, "Napster: The Hot Idea of the Year," *Fortune,* June 26, 2000, pp. 128–136. [theglobe.com] Stephanie Armour, "Tech Grads Loving Life: Pizza, Jeans, Happy Hour," *USA Today,* June 21, 1999, p. 01B.

OBJECTIVE 3
Allocate profits and losses to the partners by different methods

Sharing Partnership Profits and Losses

Allocating profits and losses among partners is one of the most challenging aspects of managing a partnership and can be a major source of disputes. Any division of profits and losses is allowed as long as the partners agree and it is in the partnership agreement. If the partners have not drawn up an agreement, or if the agreement does not state how the partners will divide profits and losses, then, by law, the partners must share profits and losses equally. If the agreement specifies a method for sharing profits but not losses, then losses are shared in the same proportion as profits. For example, a partner receiving 75 percent of the profits would likewise absorb 75 percent of any losses.

In some cases, an equal division is not fair. One partner may perform more work for the business than the other partner, or one partner may make a larger capital contribution. In the preceding example, Linda McLean might agree to work longer hours for the partnership than Karen Edwards in order to earn a greater share of profits. Edwards could argue that she should receive more of the profits because she contributed more net assets ($490,000) than McLean did ($210,000). McLean

THINKING IT OVER

Notice the credits to Capital in the two journal entries on June 1 on page 667. Must the partners contribute equal amounts?

A: No, the partners can agree on the amounts invested. The amounts invested do not necessarily determine how profits and losses will be divided.

might contend that her computer software program is the partnership's most important asset, and that her share of the profits should be greater than Edwards' share. Arriving at fair sharing of profits and losses in a partnership may be difficult. We now discuss the options available in determining partners' shares of profits and losses.

Student to Student

I find that allocating profits and losses to partners can be confusing. However, the examples given in this chapter are very clear, and I used the Working It Out questions in the margin for extra practice. (And having the answers for them helps too!)

Diane S., Kingston

Sharing Based on a Stated Fraction

Partners may state a particular fraction of the total profits and losses each individual partner will share. Suppose the partnership agreement of Sarah Cagle and Bill Elias allocates two-thirds of the business profits and losses to Cagle and one-third to Elias. If net income for the year is $270,000, and all revenue and expense accounts have been closed, the Income Summary account has a credit balance of $270,000:

Income Summary

	Bal.	270,000

The entry to close this account and allocate the profit to the partners' capital accounts is

Dec.	31	Income Summary	270,000	
		Sarah Cagle, Capital		180,000
		Bill Elias, Capital		90,000
		To allocate net income to partners.		
		(Cagle: $270,000 × ⅔; Elias: $270,000 × ⅓)		

Consider the effect of this entry. Does Cagle get cash of $180,000 and Elias cash of $90,000? No. The increase in the capital accounts of the partners cannot be linked to any particular asset, including cash. Instead, the entry indicates that Cagle's ownership in all the assets of the business increased by $180,000 and Elias's by $90,000.

If the year's operations resulted in a net loss of $132,000, the Income Summary account would have a debit balance of $132,000. In that case, the closing entry to allocate the loss to the partners' capital accounts would be

Dec.	31	Sarah Cagle, Capital	88,000	
		Bill Elias, Capital	44,000	
		Income Summary		132,000
		To allocate net loss to partners.		
		(Cagle: $132,000 × ⅔; Elias: $132,000 × ⅓)		

Just as profit of $270,000 did not mean that the partners received cash of $180,000 and $90,000, so the loss of $132,000 does not mean that the partners must contribute cash of $88,000 and $44,000. A profit or loss will increase or decrease each partner's capital account, but cash may not change hands.

Sharing Based on Capital Contributions

Profits and losses are often allocated in proportion to the partners' capital contributions in the business. Suppose Jim Antoine, Erica Barber, and Tony Culomovic are partners in ABC Company. Their capital accounts have the following balances at the end of the year, before the closing entries:

WORKING IT OUT

Ash, Black, and Cole share profits in a 30:40:30 ratio. Compute each partner's share of net income if the partnership income is $100,000.

A:

Ash:	
($100,000 × 30%) =	$30,000
Black:	
($100,000 × 40%) =	40,000
Cole:	
($100,000 × 30%) =	30,000
	$100,000

WORKING IT OUT

Ash, Black, and Cole share profits on the basis of capital account balances of $20,000, $40,000, and $140,000, respectively. Compute each partner's share of net income if the partnership net income is $100,000.

A:

Ash:	
($20,000/$200,000 × $100,000) =	$ 10,000
Black:	
($40,000/$200,000 × $100,000) =	20,000
Cole:	
($140,000/$200,000 × $100,000) =	70,000
	$100,000

Jim Antoine, Capital	$ 60,000
Erica Barber, Capital	90,000
Tony Culomovic, Capital	75,000
Total capital balances	$225,000

Assume that the partnership earned a profit of $180,000 for the year. To allocate this amount based on capital contributions, each partner's percentage share of the partnership's total capital balance must be computed. We simply divide each partner's contribution by the total capital amount. These figures, multiplied by the $180,000 profit amount, yield each partner's share of the year's profits:

Antoine:	($60,000/$225,000) × $180,000	=	$ 48,000
Barber:	($90,000/$225,000) × $180,000	=	72,000
Culomovic:	($75,000/$180,000) × $180,000	=	60,000
	Net income allocated to partners	=	$180,000

The closing entry to allocate the profit to the partners' capital accounts is

Dec. 31	Income Summary	180,000	
	Jim Antoine, Capital		48,000
	Erica Barber, Capital		72,000
	Tony Culomovic, Capital		60,000
	To allocate net income to partners.		

After this closing entry, the partners' capital balances are

Jim Antoine, Capital ($60,000 + $48,000)	$108,000
Erica Barber, Capital ($90,000 + $72,000)	162,000
Tony Culomovic, Capital ($75,000 + $60,000)	135,000
Total capital balances after allocation of net income	$405,000

Sharing Based on Capital Contributions and on Service

One partner, regardless of his or her capital contribution, may put more work into the business than the other partners. Even among partners who log equal service time, one person's superior experience and knowledge may command a greater share of income. To reward the harder-working or more valuable person, the profit-and-loss-sharing method may be based on a combination of contributed capital *and* service to the business. Most law firms take service into account in determining partner compensation.

Assume Sheila Randolph and Carolyn Scott formed a partnership in which Randolph invested $60,000 and Scott invested $40,000, a total of $100,000. Scott devotes more time to the partnership and earns the larger salary. Accordingly, the two partners have agreed to share profits as follows:

1. The first $50,000 of partnership profits is to be allocated based on partners' capital contributions to the business.
2. The next $60,000 of profits is to be allocated based on service, with Randolph receiving $24,000 and Scott receiving $36,000.
3. Any remaining amount is allocated equally.

If net income for the first year is $125,000, the partners' shares of this profit are computed as follows:

THINKING IT OVER

Under what circumstances would a partner make an initial contribution of a liability?

A: A partner could contribute an asset with a liability attached to it. For example, a partner could contribute a mortgaged building to the partnership. In transferring the building to the partnership, the partner would also be transferring the note payable (a liability), as long as the original lender agrees to the transaction.

WORKING IT OUT

Ash, Black, and Cole have capital balances of $20,000, $40,000, and $140,000, respectively. The partners share profits and losses as follows:
(1) The first $50,000 is allocated on the basis of partners' capital balances.
(2) The next $38,000 is allocated on the basis of service, with Ash, Black, and Cole receiving $10,000, $12,000, and $16,000, respectively.
(3) The remainder is divided equally.

Compute each partner's share of net income if the partnership earns $100,000.

A:
Ash:
($20,000/$200,000 × $50,000) + $10,000 + $4,000* = $19,000
Black:
($40,000/$200,000 × $50,000) + $12,000 + $4,000* = $26,000
Cole:
($140,000/$200,000 × $50,000) + $16,000 + $4,000* = $55,000

*Remainder shared equally:
$100,000 – $50,000 – $38,000 = $12,000
$12,000 / 3 = $4,000

	Randolph	Scott	Total
Total net income			$125,000
Sharing of first $50,000 of net income, based on capital contributions:			
Randolph ($60,000/$100,000 × $50,000)	$30,000		
Scott ($40,000/$100,000 × $50,000)		$20,000	
Total			50,000
Net income remaining for allocation			75,000
Sharing of next $60,000, based on service:			
Randolph	24,000		
Scott		36,000	
Total			60,000
Net income left for allocation			15,000
Remainder shared equally:			
Randolph ($15,000 × 1/2)	7,500		
Scott ($15,000 × 1/2)		7,500	
Total			15,000
Net income left for allocation			$ -0-
Net income allocated to the partners	$61,500	$63,500	$125,000

On the basis of this allocation, the closing entry is

Dec.	31	Income Summary	125,000	
		Sheila Randolph, Capital		61,500
		Carolyn Scott, Capital		63,500
		To allocate net income to partners.		

Sharing Based on "Salaries" and Interest

Partners may be rewarded for their service and their capital contributions to the business in other ways. In one sharing plan, the partners are allocated "salaries" (which are predetermined sums to be withdrawn, *not* employee salaries) plus interest on their capital balances. Assume Edward Massey and Pierre Vanier form an oil-exploration partnership. At the beginning of the year, their capital balances are $80,000 and $100,000 respectively. The partnership agreement allocates annual "salary" of $43,000 to Massey and $35,000 to Vanier. After these amounts are allocated, each partner earns 8 percent interest on his beginning capital balance. Any remaining net income is divided equally. Partnership profit of $96,000 for 2003 will be allocated as follows:

THINKING IT OVER

What factors influence the way profits and losses are shared?

A: Each partner's initial contribution of assets and liabilities; the fair market value of the assets contributed; the time each partner will devote to the business; the skills, abilities, reputation, clients, and such that each partner contributes.

	Massey	Vanier	Total
Total net income			$96,000
First, "salaries":			
Massey	$43,000		
Vanier		$35,000	
Total			78,000
Net income remaining for allocation			18,000
Second, interest on beginning capital balances:			
Massey ($80,000 × 0.08)	6,400		
Vanier ($100,000 × 0.08)		8,000	
Total			14,400
Net income remaining for allocation			3,600
Third, remainder shared equally:			
Massey ($3,600 × 1/2)	1,800		
Vanier ($3,600 × 1/2)		1,800	
Total			3,600
Net income remaining for allocation			$ -0-
Net income allocated to the partners	$51,200	$44,800	$96,000

WORKING IT OUT

Ash, Black, and Cole have capital balances of $20,000, $40,000, and $140,000, respectively. The partners share profits and losses as follows:
(1) Ash and Cole receive "salaries" of $12,000 and $14,000, respectively.
(2) Interest of 10% is paid on the capital balances.
(3) The remainder is divided equally.

Compute each partner's share of net income if the partnership earns $100,000.

A:
Ash:
$12,000 + (10% × $20,000) + $18,000* = $32,000

Black: (10% × $40,000) + $18,000* = $22,000

Cole: $14,000 + (10% × $140,000) + $18,000* = $46,000

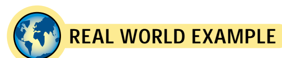
*Remainder = [$100,000 – $12,000 – $14,000 – (10% × $200,000)] = $54,000
$54,000/3 = $18,000

In the preceding illustration, net income exceeded the sum of "salary" and interest. If the partnership profit is less than the allocated sum of "salary" and interest, a negative remainder will occur at some stage in the allocation process. Even so, the partners use the same method for allocation purposes. For example, assume that Massey and Vanier Partnership earned only $82,000 in 2003.

	Massey	Vanier	Total
Total net income			$82,000
First, "salaries":			
Massey	$43,000		
Vanier		$35,000	
Total			78,000
Net income remaining for allocation			4,000
Second, interest on beginning capital balances:			
Massey ($80,000 × 0.08)	6,400		
Vanier ($100,000 × 0.08)		8,000	
Total			14,400
Net income remaining for allocation			(10,400)
Third, remainder shared equally:			
Massey ($10,400 × ½)	(5,200)		
Vanier ($10,400 × ½)		(5,200)	
Total			(10,400)
Net income remaining for allocation			$ -0-
Net income allocated to the partners	$44,200	$37,800	$82,000

A net loss would be allocated to Massey and Vanier in the same manner outlined for net income. The sharing procedure would begin with the net loss, and then allocate "salary," interest, and any other specified amounts to the partners.

For example, assume that Massey and Vanier Partnership had a loss of $12,000 in 2003.



In some large partnerships, a "units" system of profit and loss allocation is used. Each partner is awarded a particular number of units, which becomes the numerator in the fraction used for allocation. The total number of units awarded is the denominator in the fraction. The units method can allow a partnership to continue even as partners enter and withdraw from the partnership if unit formulas (rather than partner names) are a part of the partnership agreement.

	Massey	Vanier	Total
Total net income			($12,000)
First, "salaries":			
Massey	$43,000		
Vanier		$35,000	
Total			78,000
Net income (loss) remaining for allocation			(90,000)
Second, interest on beginning capital balances:			
Massey ($80,000 × 0.08)	6,400		
Vanier ($100,000 × 0.08)		8,000	
Total			14,400
Net income (loss) remaining for allocation			(104,400)
Third, remainder shared equally:			
Massey ($104,400 × ½)	(52,200)		
Vanier ($104,400 × ½)		(52,200)	
Total			(104,400)
Net income remaining for allocation			$ -0-
Net income (loss) allocated to the partners	($2,800)	($9,200)	($12,000)

We see that partners may allocate profits and losses based on a stated fraction, contributed capital, service, interest on capital, or any combination of these factors. Each partnership shapes its profit-and-loss-sharing ratio to fit its own needs.

Stop & Think

Are these "salaries" and interest amounts business expenses in the usual sense? Explain your answer.

Answer: No, partners do not work for their own business to earn a salary, as an employee does. They do not loan money to their own business to earn interest. Their goal is for the partnership to earn a profit. Therefore, "salaries" and interest in partnership agreements are simply ways of expressing the allocation of profits and losses to the partners. For example, the "salary" component of partner income rewards service to the partnership. The interest component rewards a partner's investment of cash or other assets in the business. But the partners' "salary" and interest amounts are *not* salary expense and interest expense in the partnership's accounting or tax records.

Partner Withdrawals (Drawings) of Cash and Other Assets

Like anyone else, partners need cash for personal living expenses. Partnership agreements usually allow partners to withdraw cash or other assets from the business. These withdrawals are sometimes called ***drawings***, and are recorded in a separate Withdrawals or Drawings account for each partner. (Drawings from a partnership are recorded exactly as for a proprietorship.) Assume that both Edward Massey and Pierre Vanier are allowed a monthly withdrawal of $5,000. The partnership records the March 2003 withdrawal with this entry:

Mar.	31	Edward Massey, Withdrawals	5,000	
		Pierre Vanier, Withdrawals	5,000	
		Cash		10,000
		Monthly partner withdrawals of cash.		

During the year, each partner's withdrawal account accumulates 12 such amounts, a total of $60,000 ($5,000 × 12). At the end of the period, the general ledger shows the following account balances immediately after net income has been closed to the partners' capital accounts. Assume the January 1, 2003, balances for Massey and Vanier shown below, and that $82,000 of profit has been allocated on the basis of the illustration on page 672.

REAL WORLD EXAMPLE

According to the *Income Tax Act*, partners are taxed on their share of partnership income, not on the amount of their withdrawals.

Edward Massey, Capital

Debit	Credit	
	Jan. 1, 2003 Bal.	80,000
	Dec. 31, 2003 Net income	44,200

Pierre Vanier, Capital

Debit	Credit	
	Jan. 1, 2003 Bal.	100,000
	Dec. 31, 2003 Net income	37,800

Edward Massey, Withdrawals

Debit	Credit
Dec. 31, 2003 Bal. 60,000	

Pierre Vanier, Withdrawals

Debit	Credit
Dec. 31, 2003 Bal. 60,000	

The withdrawal accounts must be closed at the end of the period (as must be done for a proprietorship). The closing entry credits each partner's Withdrawals account and debits each partner's Capital account. The amount of the withdrawal does not

depend on the partnership's income or loss for the year. In fact, it is possible for a partner to withdraw more than the balance in the capital account if, for example, profits were expected to be higher than they proved to be and withdrawals were made in anticipation of these high profits. This situation can only occur if the partnership has the cash required for the withdrawal and the other partners agree with the withdrawal and the ending capital balance.

OBJECTIVE 4
Account for the admission of a new partner to the business

Admission of a Partner

A partnership lasts only as long as its partners remain in the business. The addition of a new member or the withdrawal of an existing member dissolves the partnership. We turn now to a discussion of how partnerships dissolve—and how new partnerships arise.

Often a new partnership is formed to carry on the former partnership's business. In fact, the new partnership may choose to retain the dissolved partnership's name. PricewaterhouseCoopers LLP, for example, is an accounting and consulting firm that retires and admits partners during the year. Thus the former partnership dissolves and a new partnership begins many times. The business, however, retains the name and continues operations. Other partnerships may dissolve and then re-form under a new name. Let's look at the ways that a new member may gain admission into an existing partnership.

WORKING IT OUT

Ted and Fred are partners with capital balances of $32,000 and $48,000, respectively. Profits and losses are shared on the basis of capital balances. Ann offers Fred $120,000 for his interest in the business. What is the entry to record the transfer of capital?

A:

Fred, Capital	48,000	
Ann, Capital		48,000

Admission by Purchasing a Partner's Interest

A person may become a member of a partnership by gaining the approval of the other partner (or partners) for entrance into the firm, *and* by purchasing a present partner's interest in the business. Let's assume that Stephi Fisher and Carlo Levesque have a partnership that carries these figures:

Cash	$ 80,000	Total liabilities	$240,000
Other assets	720,000	Stephi Fisher, capital	220,000
		Carlo Levesque, capital	340,000
Total assets	$800,000	Total liabilities and capital	$800,000

Business is so successful that Fisher receives an offer from Linda Dynak, an outside party, to buy her $220,000 interest in the business for $300,000. Fisher agrees to sell out to Dynak, and Levesque approves Dynak as a new partner. The firm records the transfer of capital interest in the business with this entry:

Apr. 16	Stephi Fisher, Capital	220,000	
	Linda Dynak, Capital		220,000
	To transfer Fisher's equity in the business to Dynak.		

The debit side of the entry closes Fisher's capital account because she is no longer a partner in the firm. The credit side opens Dynak's capital account because Fisher's equity has been transferred to Dynak. The entry amount is Fisher's capital balance ($220,000) and not the $300,000 price that Dynak paid Fisher to buy into the business. The full $300,000 goes to Fisher, including the $80,000 difference between her capital balance and the price received from Dynak. In this example, the partnership does not receive cash because the transaction was between Dynak and Fisher, not between Dynak and the partnership. Suppose Dynak pays Fisher less than Fisher's capital balance. The entry on the partnership books is not affected. Fisher's equity is transferred to Dynak at book value ($220,000).

KEY POINT

The profit or loss on the sale of a partnership interest belongs personally to the partner selling the interest and will not appear on the partnership's books.

The old partnership has dissolved. Levesque and Dynak draw up a new partnership agreement, with a new profit-and-loss-sharing ratio, and continue business

operations. If Levesque does not accept Dynak as a partner, the Fisher and Levesque partnership would be dissolved, and Dynak would be unable to buy Fisher's interest.

Admission by Investing in the Partnership

A person may be admitted as a partner by investing directly in the partnership rather than by purchasing an existing partner's interest. The new partner contributes assets—for example, cash, inventory, or equipment—to the business. Assume that the partnership of Robin Ingel and Michael Jay has the following assets, liabilities, and capital:

Cash	$ 30,000	Total liabilities	$ 90,000
Other assets.........................	300,000	Robin Ingel, capital.............	105,000
		Michael Jay, capital	135,000
		Total liabilities	
Total assets	$330,000	and capital	$330,000

Laureen Kahn offers to invest equipment and land (Other assets) with a market value of $120,000 to persuade the existing partners to take her into the business. Ingel and Jay agree to dissolve the existing partnership and to start up a new business, giving Kahn one-third interest—[$120,000/($105,000 + $135,000 + $120,000) = ⅓]—in exchange for the contributed assets. Notice that Kahn is buying into the partnership at book value because her one-third investment ($120,000) equals one-third of the new partnership's total capital ($360,000). The entry to record Kahn's investment is

July	18	Other Assets	120,000	
		Laureen Kahn, Capital..................................		120,000
		To admit L. Kahn as a partner with a one-third interest in the business.		

After this entry, the partnership books show:

Cash	$ 30,000	Total liabilities......................	$ 90,000
Other assets ($300,000 + $120,000)	420,000	Robin Ingel, capital	105,000
		Michael Jay, capital	135,000
		Laureen Kahn, capital.........	120,000
		Total liabilities	
Total assets	$450,000	and capital......................	$450,000

Kahn's one-third interest in the partnership does not necessarily entitle her to one-third of the profits. The sharing of profits and losses is a separate element in the partnership agreement.

Admission by Investing in the Partnership—Bonus to the Old Partners The more successful a partnership, the higher the payment the partners may demand from a person entering the business. Partners in a business that is doing quite well might require an incoming person to pay them a bonus. The bonus comes into the partnership, increasing the current partners' capital accounts.

Suppose that Hiro Nagasawa and Lisa Schwende's partnership has earned above-average profits for ten years. The two partners share profits and losses equally. The balance sheet carries these figures:

Cash......................................	$ 80,000	Total liabilities	$200,000
Other assets	420,000	Hiro Nagasawa, capital......	140,000
		Lisa Schwende, capital	160,000
		Total liabilities	
Total assets...........................	$500,000	and capital	$500,000

WORKING IT OUT

Ted and Fred are partners with capital balances of $32,000 and $48,000, respectively. Profits and losses are shared on the basis of capital balances. Ted and Fred admit Jill to a 20% interest with a $24,000 investment. What is the entry to record Jill's admission to the partnership?

A:

Cash.........................	24,000	
Jill, Capital		20,800
Ted, Capital		1,280
Fred, Capital		1,920

Jill: $20,800 = ($32,000 + $48,000 + $24,000) × 0.2

Ted: $1,280 = $32,000/$80,000 × ($24,000 – $20,800)

Fred: $1,920 = $48,000/$80,000 × ($24,000 – $20,800)

LEARNING TIP

Notice in the March 1 journal entry that Nagasawa's and Schwende's capital accounts increased because of Parker's investment, but that Nagasawa and Schwende have not received cash. All the cash went into the partnership. Their increased capital accounts include the bonus amount contributed by Parker.

LEARNING TIP

The bonus in this example is shared equally by the existing partners because they share profits and losses equally. A bonus is normally shared by the existing partners in the profit-sharing ratio.

WORKING IT OUT

Mia and Susan are partners with capital balances of $25,000 and $75,000, respectively. They share profits and losses in a 30:70 ratio. Mia and Susan admit Tab to a 10% interest in a new partnership when Tab invests $20,000 in the business.

1. Journalize the partnership's receipt of cash from Tab.
2. What is each partner's capital in the new partnership?

A:

1.

Cash	20,000	
Tab, Capital		12,000
Mia, Capital		2,400
Susan, Capital		5,600
To admit Tab with a 10% interest in the business.		

Partnership capital before Tab is admitted ($25,000 + $75,000)	$100,000
Tab's investment in the partnership	20,000
Partnership capital after Tab is admitted	$120,000
Tab's capital in the partnership ($120,000 × 1/10)	$ 12,000
Bonus to the old partners ($20,000 – $12,000)	$ 8,000

Mia's bonus is $2,400 ($8,000 × 0.30) and Susan's bonus is $5,600 ($8,000 × 0.70).

2. Partners' capital balances:

Mia, capital ($25,000 + $2,400)	$ 27,400
Susan, capital ($75,000 + $5,600)	$ 80,600
Tab, capital	$ 12,000
Total partnership capital	$120,000

The partners agree to admit Alana Parker to a one-fourth interest with her cash investment of $180,000. Parker's capital balance on the partnership books is $120,000, computed as follows:

Partnership capital before Parker is admitted ($140,000 + $160,000)	$300,000
Parker's investment in the partnership	180,000
Partnership capital after Parker is admitted	$480,000
Parker's capital in the partnership ($480,000 × ¼)	$120,000
Bonus to the old partners ($180,000 – $120,000)	$ 60,000

In effect, Parker had to buy into the partnership at a price ($180,000) above the book value of her one-fourth interest ($120,000). Parker's extra investment of $60,000 creates a ***bonus*** for the existing partners. The entry on the partnership books to record Parker's investment is

Mar.	1	Cash	180,000	
		Alana Parker, Capital		120,000
		Hiro Nagasawa, Capital		30,000
		Lisa Schwende, Capital		30,000
		To admit A. Parker as a partner with a one-fourth interest in the business. Nagasawa and Schwende each receive a bonus of $30,000 ($60,000 × ½).		

Parker's capital account is credited for her one-fourth interest in the partnership. The bonus is allocated to the original partners (Nagasawa and Schwende) based on their profit-and-loss ratio.

The new partnership's balance sheet reports these amounts:

Cash ($80,000 + $180,000)	$260,000	Total liabilities	$200,000
Other assets	420,000	Hiro Nagasawa, capital ($140,000 + $30,000)	170,000
		Lisa Schwende, capital ($160,000 + $30,000)	190,000
		Alana Parker, capital	120,000
Total assets	$680,000	Total liabilities and capital	$680,000

Admission by Investing in the Partnership—Bonus to the New Partner A potential new partner may be so important that the existing partners offer him or her a partnership share that includes a bonus. A law firm may strongly desire a former premier, cabinet minister, or other official as a partner because of the person's reputation. A restaurant owner may want to go into partnership with a famous sports personality like Wayne Gretzky or a singer like Shania Twain.

Suppose Jenny Page and Miko Osuka have a law partnership. The firm's balance sheet appears as follows:

Cash	$210,000	Total liabilities	$180,000
Other assets	540,000	Jenny Page, capital	345,000
		Miko Osuka, capital	225,000
Total assets	$750,000	Total liabilities and capital	$750,000

The partners admit Martin Schiller, a former provincial Finance Minister, as a partner with a one-third interest in exchange for his cash investment of $150,000. At the time of Schiller's admission, the firm's capital is $570,000—Page, $345,000 plus Osuka, $225,000. Page and Osuka share profits and losses in the ratio of two-thirds to Page and one-third to Osuka. The computation of Schiller's equity in the partnership is

Partnership capital before Schiller is admitted ($345,000 + $225,000)	$570,000
Schiller's investment in the partnership	150,000
Partnership capital after Schiller is admitted	$720,000
Schiller's capital in the partnership ($720,000 × ⅓)	$240,000
Bonus to new partner ($240,000 – $150,000)	$ 90,000

In this case, Schiller bought into the partnership at a price ($150,000) below the book value of his interest ($240,000). The bonus of $90,000 went to Schiller from the other partners. The capital accounts of Page and Osuka are debited for the $90,000 difference between the new partner's equity ($240,000) and his investment ($150,000). The existing partners share this decrease in capital, which is accounted for as though it were a loss, based on their profit-and-loss ratio. The entry to record Schiller's investment is

Aug.	24	Cash	150,000	
		Jenny Page, Capital ($90,000 × ⅔)	60,000	
		Miko Osuka, Capital ($90,000 × ⅓)	30,000	
		Martin Schiller, Capital		240,000
		To admit M. Schiller as a partner with a one-third interest in the business.		

The new partnership's balance sheet reports these amounts:

Cash ($210,000 + $150,000)	$360,000	Total liabilities	$180,000
Other assets	540,000	Jenny Page, capital ($345,000 – $60,000)	285,000
		Miko Osuka, capital ($225,000 – $30,000)	195,000
		Martin Schiller, capital	240,000
Total assets	$900,000	Total liabilities and capital	$900,000

Withdrawal of a Partner from the Business

A partner may withdraw from the business for many reasons, including retirement or a dispute with the other partners. The withdrawal of a partner dissolves the old partnership. The partnership agreement should contain a provision to govern how to settle with a withdrawing partner. In the simplest case, as illustrated on page 674, a partner may withdraw and sell his or her interest to another partner in a personal transaction. The only entry needed to record this transfer of equity debits the withdrawing partner's capital account and credits the purchaser's capital account. The dollar amount of the entry is the capital balance of the withdrawing partner, regardless of the price paid by the purchaser. The accounting when one current partner buys a second partner's interest is the same as when an outside party buys a current partner's interest.

If the partner withdraws in the middle of the accounting period, the partnership books should be updated to determine the withdrawing partner's capital balance. The business must measure net income or net loss for the fraction of the year up to the withdrawal date, and allocate profit or loss according to the existing ratio. An alternative is to set an amount in the partnership agreement to be allocated regardless of the final annual results. This could be appropriate in businesses that have seasonal fluctations, where the selection of withdrawal date could lead to unfair allocations. After the books have been closed, the business then accounts for the change in partnership capital.

The withdrawing partner may receive his or her share of the business in partnership assets other than cash. The question then arises of what value to assign the partnership assets—book value or current market value? The settlement procedure may specify an independent appraisal of the assets to determine their current market value. If market

WORKING IT OUT

Jan and Ron are partners with capital balances of $45,000 and $60,000, respectively. They share profits and losses in a 25:75 ratio. Jan and Ron admit Lou to a 20% interest in a new partnership when Lou invests $15,000 in the business.

1. Journalize the partnership's receipt of cash from Lou.
2. What is each partner's capital in the new partnership?

A:

1.

Cash	15,000	
Jan, Capital	2,250	
Ron, Capital	6,750	
Lou, Capital		24,000
To admit Lou with a 20% interest in the business.		

Partnership capital before Lou is admitted ($45,000 + $60,000)	$105,000
Lou's investment in the partnership	15,000
Partnership capital after Lou is admitted	120,000
Lou's capital in the partnership ($120,000 × 0.20)	$ 24,000
Bonus to the new partner ($24,000 – $15,000)	$ 9,000

Jan's decrease in capital is $2,250 ($9,000 × 0.25) and Ron's decrease is $6,750 ($9,000 × 0.75).

2. Partner's capital balances:

Jan, capital ($45,000 – $2,250)	$ 42,750
Ron, capital ($60,000 – $6,750)	53,250
Lou, capital	24,000
Total partnership capital	$120,000

OBJECTIVE 5
Account for the withdrawal of a partner from the business

KEY POINT

When a partner leaves a partnership, she or he ceases to be an agent and no longer has the authority to bind the business to contracts. Third parties with whom the partnership has dealt should be notified that the exiting partner no longer can bind the partnership. For all other third parties, constructive notice, such as an advertisement in the newspaper, is sufficient.

> **WORKING IT OUT**
>
> Jane, Karol, and Leah are partners with capital account balances of \$20,000, \$30,000, and \$50,000, respectively. They share profits in a 2:3:5 ratio. Karol is withdrawing from the business, so the partners have the assets appraised. The building's market value is \$4,000 more than its book value. The inventory's market value is \$6,000 less than cost. What are the journal entries to revalue these assets?
>
> *A:*
>
> | | | |
> |---|---|---|
> | Building | 4,000 | |
> | Jane, Capital | | 800 |
> | Karol, Capital | | 1,200 |
> | Leah, Capital | | 2,000 |
> | | | |
> | Jane, Capital | 1,200 | |
> | Karol, Capital | 1,800 | |
> | Leah, Capital | 3,000 | |
> | Inventory | | 6,000 |

values have changed, the appraisal will result in a revaluing of the partnership assets. Thus the partners share in any market value changes that their efforts caused.

Suppose Ben Isaac is retiring in midyear from the partnership of Green, Maslowski, and Isaac. After the books have been adjusted for partial-period income but before the asset appraisal, revaluation, and closing entries, the balance sheet reports the following:

Cash		\$ 52,000	Total liabilities	\$ 93,000
Inventory		44,000	Joan Green, capital	54,000
Land		55,000	Ivan Maslowski, capital	43,000
Building	\$95,000		Ben Isaac, capital	21,000
Less: Accumulated amortization	35,000	60,000	Total liabilities and capital	
Total assets		\$211,000		\$211,000

An independent appraiser revalues the inventory at \$38,000 (down from \$44,000), and the land at \$101,000 (up from \$55,000). The partners share the differences between these assets' market values and their prior book values based on their profit-and-loss ratio.

The partnership agreement has allocated one-fourth of the profits to Green, one-half to Maslowski, and one-fourth to Isaac. (This ratio may be written 1:2:1 for one part to Green, two parts to Maslowski, and one part to Isaac.) For each share that Green or Isaac has, Maslowski has two. The entries to record the revaluation of the inventory and land are

June 30	Joan Green, Capital (\$6,000 × ¼)	1,500	
	Ivan Maslowski, Capital (\$6,000 × ½)	3,000	
	Ben Isaac, Capital (\$6,000 × ¼)	1,500	
	Inventory (\$44,000 – \$38,000)		6,000
	To revalue the inventory and allocate the loss in value to the partners.		
June 30	Land (\$101,000 – \$55,000)	46,000	
	Joan Green, Capital (\$46,000 × ¼)		11,500
	Ivan Maslowski, Capital (\$46,000 × ½)		23,000
	Ben Isaac, Capital (\$46,000 × ¼)		11,500
	To revalue the land and allocate the gain in value to the partners.		

After the revaluations, the partnership balance sheet reports:

> **WORKING IT OUT**
>
> What are the partners' capital account balances after the revaluations in the previous Working It Out?
>
> *A:*
>
> Jane: (\$20,000 + \$800 – \$1,200) = \$19,600
>
> Karol: (\$30,000 + \$1,200 – \$1,800) = \$29,400
>
> Leah: (\$50,000 + \$2,000 – \$3,000) = \$49,000

Cash		\$ 52,000	Total liabilities	\$ 93,000
Inventory		38,000	Joan Green, capital (\$54,000 – \$1,500 + \$11,500)	64,000
Land		101,000	Ivan Maslowski, capital (\$43,000 – \$3,000 + \$23,000)	63,000
Building	\$95,000		Ben Isaac, capital (\$21,000 – \$1,500 + \$11,500)	31,000
Less: Accumulated amortization	35,000	60,000		
Total assets		\$251,000	Total liabilities and capital	\$251,000

The books now carry the assets at current market value, which becomes the new book value, and the capital accounts have been adjusted accordingly. As the balance sheet shows, Isaac has a claim to \$31,000 in partnership assets. How is his withdrawal from the business accounted for?

Withdrawal at Book Value

If Ben Isaac withdraws by taking cash equal to the book value of his owner's equity, the entry would be

June	30	Ben Isaac, Capital	31,000	
		Cash		31,000
		To record withdrawal of B. Isaac from the partnership.		

This entry records the payment of partnership cash to Isaac and the closing of his capital account upon his withdrawal from the business.

Withdrawal at Less Than Book Value

The withdrawing partner may be so eager to leave the business that she or he is willing to take less than her or his equity. Assume Ben Isaac withdraws from the business, and agrees to take partnership cash of $10,000 and the new partnership's note for $15,000. This $25,000 settlement is $6,000 less than Isaac's $31,000 equity in the business. The remaining partners share this $6,000 difference—which is a bonus to them—according to their profit-and-loss ratio.

Because Isaac has withdrawn from the partnership, a new agreement—and a new profit-and-loss ratio—must be drawn up. Maslowski and Green, in forming a new partnership, may decide on any ratio that they see fit. Let's assume they agree that Maslowski will earn two-thirds of partnership profits and losses, and Green one-third. The entry to record Isaac's withdrawal at less than book value is

June	30	Ben Isaac, Capital	31,000	
		Cash		10,000
		Note Payable to Ben Isaac		15,000
		Joan Green, Capital		2,000
		Ivan Maslowski, Capital		4,000
		To record withdrawal of B. Isaac from the partnership. Green's bonus is $2,000 ($6,000 × ⅓) and Maslowski's bonus is $4,000 ($6,000 × ⅔)		

Isaac's account is closed, and Maslowski and Green may or may not continue the business as a new partnership.

WORKING IT OUT

Refer to the Working It Outs on page 678. Assume that Karol is willing to accept $20,000 for his partnership interest. What is the journal entry to record his withdrawal from the business?

A:

Karol, Capital	29,400	
Cash		20,000
Jane, Capital		2,686*
Leah, Capital		6,714†

*$9,400 × 2/7 = 2,686
†$9,400 × 5/7 = $6,714
Jane and Leah will now share profits in a 2:5 ratio.

Withdrawal at More Than Book Value

The settlement with a withdrawing partner may allow him or her to take assets of greater value than the book value of that partner's capital. Also, the remaining partners may be so eager for the withdrawing partner to leave the firm that they pay the partner a bonus to withdraw from the business. In either case, the partner's withdrawal causes a decrease in the book equity of the remaining partners. This decrease is allocated to the partners based on their profit-and-loss ratio.

The accounting for this situation follows the pattern illustrated for withdrawal at less than book value—with one exception. The remaining partners' capital accounts are debited because the withdrawing partner receives more than his or her book equity.

Suppose Linda is withdrawing from the partnership of Linda, Jacob, and Karla. The partners share profits and losses in a 1:2:3 ratio for Linda, Jacob, and Karla, respectively. After the revaluation of assets, Linda's capital balance is $100,000, and the other partners agree to pay her $120,000. The journal entry to record the payment to Linda and her withdrawal from the partnership is

Linda, Capital	100,000	
Jacob, Capital	8,000	
Karla, Capital	12,000	
Cash		120,000
To record withdrawal of Linda from the business. Jacob's capital is reduced by $8,000 [($120,000 – $100,000) × ⅖] and Karla's capital is reduced by $12,000 [(120,000 – $100,000) × ⅗].		

WORKING IT OUT

Refer to the Working It Outs on page 678. Assume that Jane and Leah agree to pay Karol $40,000 for his partnership interest. What is the journal entry to record his withdrawal from the business?

A:

Jane, Capital	3,029*	
Karol, Capital	29,400	
Leah, Capital	7,571†	
Cash		40,000

*$10,600 × 2/7 = $3,029
†$10,600 × 5/7 = $7,571

Death of a Partner

REAL WORLD EXAMPLE

Partners commonly carry life insurance on themselves, with the partners as beneficiaries. In the event of a death, the partners receive the cash flow necessary to settle with the deceased partner's estate, without putting the partnership into financial jeopardy.

Like any other form of partnership withdrawal, the death of a partner dissolves a partnership. The partnership accounts are adjusted to measure net income or loss for the fraction of the year up to the date of death, then closed to determine the partners' capital balances on that date. Settlement with the deceased partner's estate is based on the partnership agreement. The estate commonly receives partnership assets equal to the partner's capital balance. The partnership closes the deceased partner's capital account with a debit. This entry credits a payable to the estate.

Suppose Joan Green (of the partnership on page 678) dies after all accounts have been adjusted to current market value. Green's capital balance is $64,000. Green's estate may request cash for her final share of the partnership's assets. At this time the business has only $52,000 of cash, so it must borrow. Let's assume the partnership borrows $50,000 and then pays Green's estate for her capital balance. The partnership's journal entries are

July 1	Cash	50,000	
	Note payable		50,000
	To borrow money		
July 1	Joan Green, Capital	64,000	
	Cash		64,000
	To record withdrawal of Green from the business.		

Alternatively, a remaining partner may purchase the deceased partner's equity. The deceased partner's equity is debited and the purchaser's equity is credited. The amount of this entry is the ending credit balance in the deceased partner's capital account.

Liquidation of a Partnership

OBJECTIVE 6
Account for the liquidation of a partnership

Admission of a new partner or withdrawal or death of an existing partner dissolves the partnership. However, the business may continue operating with no apparent change to outsiders such as customers and creditors. In contrast, business **liquidation** is the process of going out of business by selling the entity's assets and paying its liabilities. The final step in liquidation of a business is the *distribution of the remaining cash to the owners*. Before the business is liquidated, the books should be adjusted and closed. After closing, only asset, liability, and partners' capital accounts remain open.

Liquidation of a partnership includes three basic steps:

1. Sell the assets. Allocate the gain or loss to the partners' capital accounts based on the profit-and-loss ratio.
2. Pay the partnership liabilities.
3. Disburse the remaining cash to the partners in proportion to their capital balances.

KEY POINT

Remember that the profit-and-loss ratio is used to divide gains and losses. The partners' capital balances are used to divide assets.

When a business liquidates there may not be enough cash to pay the liabilities. The partners (who are personally liable for the partnership debts) must contribute cash on the basis of their profit-and-loss ratio to cover unpaid debts.

In actual practice, the liquidation of a business can stretch over weeks or months. Selling every asset and paying every liability of the entity takes time. For example, the liquidation of a law firm of over 75 partners took almost a year.

To avoid excessive detail in our illustrations, we include only two asset categories—Cash and Noncash Assets—and a single liability category—Liabilities. Our examples also assume that the business sells the noncash assets in a single transaction and pays the liabilities in a single transaction. (In actual practice, each asset and its related amortization would be accounted for separately when it is sold, and each liability would be accounted for separately when it is paid.)

WORKING IT OUT

Partners' profit-and-loss ratio need not match the partners' capital balances. Here, for example, Jane Aviron has a 60% sharing ratio but owns $^4/_7$ (or 57%) of the capital.

Assume that Jane Aviron, Elaine Bloch, and Kim Zhang have shared profits and

losses in the ratio of 3:1:1. (This ratio is equal to 3/5, 1/5, 1/5, or a 60-percent, 20-percent, 20-percent sharing ratio.) They decide to liquidate their partnership. After the books are adjusted and closed, the general ledger contains the following balances:

Cash	$ 20,000	Liabilities	$ 60,000
Noncash assets	180,000	Jane Aviron, capital	80,000
		Elaine Bloch, capital	40,000
		Kim Zhang, capital	20,000
Total assets	$200,000	Total liabilities and capital	$200,000

Sale of Noncash Assets at a Gain

Assume the Aviron, Bloch, and Zhang partnership sells its noncash assets (shown on the balance sheet at $180,000) for cash of $300,000. The partnership realizes a gain of $120,000, which is allocated to the partners based on their profit-and-loss-sharing ratio. The entry to record this sale and allocation of the gain is

Oct.	31	Cash	300,000	
		Noncash Assets		180,000
		Jane Aviron, Capital		72,000
		Elaine Bloch, Capital		24,000
		Kim Zhang, Capital		24,000
		To sell noncash assets in liquidation and allocate gain to partners. Aviron's share of the gain is $72,000 ($120,000 × 0.60), Bloch's and Zhang's is $24,000 ($120,000 × 0.20).		

The partnership must next pay off its liabilities:

Oct.	31	Liabilities	60,000	
		Cash		60,000
		To pay liabilities in liquidation.		

In the final liquidation transaction, the remaining cash is disbursed to the partners. *The partners share in the cash according to their capital balances.* (By contrast, *gains* and *losses* on the sale of assets are shared by the partners based on their profit-and-loss-sharing ratio.) The amount of cash left in the partnership is $260,000—the $20,000 beginning balance plus the $300,000 cash sale of assets minus the $60,000 cash payment of liabilities. The partners divide the remaining cash according to their capital balances:

Oct.	31	Jane Aviron, Capital ($80,000 + $72,000)	152,000	
		Elaine Bloch, Capital ($40,000 + $24,000)	64,000	
		Kim Zhang, Capital ($20,000 + $24,000)	44,000	
		Cash		260,000
		To disburse cash to partners in liquidation.		

A convenient way to summarize the transactions in a partnership liquidation is given in Exhibit 12-4.

After the disbursement of cash to the partners, the business has no assets, liabilities, or owners' equity. All the balances are zero. By the accounting equation, partnership assets *must* equal partnership liabilities plus partnership capital.

Sale of Noncash Assets at a Loss

Liquidation of a business often includes the sale of noncash assets at a loss. When this occurs, the partners' capital accounts are debited as they share the loss in their profit-and-loss-sharing ratio. Otherwise, the accounting follows the pattern illustrated for the sale of noncash assets at a gain.

WORKING IT OUT

Kelly and Keith are partners in a partnership with cash of $10,000 and noncash assets of $50,000. The capital balances of Kelly and Keith are $40,000 and $20,000, respectively. The partners share profits and losses 60:40. The noncash assets are sold for $56,000. All liabilities have been paid. What journal entries record sale of the assets and distribution of cash to the partners?

A:

Cash	56,000	
Noncash Assets		50,000
Kelly, Capital		3,600*
Keith, Capital		2,400†

*$6,000 gain × 60% = $3,600
†$6,000 × 40% = $2,400

Kelly, Capital ($40,000 + $3,600)	43,600	
Keith, Capital ($20,000 + $2,400)	22,400	
Cash		66,000

REAL WORLD EXAMPLE

In the US in 1991, Laventhol and Horwath, then the seventh-largest accounting partnerhip, declared bankruptcy. The 250 partners were personally liable for US $47.3 million in partnership obligations that resulted from actions of onlyi a few partners.

LEARNING TIP

Keep in mind that, upon liquidation, gains on the sale of assets are divided according to the profit-and-loss ratio. The final cash disbursement is based on capital balances.

EXHIBIT 12-4

Partnership Liquidation—Sale of Assets at a Gain

	Cash	+ Noncash Assets	= Liabilities	+ Capital Aviron (60%)	+ Capital Bloch (20%)	+ Capital Zhang (20%)
Balances before sale of assets	$ 20,000	$180,000	$ 60,000	$ 80,000	$40,000	$ 20,000
Sale of assets and sharing of gain	300,000	(180,000)		72,000	24,000	24,000
Balances	320,000	-0-	60,000	152,000	64,000	44,000
Payment of liabilities	(60,000)		(60,000)			
Balances	260,000	-0-	-0-			
Disbursement of cash to partners	(260,000)			(152,000)	(64,000)	(44,000)
Balances	$ -0-	$ -0-	$ -0-	$ -0-	$ -0-	$ -0-

EXHIBIT 12-5

Financial Statements of a Partnership and a Proprietorship

Panel A—Partnership

GRAY AND HUI CONSULTING
Income statement
For the Year Ended December 31, 2003

Revenues		$460
Expenses		(270)
Net income		$190
Allocation of net income:		
To Leslie Gray	$114	
To Andrew Hui	76	$190

GRAY AND HUI CONSULTING
Statement of Owners' Equity
For the Year Ended December 31, 2003

	Gray	Hui
Capital, January 1, 2003	$50	$40
Additional investments	10	—
Net income	114	76
Subtotal	174	116
Withdrawals	(72)	(48)
Capital, December 31, 2003	$102	$68

GRAY AND HUI CONSULTING
Balance Sheet
December 31, 2003

Assets	
Cash and other assets	$170
Partners' Equity	
Leslie Gray, capital	**$102**
Andrew Hui, capital	**68**
Total capital	$170

Panel B—Proprietorship

GRAY CONSULTING
Income statement
For the Year Ended December 31, 2003

Revenues	$460
Expenses	(270)
Net income	$190

GRAY CONSULTING
Statement of Owner's Equity
For the Year Ended December 31, 2003

Capital, January 1, 2003	$90
Additional investments	10
Net income	190
Subtotal	290
Withdrawals	(120)
Capital, December 31, 2003	$170

GRAY CONSULTING
Balance Sheet
December 31, 2003

Assets	
Cash and other assets	$170
Owner's Equity	
Leslie Gray, capital	$170

Partnership Financial Statements

OBJECTIVE 7
Prepare partnership financial statements

Partnership financial statements are much like those of a proprietorship. However, a partnership income statement includes a section showing the division of net income to the partners. For example, the partnership of Leslie Gray and Andrew Hui might report its income statement for the year ended December 31, 2003, as shown in Panel A of Exhibit 12-5 on page 682. A proprietorship's financial statements are presented for comparison.

Large partnerships may not find it feasible to report the net income of every partner. Instead, the firm may report the allocation of net income to active and retired partners and average earnings per partner. For example, Exhibit 12-6 shows how the accounting and consulting firm of Main, Price & Anders reported its earnings.

The Decision Guidelines feature on pages 684–685 summarizes the main points of accounting for partnerships.

EXHIBIT 12-6

Reporting Net Income for a Large Partnership

MAIN, PRICE & ANDERS
Combined Statement of Earnings
For the Year Ended August 31, 2002

Fees for Professional Services	$9,144,920
...	
Earnings for the year	$2,978,800
Allocation of earnings	
To partners active during the year—	
Resigned, retired, and deceased partners	$ 199,010
Partners active at year end	2,620,291
To retired and deceased partners—	
Retirement and death benefits	83,100
Not allocated to partners—retained for specific partnership purposes	76,399
	$2,978,800
Average earnings per partner at year end (28 partners)	$ 106,400

Stop & Think

Suppose the Aviron, Bloch, and Zhang partnership sold its noncash assets for $60,000 and all other details in Exhibit 12-4 remained the same. This creates a loss of $120,000 on the sale of the noncash assets. Allocate the loss to the partners. Identify ways that the partnership could deal with the negative balance (a capital deficiency) in Zhang's capital account.

Answer: Allocation of the $120,000 loss on the sale of assets is shown below.

								Capital				
	Cash	+	Noncash Assets	=	Liabilities	+	*Aviron (60%)*	+	*Bloch (20%)*	+	*Zhang (20%)*
Balances before sale of assets	$ 20,000		$180,000		$ 60,000		$ 80,000		$ 40,000		$ 20,000
Sale of assets and sharing of loss	60,000		(180,000)				(72,000)		(24,000)		(24,000)
Balances	80,000		-0-		60,000		8,000		16,000		(4,000)
Payment of liabilities	(60,000)				(60,000)						
Balances	20,000		-0-		-0-		8,000		16,000		(4,000)
Disbursement of cash to partners	(20,000)						(8,000)		(16,000)		4,000
Balances	$ -0-		$ -0-		$ -0-		$ -0-		$ -0-		$ -0-

To deal with the $4,000 capital deficiency in Zhang's Capital account, two possibilities are:

1. Zhang could contribute assets to the partnership in an amount equal to her capital deficiency. If Zhang contributed cash, the journal entry to record this is

Cash	4,000	
Kim Zhang, Capital		4,000

2. Kim Zhang's partners, Jane Aviron and Elaine Bloch, could agree to absorb Zhang's capital deficiency by decreasing their own capital balances in proportion to their remaining profit-sharing percentages: Aviron, 60/80; Bloch, 20/80. The journal entry to record this is

Jane Aviron, Capital	3,000	
Elaine Bloch, Capital	1,000	
Kim Zhang, Capital		4,000

DECISION GUIDELINES — *Accounting for Partnerships*

Decision	Guidelines
How to organize the business?	A partnership offers both advantages and disadvantages in comparison with proprietorships and corporations. (See Exhibit 12–2, page 665.)
On what matters should the partners agree?	See the list on page 663, under the heading "The Written Partnership Agreement."
At what value does the partnership record assets and liabilities?	Current market value on the date of acquisition, because, in effect, the partnership is buying its assets at their current market value.
How are partnership profits and losses shared among the partners?	• Equally if there is no profit-and-loss sharing agreement. • As provided in the partnership agreement. Can be based on the partners' a. Stated fractions b. Capital contributions c. Service to the partnership d. "Salaries" and interest on their capital contributions.

What happens when a partner withdraws from the partnership?	The old partnership ceases to exist. The remaining partners may or may not form a new partnership.
How are new partners admitted to the partnership?	• *Purchase a partner's interest.* The old partnership is dissolved. The remaining partners may admit the new partner to the partnership. If not, the new partner gets no voice in the management of the firm but shares in the profits and losses of the partnership. Close the withdrawing partner's Capital account, and open a Capital account for the new partner. Carry over the old partner's Capital balance to the Capital account of the new partner. • *Invest in the partnership.* Buying in at book value creates no bonus to any partner. Buying in at a price above book value creates a bonus to the old partners. Buying in at a price below book value creates a bonus for the new partner.
How to account for the withdrawal of a partner from the business?	• First, adjust and close the books up to the date of the partner's withdrawal from the business. • Second, appraise the assets and the liabilities to determine their current market value. • Third, account for the partner's withdrawal a. At book value (no change in remaining partners' Capital balances) b. At less than book value (increase the remaining partners' Capital balances) c. At more than book value (decrease the remaining partners' Capital balances)
What happens if the partnership goes out of business?	Liquidate the partnership, as follows: a. Adjust and close the partnership books up to the date of liquidation. b. Sell the partnership's assets. Allocate gain or loss to the partners' Capital accounts based on their profit-and-loss ratio. c. Pay the partnership liabilities. d. Pay any remaining cash to the partners based on their Capital balances.
How do partnership financial statements differ from those of a proprietorship?	• The partnership income statement reports the allocation of net income or net loss to the partners. • The partnership balance sheet (or a separate schedule) reports the Capital balance of each partner. • The cash flow statement is the same for a partnership as for a proprietorship.

Summary Problem for Your Review

The partnership of Taylor and Uvalde is considering admitting Steven Vaughn as a partner on January 2, 2002. The partnership general ledger includes the following balances on that date:

Cash	$ 18,000	Total liabilities	$100,000
Other assets	220,000	Debby Taylor, capital	90,000
		Thomas Uvalde, capital	48,000
Total assets	$238,000	Total liabilities and capital	$238,000

Debby Taylor's share of profits and losses is 60 percent and Thomas Uvalde's share is 40 percent.

Required

(Items 1 and 2 are independent.)

1. Suppose Vaughn pays Uvalde $62,000 to acquire Uvalde's interest in the business after Taylor approves Vaughn as a partner.
   a. Record the transfer of owner's equity on the partnership books.
   b. Prepare the partnership balance sheet immediately after Vaughn is admitted as a partner.
2. Suppose that Vaughn becomes a partner by investing $62,000 cash to acquire a one-fourth interest in the business.
   a. Compute Vaughn's capital balance and record his investment in the business.
   b. Prepare the partnership balance sheet immediately after Vaughn is admitted as a partner. Include the appropriate heading.
3. Which way of admitting Vaughn to the partnership increases its total assets? Give your reason.

Solution to Review Problem

Requirement 1

a.

2002				
Jan.	2	Thomas Uvalde, Capital	48,000	
		Steven Vaughn, Capital		48,000
		To transfer Uvalde's equity in the partnership to Vaughn.		

b. The balance sheet for the partnership of Taylor and Vaughn is identical to the balance sheet given for Taylor and Thomas Uvalde in the problem, except Steven Vaughn's name replaces Thomas Uvalde's name in the title and in the listing of Capital accounts.

Requirement 2

a. Computation of Vaughn's capital balance:

Partnership capital before Vaughn is admitted ($90,000 + $48,000)	$138,000
Vaughn's investment in the partnership	62,000
Partnership capital after Vaughn is admitted	$200,000
Vaughn's capital in the partnership ($200,000 × ¼)	$ 50,000

2002				
Jan.	2	Cash	62,000	
		Steven Vaughn, Capital		50,000
		Debby Taylor, Capital		7,200
		Thomas Uvalde, Capital		4,800
		To admit Vaughn as a partner with a one-fourth interest in the business. Taylor's bonus is $7,200 [($62,000 – $50,000) × 0.60] and Uvalde's bonus is $4,800 [($62,000 – $50,000) × 0.40].		

b.

TAYLOR, UVALDE, AND VAUGHN
Balance Sheet
January 2, 2002

Cash*	$ 80,000	Total liabilities	$100,000
Other assets	220,000	Debby Taylor, capital**	97,200
		Thomas Uvalde, capital***	52,800
		Steven Vaughn, capital	50,000
		Total liabilities	
Total assets	$300,000	and capital	$300,000

*$18,000 + $62,000 = $80,000
**$90,000 + $ 7,200 = $97,200
*** $48,000 + $ 4,800 = $52,800

Requirement 3

Vaughn's investment in the partnership increases its total assets by the amount of his contribution. Total assets of the business are $300,000 after his investment, compared to $238,000 before. By contrast, Vaughn's purchase of Uvalde's interest in the business is a personal transaction between the two individuals. It does not affect the assets of the partnership regardless of the amount Vaughn pays Uvalde.

Cyber Coach

Visit the Student Resources area of the *Accounting* Companion Website for extra practice with the new material in Chapter 12.
www.pearsoned.ca/horngren

Summary

1. **Identify the characteristics of a partnership.** A *partnership* is a business co-owned by two or more persons for profit. The characteristics of this form of business organization are its *ease of formation, limited life, mutual agency, unlimited liability,* and *no partnership income taxes.* In a *limited partnership*, the limited partners have limited personal liability for the obligations of the business.

   A written *partnership agreement* establishes procedures for admission of a new partner, withdrawals of a partner, and the sharing of profits and losses among the partners. When a new partner is admitted to the firm or an existing partner withdraws, the old partnership is *dissolved*, or ceases to exist. A new partnership may or may not emerge to continue the business.
2. **Account for partners' initial investments in a partnership.** Accounting for a partnership is similar to accounting for a proprietorship. However, a partnership has more than one owner. Each partner has an individual capital account and a withdrawal account.
3. **Allocate profits and losses to the partners by different methods.** Partners share net income or loss in any manner they choose. Common sharing agreements base the *profit-and-loss ratio* on a stated fraction, partners' capital contributions, and/or their service to the partnership. Some partnerships call the cash withdrawals of partners *salaries* and *interest*, but these amounts are not expenses of the business. Instead, they are merely ways to describe the allocation of partnership net income to the partners.
4. **Account for the admission of a new partner to the business.** An outside person may become a partner by purchasing a current partner's interest or by investing in the partnership. In some cases the new partner must pay the current partners a bonus to join. In other situations the new partner may receive a bonus to join.
5. **Account for the withdrawal of a partner from the business.** When a partner withdraws, partnership assets may be reappraised. Partners share any gain or loss on the asset revaluation on the basis of their profit-and-loss ratio. The withdrawing partner may receive payment equal to,

greater than, or less than her or his capital book value, depending on the agreement with the other partners.

6. **Account for the liquidation of a partnership.** In *liquidation,* a partnership goes out of business by selling the assets, paying the liabilities, and disbursing any remaining cash to the partners.

7. **Prepare partnership financial statements.** Partnership *financial statements* are similar to those of a proprietorship. However, the partnership income statement commonly reports the allocation of net income to the partners, and the balance sheet has a Capital account for each partner.

Self-Study Questions

Test your understanding of the chapter by marking the correct answer for each of the following questions:

1. Which of these characteristics does not apply to a partnership? (*p. 664*)
   a. Unlimited life
   b. Mutual agency
   c. Unlimited liability
   d. No income tax paid by the business entity
2. A partnership records a partner's investment of assets in the business at (*p. 666*)
   a. The partner's book value of the assets invested
   b. The market value of the assets invested
   c. A special value set by the partners
   d. Any of the above, depending upon the partnership agreement
3. The partnership of Lane, Murdock, and Nu divides profits in the ratio of 4:5:3. During 2003, the business earned $40,000. Nu's share of this income is (*p. 669*)
   a. $10,000
   b. $13,333
   c. $16,000
   d. $16,667
4. Suppose the partnership of Lane, Murdock, and Nu in the preceding question lost $40,000 during 2003. Murdock's share of this loss is (*p. 670*)
   a. Not determinable because the ratio applies only to profits
   b. $13,333
   c. $16,000
   d. $16,667
5. The partners of Placido, Quinn, and Rolfe share profits and losses 1⁄5, 1⁄6, and 19⁄30. During 2004, the first year of their partnership, the business earned $120,000, and each partner withdrew $50,000 for personal use. What is the balance in Rolfe's capital account after all closing entries? (*pp. 673–674*)
   a. Not determinable because Rolfe's beginning capital balance is not given
   b. Minus $10,000
   c. $26,000
   d. $70,000
6. Barbara Fuller buys into the partnership of Graff and Harrell by purchasing a one-third interest for $55,000. Prior to Fuller's entry, Edward Graff's capital balance was $46,000, and Louisa Harrell's balance was $52,000; profits and losses were shared equally. The entry to record Fuller's buying into the business is (*pp. 675–676*)

a. Cash	55,000	
Barbara Fuller, Capital		55,000
b. Edward Graff, Capital	27,500	
Louisa Harrell, Capital	27,500	
Barbara Fuller, Capital		55,000
c. Cash	55,000	
Barbara Fuller, Capital		51,000
Edward Graff, Capital		2,000
Louisa Harrell, Capital		2,000
d. Cash	51,000	
Edward Graff, Capital	2,000	
Louisa Harrell, Capital	2,000	
Barbara Fuller, Capital		55,000

7. The partners of Tsui, Valik, and Wollenberg share profits and losses equally. Their capital balances are $40,000, $50,000, and $60,000 respectively, when Brenda Wollenberg sells her interest in the partnership to Brent Valik for $90,000. Raymond Tsui and Valik continue the business. Immediately after Wollenberg's retirement, the total assets of the partnership are (*pp. 674–675*)
   a. Increased by $30,000
   b. Increased by $90,000
   c. Decreased by $60,000
   d. The same as before Wollenberg sold her interest to Valik
8. Prior to Bill Hogg's withdrawal from the partnership of Hogg, Ho, and Lee, the partners' capital balances were $140,000, $110,000 and $250,000 respectively. The partners share profits and losses 1⁄3, 1⁄4, and 5⁄12. The appraisal indicates that assets should be written down by $36,000. Arthur Ho's share of the write-down is (*p. 679*)
   a. $7,920
   b. $9,000
   c. $12,000
   d. $18,000
9. The process of closing the business, selling the assets, paying the liabilities, and disbursing remaining cash to the owners is called (*pp. 680–681*)
   a. Dissolution
   b. Forming a new partnership
   c. Withdrawal
   d. Liquidation
10. Eric Hirst and Brenda Mallouk have shared profits and losses equally. Immediately prior to the final cash disbursement in a liquidation of their partnership, the books show:

Cash		Liabilities		Eric Hirst, Capital		Brenda Mallouk, Capital
$100,000	=	$-0-	+	$60,000	+	$40,000

How much cash should Hirst receive? (*p. 681*)
a. $40,000
b. $50,000
c. $60,000
d. None of the above

Answers to the Self-Study Questions follow the Similar Accounting Terms.

Accounting Vocabulary

Dissolution *(p. 664)*
General partnership *(p. 665)*
Limited partnership *(p. 666)*
Limited liability partnership *(p. 666)*
Liquidation *(p. 680)*
Mutual agency *(p. 664)*
Partnership *(p. 662)*
Partnership agreement *(p. 663)*
Unlimited personal liability *(p. 664)*

Similar Accounting Terms

Limited Liability Partnership	LLP
Liquidation	Winding up the business
Owner's equity	Capital
Withdrawals	Drawings

Answers to Self-Study Questions

1. a
2. b
3. a ($\$40,000 \times \frac{3}{12} = \$10,000$)
4. d ($\$40,000 \times \frac{5}{12} = \$16,667$)
5. a
6. c [$(\$46,000 + \$52,000 + \$55,000) \times \frac{1}{3} = \$51,000$; $\$55,000 - \$51,000 = \$4,000$; $\$4,000 \div 2 = \$2,000$ each to Graff and Harrell]
7. d
8. b ($\$36,000 \times \frac{1}{4} = \$9,000$)
9. d
10. c

Assignment Material

Questions

1. List eight items that the partnership agreement should specify.
2. Ron Montgomery, who is a partner in M&N Associates, commits the firm to a contract for a job within the scope of its regular business operations. What term describes Montgomery's ability to obligate the partnership?
3. If a partnership cannot pay a debt, who must make payment? What term describes this obligation of the partners?
4. How is income of a partnership taxed?
5. Identify the advantages and disadvantages of the partnership form of business organization.
6. Robin Randall and Sylvia Smith's partnership agreement states that Randall gets 60 percent of profits and Smith gets 40 percent. If the agreement does not discuss the treatment of losses, how are losses shared? How do the partners share profits and losses if the agreement specifies no profit-and-loss-sharing ratio?
7. What determines the amount of the credit to a partner's Capital account when the partner contributes assets other than cash to the business?
8. Do partner withdrawals of cash for personal use affect the sharing of profits and losses by the partner? If so, explain how. If not, explain why not.
9. Name two events that can cause the dissolution of a partnership.
10. Briefly describe how to account for the purchase of an existing partner's interest in the business.
11. Jeff Malcolm purchases Sheila Wilson's interest in the Wilson & Kareem partnership. What right does Malcolm obtain from the purchase? What is required for Malcolm to become Paula Kareem's partner?
12. Sal Assissi and Barb Carter each have capital of $75,000 in their business. They share profits in the

ratio of 55:45. Kathy Denman acquires a one-fifth share in the partnership by investing cash of $50,000. What are the capital balances of the three partners immediately after Denman is admitted?

13. When a partner resigns from the partnership and receives assets greater than her or his capital balance, how is the difference shared by the other partners?
14. Distinguish between dissolution and liquidation of a partnership.
15. Name the three steps in liquidating a partnership.
16. The partnership of Ralls and Sauls is in the process of liquidation. How do the partners share (a) gains and losses on the sale of noncash assets, and (b) the final cash disbursement?
17. Compare and contrast the financial statements of a proprietorship and a partnership.
18. Summarize the situations in which partnership allocations are based on (a) the profit-and-loss ratio, and (b) the partners' capital balances.

Exercises

Exercise 12-1 *Partnership characteristics* ***(Obj. 1)***

Sandy Saxe and Ida Weiss are forming a business to imprint T-shirts. Saxe suggests that they organize as a partnership in order to avoid the unlimited liability of a proprietorship. According to Saxe, partnerships are not very risky.

Saxe explains to Weiss that if the business does not succeed, each partner can withdraw from the business, taking the same assets that she or he invested at its beginning. Saxe states that the main disadvantage of the partnership form of organization is double taxation: First, the partnership pays a business income tax; second, each partner also pays personal income tax on her or his share of the business's profits.

Correct the errors in Saxe's explanation.

Exercise 12-2 *Organizing a business as a partnership* ***(Obj. 1)***

Rhonda Hough, a friend from college, approaches you about forming a partnership to export software. Since graduation, Rhonda has worked for the World Bank, developing important contacts among government officials and business leaders in Poland and Hungary. Eager to upgrade their data-processing capabilities, Eastern Europeans are looking for ways to obtain computers. Rhonda believes she is in a unique position to capitalize on this opportunity. With your expertise in finance, you would have responsibility for accounting and finance in the partnership.

Required

Discuss the advantages and disadvantages of organizing the export business as a partnership rather than a proprietorship. Comment on the way partnership income is taxed.

Exercise 12-3 *A partner's investment in a partnership* ***(Obj. 2)***

Val Dierks invests a building in a partnership with Lena Marx. Dierks purchased the building for $600,000. Accumulated amortization on the date of forming the partnership is $160,000. A real estate appraiser states that the building is now worth $800,000. Dierks wants $800,000 capital in the new partnership, but Marx objects. Marx believes that Dierk's capital contribution into the partnership should be measured by the book value of her building.

Marx and Dierks seek your advice. Which value of the building is appropriate for measuring Dierks's capital—book value or current market value? State the reason for your answer. Give the partnership's journal entry to record Dierks's investment in the business.

Exercise 12-4 *Investments by partners* ***(Obj. 2)***

Duane Warner and Eli Broad are forming the partnership Sunshine Development to

develop a theme park near Victoria. Warner contributes cash of $1 million and land valued at $15 million. When Warner purchased the land, its cost was $4 million. The partnership will assume Warner's $1.5 million note payable on the land. Broad invests cash of $5 million and construction equipment that he purchased for $3.5 million (accumulated amortization to date, $1.5 million). The equipment's market value is equal to its book value.

Required

1. Before recording any journal entries, compute the partnership's total assets, total liabilities, and total owners' equity immediately after organizing.
2. Journalize the partnership's receipt of assets and liabilities from Warner and from Broad. Record each asset at its current market value with no entry to accumulated amortization.
3. Use your journal entries to prove the correctness of total owners' equity from requirement 1.

Exercise 12-5 *Recording a partner's investment* ***(Obj. 2)***

Ann Richards has operated an apartment-locater service as a proprietorship. She and Tara Holmes have decided to reorganize the business as a partnership, effective April 1. Richards' investment in the partnership consists of cash, $20,000; accounts receivable, $11,000 less allowance for uncollectibles, $1,000; office furniture, $3,000 less accumulated amortization, $1,000; a small building, $55,000 less accumulated amortization, $27,500; accounts payable, $4,000; and a note payable to the bank, $10,000.

To determine Richards' equity in the partnership, she and Holmes hire an independent appraiser. This outside party provides the following market values of the assets and liabilities that Richards is contributing to the business: cash, accounts receivable, office furniture, accounts payable, and note payable—the same as Richards' book value; allowance for uncollectible accounts, $3,000; building, $71,000; and accrued expenses payable (including interest on the note payable), $1,000.

Required

Make the entry on the partnership books to record Richards' investment.

Exercise 12-6 *Computing partners' shares of net income and net loss* ***(Obj. 3)***

Matt Baines and Dave Bristow form a partnership, investing $80,000 and $140,000 respectively. Determine their shares of net income or net loss for each of the following situations:

a. Net loss is $104,000, and the partners have no written partnership agreement.
b. Net income is $88,000 and the partnership agreement states that the partners share profits and losses based on their capital contributions.
c. Net loss is $154,000, and the partnership agreement states that the partners share profits based on their capital contributions.
d. Net income is $220,000. The first $120,000 is shared based on the partner capital contributions. The next $90,000 is based on partner service, with Baines receiving 30 percent and Bristow receiving 70 percent. The remainder is shared equally.

Exercise 12-7 *Computing partners' capital balances* ***(Obj. 3)***

Matt Baines withdrew cash of $124,000 for personal use, and Dave Bristow withdrew cash of $100,000 during the year. Using the data from situation (d) in Exercise 12-6, journalize the entries to close to each capital account the (a) income summary account, and (b) the partners' withdrawal accounts. Explanations are not required. Indicate the amount of increase or decrease in each partner's capital balance. What was the overall effect on partnership capital?

Exercise 12-8 *Admitting a new partner* ***(Obj. 4)***

Gemma Mendez is admitted to a partnership. Prior to the admission of Mendez, the partnership books show Susan Hecker's capital balance at $150,000 and Louis Vitale's capital balance at $75,000. Hecker and Vitale share profits and losses equally. Compute the amount of each partner's equity on the books of the new partnership under each of the following plans:

a. Mendez purchases Vitale's interest in the business, paying $90,000. The $90,000 payment is not invested in the partnership but instead goes directly to Vitale.
b. Mendez invests $75,000 to acquire a one-fourth interest in the partnership.
c. Mendez invests $135,000 to acquire a one-fourth interest in the partnership.

Exercise 12-9 *Recording the admission of a new partner* ***(Obj. 4)***

Make the partnership journal entry to record the admission of Mendez under plans a, b, and c in Exercise 12-8. Explanations are not required.

Exercise 12-10 *Withdrawal of a partner from a business* ***(Obj. 5)***

After closing the books, Artemis & Chan's partnership balance sheet reports owner's equity of $36,000 for Artemis and $48,000 for Chan. Artemis is withdrawing from the firm. He and Chan agree to write down partnership assets by $18,000. They have shared profits and losses in the ratio of one-third to Artemis and two-thirds to Chan. If the partnership agreement states that a partner withdrawing from the firm will receive assets equal to the book value of his owner's equity, how much will Artemis receive?

Chan will continue to operate the business as a proprietorship. What is Chan's beginning capital on the proprietorship books?

Exercise 12-11 *Withdrawal of a partner* ***(Obj. 5)***

Lana Brown is retiring from the partnership of Brown, Green, and White on May 31. The partner capital balances are Brown, $72,000; Green, $102,000; and White, $44,000. The partners agree to have the partnership assets revalued to current market values. The independent appraiser reports that the book value of the inventory should be decreased by $16,000, and the book value of the land should be increased by $64,000. The partners agree to these revaluations. The profit-and-loss ratio has been 5:3:2 for Brown, Green, and White, respectively. In retiring from the firm, Brown received $50,000 cash and a $50,000 note from the partnership.

Required

Journalize (a) the asset revaluations, and (b) Brown's withdrawal from the firm.

Exercise 12-12 *Liquidation of a partnership* ***(Obj. 6)***

Marsh, Ng, and Orsulak are liquidating their partnership. Before selling the noncash assets and paying the liabilities, the capital balances are Marsh, $25,000; Ng, $15,000; and Orsulak, $10,000. The partnership agreement divides profits and losses equally.

Required

1. After selling the noncash assets and paying the liabilities, suppose the partnership has cash of $50,000. How much cash will each partner receive in final liquidation?
2. After selling the noncash assets and paying the liabilities, suppose the partnership has cash of $44,000. How much cash will each partner receive in final liquidation?

Exercise 12-13 *Liquidation of a partnership* ***(Obj. 6)***

Prior to liquidation, the accounting records of Pratt, Qualls, and Ramirez included the following balances and profit-and-loss-sharing percentages:

	Cash	+	Noncash Assets	=	Liabilities	+	Capital Pratt (40%)	+	Capital Qualls (30%)	+	Capital Ramirez (30%)
Balances before sale of assets	$10,000		$57,000		$21,000		$20,000		$15,000		$11,000

The partnership sold the noncash assets for $73,000, paid the liabilities, and disbursed the remaining cash to the partners. Complete the summary of transactions in the liquidation of the partnership. Use the format illustrated in Exhibit 12-4.

Exercise 12-14 *Liquidation of a partnership* ***(Obj. 6)***

The partnership of Lee, Massé, and Nix is dissolving. Business assets, liabilities, and partners' capital balances prior to dissolution follow. The partners share profits and losses as follows: Cory Lee, 25 percent; Sandra Massé, 55 percent; and Clyde Nix, 20 percent.

Required

Create a spreadsheet or solve manually—as directed by your instructor—to show the ending balances in all accounts after the noncash assets are sold for $272,000 and for $180,000. Determine the unknown amounts, represented by (?):

	A	B	C	D	E	F
1			Lee, Massé, and Nix			
2			Sale of Noncash Assets			
3			(For $272,000)			
4				Cory	Sandra	Clyde
5		Noncash		Lee,	Massé,	Nix,
6	Cash	Assets	Liabilities	Capital	Capital	Capital
7						
8	$ 12,000	$252,000	$154,000	$24,000	$74,000	$12,000
9	272,000	(252,000)		? †	?	?
10						
11	$284,000	$ 0	$154,000	$?	$?	$?
12						
13						† ($A9 – $B8)*.25
14			(For $180,000)			
15						
16				Cory	Sandra	Clyde
17		Noncash		Lee,	Massé,	Nix,
18	Cash	Assets	Liabilities	Capital	Capital	Capital
19						
20	$ 12,000	$252,000	$154,000	$24,000	$74,000	$12,000
21	180,000	(252,000)		? **	?	?
22						
23	$192,000	$ 0	$154,000	$?	$?	$?
24						
						** ($A21 – $B20)*.25

Identify two ways the partners can deal with the negative ending balance in Nix's capital account.

Challenge Exercise

Exercise 12-15 *Preparing a partnership balance sheet* ***(Obj. 7)***

On October 31, 2003, Jill Mathers and Don Smith agree to combine their proprietorships as a partnership. Their balance sheets on October 31 are as follows:

	Mathers' Business		Smith's Business	
Assets	*Book Value*	*Current Market Value*	*Book Value*	*Current Market Value*
Cash	$ 6,000	$ 6,000	$ 5,000	$ 5,000
Accounts receivable (net)	22,000	20,000	8,000	7,000
Inventory	51,000	46,000	34,000	36,000
Capital assets (net)	122,000	105,000	54,000	60,000
Total assets	$201,000	$177,000	$101,000	$108,000
Liabilities and Capital				
Accounts payable	$ 24,000	$ 24,000	$ 10,000	$ 10,000
Accrued expenses payable	2,000	2,000	2,000	2,000
Notes payable	55,000	55,000		
Jill Mathers, capital	120,000	96,000		
Don Smith, capital			89,000	96,000
Total liabilities and capital	$201,000	$177,000	$101,000	$108,000

Required

Prepare the partnership balance sheet at October 31, 2003.

Beyond the Numbers

Beyond the Numbers 12–1 *Partnership issues* ***(Obj. 1, 5)***

The following questions relate to issues faced by partnerships.

1. The text suggests that a written partnership agreement may be drawn up between the partners in a partnership. One benefit of an agreement is that it provides a mechanism for resolving disputes between the partners. What are five areas of dispute that might be resolved by a partnership agreement?
2. The statement has been made that "If you must take on a partner, make sure the partner is richer than you are.'' Why is this statement valid?
3. Desaulles, Howard & James is a partnership of lawyers. Howard is planning to move to Australia. What are the options open to her to convert her share of the partnership assets to cash?

Ethical Issue

Gail LaRue and Cindy Ng operate The Party Centre, a party supply store in Burnaby, British Columbia. The partners split profits and losses equally, and each takes an annual withdrawal of $80,000. To even out the workload, Ng does the buying and LaRue serves as the accountant. From time to time, they use small amounts of store merchandise for personal use. In preparing for a large private party, LaRue took engraved invitations, napkins, place mats, and other goods that cost $2,000. She recorded the transaction as follows:

Cost of Goods Sold	$2,000	
Inventory		$2,000

Required

1. How should LaRue have recorded this transaction?
2. Discuss the ethical dimension of LaRue's action.

Problems (Group A)

Problem 12-1A *Writing a partnership agreement* ***(Obj. 1)***

Maria Rotor and Marie Deslauriers are discussing the formation of a partnership to import fabric. Rotor is especially artistic, so she will travel to Central America to buy merchandise. Deslauriers is an excellent salesperson, and has already lined up several large stores to sell the fabric.

Required

Write a partnership agreement to cover all elements essential for the business to operate smoothly. Make up names, amounts, profit-and-loss-sharing percentages, and so on as needed.

Problem 12-2A *Investments by partners* ***(Obj. 2, 7)***

Jay Woeller and Claudette LeBlanc formed a partnership on March 15, 2003. The partners agreed to invest equal amounts of capital. Woeller invested his proprietorship's assets and liabilities (credit balances in parentheses):

	Woeller's Book Value	Current Market Value
Accounts receivable	$ 12,000	$12,000
Allowance for doubtful accounts	(1,000)	(1,500)
Inventory	44,000	31,000
Prepaid expenses	2,500	2,500
Store equipment	37,000	27,000
Accumulated amortization	(10,000)	(-0-)
Accounts payable	(22,000)	(22,000)

On March 15, LeBlanc invested cash in an amount equal to the current market value of Woeller's partnership capital. The partners decided that Woeller would earn 70 percent of partnership profits because he would manage the business. LeBlanc agreed to accept 30 percent of profits. During the period ended December 31, 2003, the partnership earned $90,000. LeBlanc's withdrawals were $32,000 and Woeller's withdrawals were $36,000.

Required

1. Journalize the partners' initial investments.
2. Prepare the partnership balance sheet immediately after its formation on March 15, 2003.
3. Journalize the December 31, 2003, entries to close the Income Summary account and the partner withdrawals accounts.

Problem 12-3A *Admitting a new partner* ***(Obj. 4)***

Green Lake Resort is a partnership, and its owners are considering admitting Greg Rivers as a new partner. On July 31, 2003, the capital accounts of the three existing partners and their shares of profits and losses are as follows:

	Capital	Profit-and-Loss Ratio
Ellen Urlang	$ 72,000	1/6
Amy Sharp	96,000	1/3
Robert Hayes	132,000	1/2

Required

Journalize the admission of Rivers as a partner on July 31, 2003, for each of the following independent situations.

1. Rivers pays Hayes $75,000 cash to purchase one-half of Hayes' interest.
2. Rivers invests $75,000 in the partnership, acquiring a one-fifth interest in the business.
3. Rivers invests $60,000 in the partnership, acquiring a one-eighth interest in the business.
4. Rivers invests $45,000 in the partnership, acquiring a 15% interest in the business.

Problem 12-4A *Computing partners' shares of net income and net loss* ***(Obj. 3, 7)***

Robin Kantor, Kami Karlin, and Joe Schipper have formed a partnership. Kantor invested $40,000, Karlin $80,000, and Schipper $120,000. Kantor will manage the store, Karlin will work in the store three-quarters of the time, and Schipper will not work in the business.

Required

1. Compute the partners' shares of profits and losses under each of the following plans:
   a. Net income is $174,000, and the partnership agreement does not specify how profits and losses are shared.
   b. Net loss is $94,000, and the partnership agreement allocates 45 percent of profits to Kantor, 35 percent to Karlin, and 20 percent to Schipper. The agreement does not discuss the sharing of losses.
   c. Net income is $208,000. The first $100,000 is allocated based on "salaries" of $68,000 for Kantor and $32,000 for Karlin. The remainder is allocated based on partners' capital contributions.
   d. Net income for the year is $182,000. The first $60,000 is allocated on the basis of partners' capital contributions. The next $60,000 is based on service, with $40,000 going to Kantor and $20,000 going to Karlin. Any remainder is shared equally.
2. Revenues for the year were $1,144,000 and expenses were $962,000. Under plan (d), prepare the partnership income statement for the year. Assume a year end of September 30, 2003.
3. How will what you have learned in this problem help you manage a partnership?

Problem 12-5A *Recording changes in partnership capital* ***(Obj. 4, 5)***

Outdoor Equipment is a partnership owned by three individuals. The partners share profits and losses in the ratio of 30 percent to Jane Mutchler, 40 percent to John Voorhees, and 30 percent to Ivana Weill. At December 31, 2002, the firm has the following balance sheet:

Cash		$ 35,000	Total liabilities	$115,000
Accounts receivable	$ 20,000			
Less: Allowance for uncollectibles	1,000	19,000		
Inventory		98,000	Jane Mutchler, capital	45,000
Equipment	150,000		John Voorhees, capital	59,000
Less: Accumulated amortization	30,000	120,000	Ivana Weill, capital	50,000
Total assets		$272,000	Total liabilities and capital	$272,000

Jane Mutchler withdraws from the partnership on this date.

Required

Record Mutchler's withdrawal from the partnership under the following plans:

1. Mutchler gives her interest in the business to Lynn Arturo, her cousin, with the consent of Voorhees and Weill.
2. In personal transactions, Mutchler sells her equity in the partnership to Michel André and Steven Craig, who each pay Mutchler $20,000 for one-half of her interest. Voorhees and Weill agree to accept André and Craig as partners.
3. The partnership pays Mutchler cash of $5,000, and gives her a note payable for the remainder of her book equity in settlement of her partnership interest.
4. Mutchler receives cash of $20,000 and a note for $30,000 from the partnership.
5. The partners agree that the equipment is worth $200,000, and that accumulated amortization should remain at $30,000. After the revaluation, the partnership settles with Mutchler by giving her cash of $10,000 and inventory for the remainder of her book equity.

Problem 12-6A *Liquidation of a partnership* ***(Obj. 6)***

The partnership of Cheung, Kosse & Lufkin has experienced operating losses for three consecutive years. The partners, who have shared profits and losses in the ratio of Fran Cheung, 15 percent, Walt Kosse, 60 percent, and Emil Lufkin, 25 percent, are considering the liquidation of the business. They ask you to analyze the effects of liquidation under various assumptions about the sale of the noncash assets. They present the following condensed partnership balance sheet at December 31, 2002:

Cash	$ 34,000	Liabilities	$126,000
Noncash assets	306,000	Fran Cheung, capital	48,000
		Walt Kosse, capital	132,000
		Emil Lufkin, capital	34,000
		Total liabilities	
Total assets	$340,000	and capital	$340,000

Required

1. Prepare a summary of liquidation transactions (as illustrated in the chapter) for each of the following situations:
   a. The noncash assets are sold for $350,000.
   b. The noncash assets are sold for $282,000.
2. Make the journal entries to record the liquidation transactions in requirement 1(b).

Problem 12-7A *Liquidation of a partnership* ***(Obj. 6)***

Link Back to Chapter 4 (Closing Entries). RMG & Company is a partnership owned by S. Ryan, G. Morales, and D. Goldberg, who share profits and losses in the ratio of 1:3:4. The adjusted trial balance of the partnership (in condensed form) at June 30, 2003, follows:

Required

1. Prepare the June 30, 2003, entries to close the revenue, expense, income summary, and withdrawals accounts.
2. Using T-accounts, insert the opening capital balances in the partners' capital accounts, post the closing entries to the capital accounts, and determine each partner's ending capital balance.
3. The partnership liquidates on June 30, 2003, by selling the noncash assets for $150,000. Using the ending balances of the partners' capital accounts, prepare a summary of liquidation transactions (as illustrated in Exhibit 12–4).

RMG & COMPANY Adjusted Trial Balance June 30, 2003		
Cash	$ 36,000	
Noncash assets	174,000	
Liabilities		$150,000
S. Ryan, capital		33,000
G. Morales, capital		61,500
D. Goldberg, capital		93,000
S. Ryan, withdrawals	21,000	
G. Morales, withdrawals	52,500	
D. Goldberg, withdrawals	81,000	
Revenues		162,000
Expenses	135,000	
Totals	$499,500	$499,500

Problem 12-8A *Accounting for partners' investments; allocating profits and losses; accounting for the admission of a new partner; accounting for the withdrawal of a partner; preparing a partnership balance sheet* ***(Obj. 2, 3, 4, 5, 7)***

2002

June 10 Amie Dhal and Marie Sung have agreed to pool their assets and form a partnership to be called D&S Consulting. They agree to share all profits equally and make the following initial investments:

	Dhal	Sung
Cash	$10,000	$20,000
Accounts receivable (net)	22,000	18,000
Office furniture	24,000	16,000

2003

May 31 The partnership's reported net income was $130,000 for the year ended May 31, 2003.

June 1 Dhal and Sung agree to accept Mark Mason into the partnership with a $120,000 investment for 30% of the business. The partnership agreement is amended to provide for the following sharing of profits and losses:

	Dhal	Sung	Mason
Annual "salary"	$60,000	$80,000	$50,000
Interest on investment	10%	10%	10%
Balance in ratio of	3 :	2 :	5

2004

May 31 The partnership's reported net income was $320,000.

Oct. 10 Dhal withdrew $56,000 cash from the partnership and Sung withdrew $38,000 (Mason did not make any withdrawals).

2005

May 31 The partnership's reported net income was $120,000.

June 2 After a disagreement as to the directions in which the partnership should be moving, Mason decided to withdraw from the partnership. The three partners agreed that Mason could take cash of $200,000 in exchange for his equity in the partnership.

Required

1. Journalize all of the transactions for the partnership.
2. Prepare the partners' equity section of the balance sheet as of June 2, 2005.

Problem 12-9A *Accounting for partners' investments; allocating profits and losses; accounting for the admission of a new partner; accounting for the liquidation of a partnership* ***(Obj. 2, 3, 4, 5, 6)***

Judy Chapin, Herb Nobes, and Jean Yee started a partnership to operate a management consulting business. The partnership (CNY Partners) had the following transactions:

2002

Jan. 2 Chapin, Nobes and Yee formed the partnership by signing an agreement that stated that all profits will be shared in a 3:2:5 ratio and by making the following investments:

	Chapin	Nobes	Yee
Cash	$ 2,000	$ 3,500	$11,500
Accounts receivable (net)	7,000	10,500	15,000
Office furniture	0	5,500	0
Computer equipment	13,000	0	4,500

Dec. 31 The partnership reported net income of $21,000 for the year.

2003

June 7 Chapin and Yee agreed that Nobes could sell his share of the partnership to Andre Dawson for $31,000. The new partners agreed to keep the same profit sharing arrangement (3:2:5 for Chapin:Dawson:Yee).

Dec. 31 The partnership reported a net loss of $25,000 for the year.

2004

Jan. 3 The partners agreed to liquidate the partnership. On this date the balance sheet showed the following items:

Cash	$ 6,500
Accounts receivable	123,000
Allowance for uncollectible accounts	6,000
Office furniture	30,000
Computer equipment	75,000
Accumulated amortization (total)	23,000
Accounts payable	137,000

The assets were sold for the following amounts:

Accounts receivable	$60,000
Office furniture	32,500
Computer equipment	45,000

Chapin and Dawson both have personal assets, but Yee does not.

Required

Journalize all of the transactions for the partnership.

Problems (Group B)

Problem 12-1B *Writing a partnership agreement* ***(Obj. 1)***

Mary Basdeo and Sue Keim are discussing the formation of a partnership to install payroll accounting systems. Basdeo is skilled in systems design, and she is convinced that her designs will draw large sales volumes. Keim is an excellent salesperson, and she has already lined up several clients.

Required

Write a partnership agreement to cover all elements essential for the business to operate smoothly. Make up names, amounts, profit-and-loss sharing percentages, and so on, as needed.

Problem 12-2B *Investments by partners* ***(Obj. 2, 7)***

On June 30, 2003, Sean Russell and Chris Mak formed a partnership. The partners agreed to invest equal amounts of capital. Mak invested his proprietorship's assets and liabilities (credit balances in parentheses).

On June 30, 2003, Russell invested cash in an amount equal to the current market value of Mak's partnership capital. The partners decided that Mak would earn two-thirds of partnership profits because he would manage the business. Russell agreed to accept one-third of profits. During the remainder of the year, the partnership earned $105,000. Mak's withdrawals were $40,000, and Russell's withdrawals were $30,000.

	Mak's Book Value	Current Market Value
Accounts receivable	$ 8,000	$ 8,000
Allowance for doubtful accounts	(-0-)	(1,000)
Inventory	22,000	24,000
Prepaid expenses	2,000	2,000
Office equipment	46,000	28,000
Accumulated amortization—office equipment	(16,000)	(-0-)
Accounts payable	(20,000)	(20,000)

Required

1. Journalize the partners' initial investments.
2. Prepare the partnership balance sheet immediately after its formation on June 30, 2003.
3. Journalize the December 31, 2003, entries to close the Income Summary account and the partner withdrawals accounts.

Problem 12-3B *Admitting a new partner* ***(Obj. 4)***

Hazelwood Consulting Associates is a partnership, and its owners are considering admitting Helen Oldham as a new partner. On March 31, 2003, the capital accounts of the three existing partners and their shares of profits and losses are as follows:

	Capital	Profit-and-Loss Ratio
Jim Zook	$ 80,000	15%
Richard Land	200,000	30%
Jennifer Lim	320,000	55%

Required

Journalize the admission of Oldham as a partner on March 31, 2003, for each of the following independent situations:

1. Oldham pays Lim $290,000 cash to purchase Lim's interest in the partnership.
2. Oldham invests $120,000 in the partnership, acquiring a one-sixth interest in the business.
3. Oldham invests $120,000 in the partnership, acquiring a one-fifth interest in the business.
4. Oldham invests $80,000 in the partnership, acquiring a 10% interest in the business.

Problem 12-4B *Computing partners' shares of net income and net loss* ***(Obj. 3, 7)***

Larry Aplevich, Elinor Davis, and Paul Diehl have formed a partnership. Aplevich invested $30,000, Davis $36,000, and Diehl $54,000. Aplevich will manage the store, Davis will work in the store half time, and Diehl will not work in the business.

Required

1. Compute the partners' shares of profits and losses under each of the following plans:
   a. Net loss is $85,800, and the partnership agreement does not specify how profits and losses are shared.
   b. Net loss is $120,000, and the partnership agreement allocates 40 percent of profits to Aplevich, 25 percent to Davis, and 35 percent to Diehl. The agreement does not discuss the sharing of losses.
   c. Net income is $184,000. The first $80,000 is allocated based on "salaries," with Aplevich receiving $56,000 and Davis receiving $24,000. The remainder is allocated based on partner capital contributions.
   d. Net income for the year is $360,000. The first $160,000 is allocated based on partner capital contributions. The next $72,000 is based on service, with Aplevich receiving $56,000 and Davis receiving $16,000. Any remainder is shared equally.
2. Revenues for the year were $1,760,000 and expenses were $1,380,000. Under plan (d), prepare the partnership income statement for the year. Assume a January 31, 2003 year end.
3. How will what you learned in this problem help you manage a partnership?

Problem 12-5B *Recording changes in partnership capital* ***(Obj. 4, 5)***

Personal Finance Services is a partnership owned by three individuals. The partners share profits and losses in the ratio of 28 percent to Katherine Smythe, 38 percent to Max Dune, and 34 percent to Emily Hahn. At December 31, 2003, the firm has the following balance sheet:

Cash		$ 18,000	Total liabilities	$ 97,500
Accounts receivable	$33,000			
Less: Allowance				
for uncollectibles	6,000	27,000	Katherine Smythe, capital	139,500
Building	$465,000		Max Dune, capital	75,000
Less: Accumulated			Emily Hahn, capital	93,000
amortization	105,000	360,000	Total liabilities	
Total assets		$405,000	and capital	$405,000

Dune withdraws from the partnership on December 31, 2003, to establish his own consulting practice.

Required

Record Dune's withdrawal from the partnership under the following plans:

1. Dune gives his interest in the business to Tony Dutoit, his nephew, with the consent of Smythe and Hahn.
2. In personal transactions, Dune sells his equity in the partnership to Bea Patell and Al Bruckner, who each pay Dune $75,000 for one-half of his interest. Smythe and Hahn agree to accept Patell and Bruckner as partners.
3. The partnership pays Dune cash of $22,500, and gives him a note payable for the remainder of his book equity in settlement of his partnership interest.
4. Dune receives cash of $15,000 and a note for $105,000 from the partnership.
5. The partners agree that the building is worth only $420,000, and that its accumulated amortization should remain at $105,000. After the revaluation, the partnership settles with Dune by giving him cash of $21,150 and a note payable for the remainder of his book equity.

Problem 12-6B *Liquidation of a partnership* ***(Obj. 6)***

The partnership of Amping, Blair, and Trippi has experienced operating losses for three consecutive years. The partners, who have shared profits and losses in the ratio of Denise Amping, 10 percent, Bert Blair, 30 percent, and Toni Trippi, 60 percent, are considering the liquidation of the business. They ask you to analyze the effects of liquidation under various possibilities about the sale of the noncash assets. They present the following condensed partnership balance sheet at December 31, 2002:

Cash	$ 54,000	Liabilities	$242,000
Noncash assets	404,000	Denise Amping, capital	62,000
		Bert Blair, capital	78,000
		Toni Trippi, capital	76,000
Total assets	$458,000	Total liabilities and capital	$458,000

Required

1. Prepare a summary of liquidation transactions (as illustrated in the chapter) for each of the following situations:
   a. The noncash assets are sold for $424,000.
   b. The noncash assets are sold for $344,000.
2. Make the journal entries to record the liquidation transactions in requirement 1(b).

Problem 12-7B *Liquidation of a partnership* ***(Obj. 6)***

Link Back to Chapter 4 (Closing Entries). BP&O is a partnership owned by B. Bell, S. Pastena, and C. O'Donnell, who share profits and losses in the ratio of 5:3:2. The adjusted trial balance of the partnership (in condensed form) at September 30, 2003, follows:

BP&O
Adjusted Trial Balance
September 30, 2003

Cash	$ 50,000	
Noncash assets	177,000	
Liabilities		$145,000
B. Bell, capital		57,000
S. Pastena, capital		44,000
C. O'Donnell, capital		21,000
B. Bell, withdrawals	45,000	
S. Pastena, withdrawals	37,000	
C. O'Donnell, withdrawals	18,000	
Revenues		422,000
Expenses	362,000	
Totals	$689,000	$689,000

Required

1. Prepare the September 30, 2003, entries to close the revenue, expense, income summary, and withdrawals accounts.
2. Using T-accounts, insert the opening capital balances in the partner capital accounts, post the closing entries to the capital accounts, and determine each partner's ending capital balance.
3. The partnership liquidates on September 30, 2003, by selling the noncash assets for $132,000. Using the ending balances of the partners' capital accounts, prepare a summary of liquidation transactions (as illustrated in Exhibit 12–4).

Problem 12-8B *Accounting for partners' investments; allocating profits and losses; accounting for the admission of a new partner; accounting for the withdrawal of a partner; preparing partnership balance sheet* ***(Obj. 2, 3, 4, 5, 7)***

2002

June 10 Steven Dikolli and Sharon McCracken have agreed to pool their assets and form a partnership to be called D&M Logistics. They agree to share all profits equally and make the following initial investments:

	Dikolli	McCracken
Cash	$14,000	$24,000
Accounts receivable (net)	28,000	14,000
Office furniture (net)	32,000	18,000

2003

May 31 The partnership's reported net income was $152,000 for the year ended May 31, 2003.

June 1 Dikolli and McCracken agree to accept Myra Pinos into the partnership with a $140,000 investment for 40% of the business. The partnership agreement is amended to provide for the following sharing of profits and losses:

	Dikolli	McCracken	Pinos
Annual "salary"	$80,000	$60,000	$40,000
Interest on investment	10%	10%	10%
Balance in ratio of	2 :	3 :	5

2004

May 31 The partnership's reported net income is $380,000.

Oct. 10 Dikolli withdrew $60,000 cash from the partnership and McCracken withdrew $40,000 (Pinos did not make any withdrawals).

2005

May 31 The partnership's reported net income is $150,000.

June 2 After a disagreement as to the directions in which the partnership should be moving, Pinos decided to withdraw from the partnership. The three partners agreed that Pinos could take cash of $340,000 in exchange for her equity in the partnership.

Required

1. Journalize all of the transactions for the partnership.
2. Prepare the partners' equity section of the balance sheet as of June 2, 2005.

Problem 12-9B *Accounting for partners' investments; allocating profits and losses; accounting for the admission of a new partner; accounting for the liquidation of a partnership* ***(Obj. 2, 3, 4, 5, 6)***

William Press, Julie Harris, and Regina Visser started a partnership to operate a catering business. The partnership (PH&V Catering) had the following transactions:

2002

Jan. 2 Press, Harris, and Visser formed the partnership by signing an agreement that stated that all profits will be shared in a 2:3:5 ratio and by making the following investments:

	Press	Harris	Visser
Cash	$18,000	$12,000	$22,000
Accounts receivable (net)	30,000	22,000	90,000
Office furniture (net)	0	0	22,000
Catering equipment (net)	32,000	58,000	0

Dec. 31 The partnership reported net income of $80,000 for the year.

2003

June 7 Press and Visser agreed that Harris could sell her share of the partnership to Ray Ewing for $124,000. The new partners agreed to keep the same profit-sharing arrangement (2:3:5 for Press:Ewing:Visser).

Dec. 31 The partnership reported a net loss of $100,000 for the year.

2004

Jan. 3 The partners agreed to liquidate the partnership. On this date the balance sheet showed the following items:

Cash	$ 26,000
Accounts receivable	474,000
Allowance for uncollectible accounts	34,000
Office furniture	112,000
Catering equipment	360,000
Accumulated amortization (total)	74,000
Accounts payable	578,000

The assets were sold for the following amounts:

Accounts receivable	$286,000
Office furniture	124,000
Catering equipment	160,000

Press and Ewing both have personal assets, but Visser does not.

Required

Journalize all of the transactions for the partnership.

Challenge Problems

Problem 12-1C *Deciding on a capital structure* ***(Obj. 1, 2)***

Rebecca Bernstein and Peter Tong have been in a partnership for five years. The principal business of the partnership is systems design for financial institutions. Gross revenues have increased from $82,000 in 1998 to $935,000 in 2003, the year just ended. The number of employees has increased from two in the first year to nine in the most recent year. Bernstein and Tong realized that they had to build up the partnership's capital and have withdrawn only part of the annual profits. As a result, their capital accounts have increased from $50,000 (Bernstein, $35,000; Tong, $15,000) in 1998 to $520,000 (Bernstein, $280,000; Tong, $240,000) in 2003.

The two partners realize that they must expand their capital base to expand their operations in order to meet the increasing demand for their systems designs. At the same time they wish to take personal advantage of the partnership's earnings. They have been trying to determine whether they should continue the partnership and borrow the necessary funds, take on one or more partners (several of their employees have expressed interest and have capital to invest), or incorporate and sell a portion of the business to outsiders. With respect to incorporation, Martin Askew, a former classmate of Bernstein's who works for a stockbroker, has indicated he knows of investors who would be interested in buying a share of the business.

Required

Bernstein and Tong have come to you to ask for advice. In response to your questions, they indicate they will need additional capital of $400,000 to $500,000.

Problem 12-2C *The effects of accounting decisions on profits* ***(Obj. 3)***

Mary Antoine, Susan Chiu, and Alan May have been partners in a systems design business for the past eight years. Antoine and May work full-time in the business; Chiu has a public accounting practice and works about five to ten hours per week

on the administrative side of the business. The business has been successful and the partners are considering expansion.

The partnership agreement states that profits will be distributed as follows:

1. Partners will get 12 percent on their average capital balances.
2. Antoine will get a "salary" of $50,000; Chiu will get a "salary" of $6,250; May will get a "salary" of $50,000.
3. The balance remaining will be distributed on the basis of Antoine, 40 percent; Chiu, 20 percent; and May, 40 percent.

The agreement also stipulates that the distributions outlined in parts 1 and 2 of the agreement will be made even if there are not sufficient profits and that any deficiency will be shared on the basis of part 3.

The capital structure was as follows at December 31, 2003:

Antoine	$ 112,500
Chiu	687,500
May	287,500
Total	$1,087,500

There has been some stress in the partnership of late because Antoine believes that she is contributing a major part of the effort but is earning much less than May; Chiu is upset because she believes that she is earning the least even though her capital is essentially funding the partnership.

Required

Mary Antoine, Susan Chiu, and Alan May have come to you to ask for advice as to how they might amicably settle the present dispute. Assume net income in 2003 was $262,500.

Extending Your Knowledge

Decision Problem

Settling disagreements among partners (Obj. 3)

Barbara Jevons invested $40,000 and Tara Schlee invested $20,000 in a public relations firm that has operated for 10 years. Neither partner has made an additional investment. They have shared profits and losses in the ratio of 2:1, which is the ratio of their investments in the business. Jevons manages the office, supervises the 16 employees, and does the accounting. Schlee, the moderator of a television talk show, is responsible for marketing. Her high profile generates important revenue for the business. During the year ended December 2003, the partnership earned net income of $100,000, shared in the 2:1 ratio. On December 31, 2003, Jevons's capital balance was $210,000 and Schlee's capital balance was $140,000.

Required

Respond to each of the following situations:

1. What explains the difference between the ratio of partner capital balances at December 31, 2003, and the 2:1 ratio of partner investments and profit sharing?
2. Schlee believes the profit-and-loss-sharing ratio is unfair. She proposes a change, but Jevons insists on keeping the 2:1 ratio. What two factors may underlie Schlee's unhappiness?

3. During January 2004, Jevons learned that revenues of $15,000 were omitted from the reported 2003 income. She brings this to Schlee's attention, pointing out that her share of this added income is two-thirds, or $10,000 and Schlee's share is one-third, or $5,000. Schlee believes they should share this added income based on their capital balances: 60 percent (or $9,000) to Jevons, and 40 percent (or $6,000) to Schlee. Which partner is correct? Why?
4. Assume that an account payable of $12,000 for an operating expense in 2003 was omitted from 2003 reported income. On what basis would the partners share this amount?

Financial Statement Problem

Fortin, Lin & Royce is a regional accounting firm with four offices. Summary data from the partnership's annual report follow:

(Dollars in thousands, except where indicated)	Years Ended June 30				
	2001	2000	1999	1998	1997
Revenues					
Assurance services	$1,234	$1,122	$1,064	$1,093	$1,070
Consulting services	1,007	775	658	473	349
Tax services	743	628	567	515	557
Total Revenues	$2,984	$2,525	$2,289	$2,081	$1,976
Operating Summary					
Revenues	$2,984	$2,525	$2,289	$2,081	$1,976
Personnel Costs	1,215	1,004	887	805	726
Other Costs	712	630	517	458	415
Income to Partners	$1,057	$ 891	$ 885	$ 818	$ 835
Statistical Data					
Average Number of Partners	9	9	9	8	8

Required

1. What percentages of total revenues did FLB earn by performing assurance services (similar to audit), consulting services, and tax services during 1997? What were the percentages in 2001? Which type of service grew the most from 1997 to 2001?
2. Compute the average revenue per partner in 2001. Assume each partner works 2,000 hours per year. On average, how much does each partner charge a client for one hour of time?
3. How much net income did each KPMG partner earn, on average, in 2001?s