

# Accounting for Partnerships



## A Look at This Appendix

This appendix explains the partnership form of organization. Important partnership characteristics are described along with the accounting concepts and procedures for its most fundamental transactions.

## Learning Objectives

### CONCEPTUAL

**C1** Identify characteristics of partnerships and similar organizations. (p. D-2)

### ANALYTICAL

**A1** Compute partner return on equity and use it to evaluate partnership performance. (p. D-14)

### PROCEDURAL

**P1** Prepare entries for partnership formation. (p. D-5)

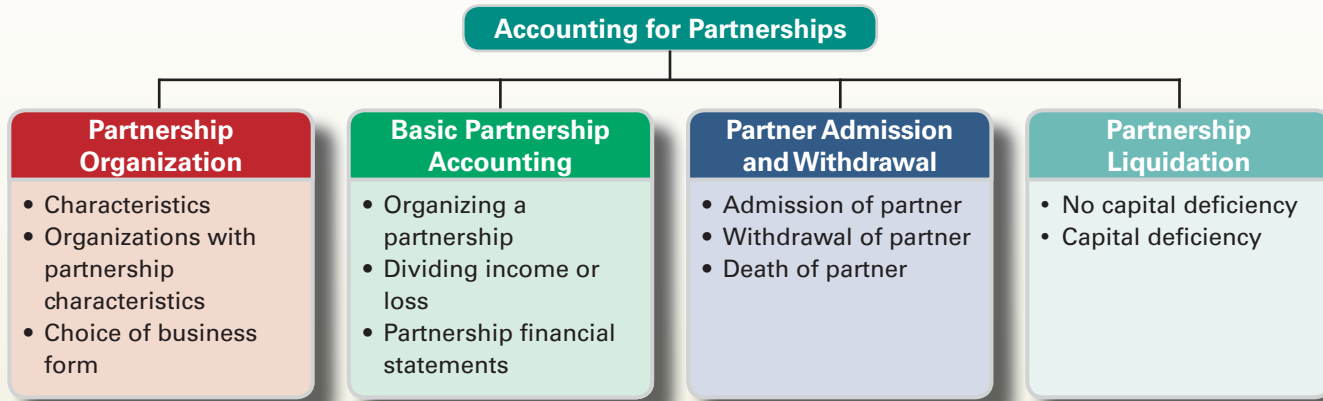
**P2** Allocate and record income and loss among partners. (p. D-5)

**P3** Account for the admission and withdrawal of partners. (p. D-8)

**P4** Prepare entries for partnership liquidation. (p. D-11)

The three basic types of business organizations are proprietorships, partnerships, and corporations. Partnerships are similar to proprietorships, except they have more than one owner. This appendix explains partnerships and looks at several variations of them such as limited

partnerships, limited liability partnerships, S corporations, and limited liability companies. Understanding the advantages and disadvantages of the partnership form of business organization is important for making informed business decisions.



## PARTNERSHIP FORM OF ORGANIZATION

**C1** Identify characteristics of partnerships and similar organizations.

A **partnership** is an unincorporated association of two or more people to pursue a business for profit as co-owners. Many businesses are organized as partnerships. They are especially common in small retail and service businesses. Many professional practitioners, including physicians, lawyers, investors, and accountants, also organize their practices as partnerships.

### Characteristics of Partnerships

Partnerships are an important type of organization because they offer certain advantages with their unique characteristics. We describe these characteristics in this section.



**Voluntary Association** A partnership is a voluntary association between partners. Joining a partnership increases the risk to one's personal financial position. Some courts have ruled that partnerships are created by the actions of individuals even when there is no *express agreement* to form one. Omar Soliman and Nick Friedman are partners who voluntarily created the company **College Hunks Hauling Junk**.

**Partnership Agreement** Forming a partnership requires that two or more legally competent people (who are of age and of sound mental capacity) agree to be partners. Their agreement becomes a **partnership contract**, also called *articles of copartnership*. Although it should be in writing, the contract is binding even if it is only expressed verbally. Partnership agreements normally include details of the partners' (1) names and contributions, (2) rights and duties, (3) sharing of income and losses, (4) withdrawal arrangement, (5) dispute procedures, (6) admission and withdrawal of partners, and (7) rights and duties in the event a partner dies.

**Limited Life** The life of a partnership is limited. Death, bankruptcy, or any event taking away the ability of a partner to enter into or fulfill a contract ends a partnership. Any one of the partners can also terminate a partnership at will.

**Taxation** A partnership is not subject to taxes on its income. The income or loss of a partnership is allocated to the partners according to the partnership agreement, and it is included in determining the taxable income for each partner's tax return. Partnership income or loss is allocated each year whether or not cash is distributed to partners.

**Mutual Agency** **Mutual agency** implies that each partner is a fully authorized agent of the partnership. As its agent, a partner can commit or bind the partnership to any contract within the scope of the partnership business. For instance, a partner in a merchandising business can sign contracts binding the partnership to buy merchandise, lease a store building, borrow money, or hire

**Point:** When a new partner is admitted, all parties usually must agree to the admission.

**Point:** The end of a partnership is referred to as its *dissolution*.

**Point:** Partners are taxed on their share of partnership income, not on their withdrawals. Partners receive a "K-1" form each year showing their share of income they must report on their personal tax return.

employees. These activities are all within the scope of a merchandising firm. A partner in a law firm, acting alone, however, cannot bind the other partners to a contract to buy snowboards for resale or rent an apartment for parties. These actions are outside the normal scope of a law firm's business. Partners also can agree to limit the power of any one or more of the partners to negotiate contracts for the partnership. This agreement is binding on the partners and on outsiders who know it exists. It is not binding on outsiders who do not know it exists. Outsiders unaware of the agreement have the right to assume each partner has normal agency powers for the partnership. Mutual agency exposes partners to the risk of unwise actions by any one partner.

**Unlimited Liability** **Unlimited liability** implies that each partner can be called on to pay a partnership's debts. When a partnership cannot pay its debts, creditors usually can apply their claims to partners' *personal* assets. If a partner does not have enough assets to meet his or her share of the partnership debt, the creditors can apply their claims to the assets of the other partners. A partnership in which all partners have *mutual agency* and *unlimited liability* is called a **general partnership**. Mutual agency and unlimited liability are two main reasons that most general partnerships have only a few members.

**Co-Ownership of Property** Partnership assets are owned jointly by all partners. Any investment by a partner becomes the joint property of all partners. Partners have a claim on partnership assets based on their capital account and the partnership contract.

## Organizations with Partnership Characteristics

Organizations exist that combine certain characteristics of partnerships with other forms of organizations. We discuss several of these forms in this section.

**Limited Partnerships** Some individuals who want to invest in a partnership are unwilling to accept the risk of unlimited liability. Their needs can be met with a **limited partnership**. This type of organization is identified in its name with the words "Limited Partnership" or "Ltd." or "LP." A limited partnership has two classes of partners, general and limited. At least one partner must be a **general partner**, who assumes management duties and unlimited liability for the debts of the partnership. The **limited partners** have no personal liability beyond the amounts they invest in the partnership. Limited partners have no active role except as specified in the partnership agreement. A limited partnership agreement often specifies unique procedures for allocating income and losses between general and limited partners. The accounting procedures are similar for both limited and general partnerships.

**Limited Liability Partnerships** Most states allow individuals to form a **limited liability partnership**. This is identified in its name with the words "Limited Liability Partnership" or by "LLP." This type of partnership is designed to protect innocent partners from malpractice or negligence claims resulting from the acts of another partner. When a partner provides service resulting in a malpractice claim, that partner has personal liability for the claim. The remaining partners who were not responsible for the actions resulting in the claim are not personally liable for it. However, most states hold all partners personally liable for other partnership debts. Accounting for a limited liability partnership is the same as for a general partnership.



**Point:** The majority of states adhere to the Uniform Partnership Act for the basic rules of partnership formation, operation, and dissolution.

**Point:** Limited life, mutual agency, and unlimited liability are disadvantages of a partnership.

### Decision Insight



**Pencil Pushing Partners** Most states allow any business to form as a limited liability partnership (LLP); however, some states only allow approved professional service companies to form them. Of the four largest CPA firms in the United States (KPMG, Deloitte, PricewaterhouseCoopers, and Ernst & Young), all are set up as LLPs. ■



**S Corporations** Certain corporations with 100 or fewer stockholders can elect to be treated as a partnership for income tax purposes. These corporations are called *Sub-Chapter S* or simply **S corporations**. This distinguishes them from other corporations, called *Sub-Chapter C* or

**Point:** Many accounting, law, consulting, and architectural firms are set up as LLPs.

**Global:** Forms of business organizations allowed vary by country.

**Point:** The majority of proprietorships and partnerships that are organized today are set up as LLCs.

**Point:** Accounting for LLCs is similar to that for partnerships (and proprietorships). One difference is that Owner (Partner), Capital is usually called *Members, Capital* for LLCs.

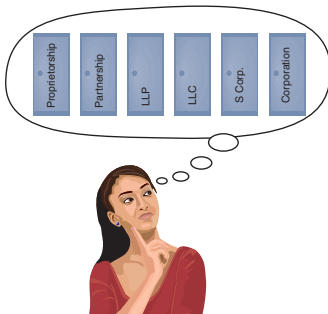
simply **C corporations**. S corporations provide stockholders the same limited liability feature that C corporations do. The advantage of an S corporation is that it does not pay income taxes. If stockholders work for an S corporation, their salaries are treated as expenses of the corporation. The remaining income or loss of the corporation is allocated to stockholders for inclusion on their personal tax returns. Except for C corporations having to account for income tax expenses and liabilities, the accounting procedures are the same for both S and C corporations.

**Limited Liability Companies** A relatively new form of business organization is the **limited liability company**. The names of these businesses usually include the words “Limited Liability Company” or an abbreviation such as “LLC” or “LC.” This form of business has certain features similar to a corporation and others similar to a limited partnership. The owners, who are called *members*, are protected with the same limited liability feature as owners of corporations. While limited partners cannot actively participate in the management of a limited partnership, the members of a limited liability company can assume an active management role. A limited liability company usually has a limited life. For income tax purposes, a limited liability company is typically treated as a partnership. This treatment depends on factors such as whether the members’ equity interests are freely transferable and whether the company has continuity of life. A limited liability company’s accounting system is designed to help management comply with the dictates of the articles of organization and company regulations adopted by its members. The accounting system also must provide information to support the company’s compliance with state and federal laws, including taxation. The company **College Hunks Hauling Junk** is an LLC.



### Choosing a Business Form

Choosing the proper business form is crucial. Many factors should be considered, including taxes, liability risk, tax and fiscal year-end, ownership structure, estate planning, business risks, and earnings and property distributions. The following table summarizes several important characteristics of business organizations:



	Proprietorship	Partnership	LLP	LLC	S Corp.	Corporation
Business entity . . . . .	Yes	Yes	Yes	Yes	Yes	Yes
Legal entity . . . . .	No	No	No	Yes	Yes	Yes
Limited liability . . . . .	No	No	Limited*	Yes	Yes	Yes
Business taxed . . . . .	No	No	No	No	No	Yes
One owner allowed . . . . .	Yes	No	No	Yes	Yes	Yes

\* A partner’s personal liability for LLP debts is limited. Most LLPs carry insurance to protect against malpractice.

We must remember that this table is a summary, not a detailed list. Many details underlie each of these business forms, and several details differ across states. Also, state and federal laws change, and a body of law is still developing around LLCs. Business owners should look at these details and consider unique business arrangements such as organizing various parts of their businesses in different forms.

**Point:** The Small Business Administration provides suggestions and information on setting up the proper form for your organization—see [SBA.gov](http://SBA.gov).

### Quick Check

Answers — p. D-17



1. A partnership is terminated in the event (a) a partnership agreement is not in writing, (b) a partner dies, (c) a partner exercises mutual agency.
2. What does the term *unlimited liability* mean when applied to a general partnership?
3. Which of the following forms of organization do not provide limited liability to *all* of its owners? (a) S corporation, (b) limited liability company, (c) limited partnership.

## BASIC PARTNERSHIP ACCOUNTING

Since ownership rights in a partnership are divided among partners, partnership accounting

- Uses a capital account for each partner.
- Uses a withdrawals account for each partner.
- Allocates net income or loss to partners according to the partnership agreement.

This section describes partnership accounting for organizing a partnership, distributing income and loss, and preparing financial statements.



### Organizing a Partnership

When partners invest in a partnership, their capital accounts are credited for the invested amounts. Partners can invest both assets and liabilities. Each partner's investment is recorded at an agreed-on value, normally the market values of the contributed assets and liabilities at the date of contribution. To illustrate, Kayla Zayn and Hector Perez organize a partnership on January 11 called BOARDS that offers year-round facilities for skateboarding and snowboarding. Zayn's initial net investment in BOARDS is \$30,000, made up of cash (\$7,000), boarding facilities (\$33,000), and a note payable reflecting a bank loan for the new business (\$10,000). Perez's initial investment is cash of \$10,000. These amounts are the values agreed on by both partners. The entries to record these investments follow.

**P1** Prepare entries for partnership formation.

#### Zayn's Investment

Jan. 11	Cash .....	7,000	
	Boarding facilities .....	33,000	
	Note payable .....		10,000
	K. Zayn, Capital .....		30,000
	<i>To record the investment of Zayn.</i>		

Assets	=	Liabilities	+	Equity
+7,000		+10,000		+30,000
+33,000				

#### Perez's Investment

Jan. 11	Cash .....	10,000	
	H. Perez, Capital .....		10,000
	<i>To record the investment of Perez.</i>		

Assets	=	Liabilities	+	Equity
+10,000				+10,000

In accounting for a partnership, the following additional relations hold true: (1) Partners' withdrawals are debited to their own separate withdrawals accounts. (2) Partners' capital accounts are credited (or debited) for their shares of net income (or net loss) when closing the accounts at the end of a period. (3) Each partner's withdrawals account is closed to that partner's capital account. Separate capital and withdrawals accounts are kept for each partner.

**Point:** Both equity and cash are reduced when a partner withdraws cash from a partnership.

### Decision Insight



**Broadway Partners** **Big River Productions** is a partnership that owns the rights to the play *Big River*. The play is performed on tour and periodically on Broadway. For a recent year-end, its Partners' Capital was approximately \$300,000, and it was distributed in its entirety to the partners. ■



### Dividing Income or Loss

Partners are not employees of the partnership but are its owners. If partners devote their time and services to their partnership, they are understood to do so for profit, not for salary. This means there are no salaries to partners that are reported as expenses on the partnership income statement. However, when net income or loss of a partnership is allocated among partners, the partners can agree to allocate "salary allowances" reflecting the relative value of services

**P2** Allocate and record income and loss among partners.

provided. Partners also can agree to allocate “interest allowances” based on the amount invested. For instance, since Zayn contributes three times the investment of Perez, it is only fair that this be considered when allocating income between them. Like salary allowances, these interest allowances are not expenses on the income statement.

Partners can agree to any method of dividing income or loss. In the absence of an agreement, the law says that the partners share income or loss of a partnership equally. If partners agree on how to share income but say nothing about losses, they share losses the same way they share income. Three common methods to divide income or loss use (1) a stated ratio basis, (2) the ratio of capital balances, or (3) salary and interest allowances and any remainder according to a fixed ratio. We explain each of these methods in this section.

**Point:** Partners can agree on a ratio to divide income and another ratio to divide a loss.

**Point:** The fractional basis can be stated as a proportion, ratio, or percent. For example, a 3:2 basis is the same as  $\frac{3}{5}$  and  $\frac{2}{5}$ , or 60% and 40%.

Assets = Liabilities + Equity  
 -60,000  
 +40,000  
 +20,000

**Allocation on Stated Ratios** The *stated ratio* (also called the *income-and-loss-sharing ratio*, the *profit and loss ratio*, or the *P&L ratio*) method of allocating partnership income or loss gives each partner a fraction of the total. Partners must agree on the fractional share each receives. To illustrate, assume the partnership agreement of K. Zayn and H. Perez says Zayn receives two-thirds and Perez one-third of partnership income and loss. If their partnership’s net income is \$60,000, it is allocated to the partners when the Income Summary account is closed as follows.

Dec. 31	Income Summary .....	60,000	
	K. Zayn, Capital .....		40,000
	H. Perez, Capital .....		20,000
	<i>To allocate income and close Income Summary.</i>		

**Allocation on Capital Balances** The *capital balances* method of allocating partnership income or loss assigns an amount based on the ratio of each partner’s relative capital balance. If Zayn and Perez agree to share income and loss on the ratio of their beginning capital balances—Zayn’s \$30,000 and Perez’s \$10,000—Zayn receives three-fourths of any income or loss (\$30,000/\$40,000) and Perez receives one-fourth (\$10,000/\$40,000). The journal entry follows the same format as that using stated ratios (see the preceding entries).

**Point:** To determine the percent of income received by each partner, divide an individual partner’s share by total net income.

**Allocation on Services, Capital, and Stated Ratios** The *services, capital, and stated ratio* method of allocating partnership income or loss recognizes that service and capital contributions of partners often are not equal. Salary allowances can make up for differences in service contributions. Interest allowances can make up for unequal capital contributions. Also, the allocation of income and loss can include *both* salary and interest allowances. To illustrate, assume that the partnership agreement of K. Zayn and H. Perez reflects differences in service and capital contributions as follows: (1) annual salary allowances of \$36,000 to Zayn and \$24,000 to Perez, (2) annual interest allowances of 10% of a partner’s beginning-year capital balance, and (3) equal share of any remaining balance of income or loss. These salaries and interest allowances are *not* reported as expenses on the income statement. They are simply a means of dividing partnership income or loss. The remainder of this section provides two illustrations using this three-point allocation agreement.

**Illustration when income exceeds allowance.** If BOARDS has first-year net income of \$70,000, and Zayn and Perez apply the three-point partnership agreement described in the prior paragraph, income is allocated as shown in Exhibit D.1. Zayn gets \$42,000 and Perez gets \$28,000 of the \$70,000 total.

**Illustration when allowances exceed income.** The sharing agreement between Zayn and Perez must be followed even if net income is less than the total of the allowances. For example, if BOARDS’ first-year net income is \$50,000 instead of \$70,000, it is allocated to the partners as shown in Exhibit D.2. Computations for salaries and interest are identical to those in Exhibit D.1. However, when we apply the total allowances against income, the balance of income is negative. This \$(14,000) negative balance is allocated equally to the partners per their sharing agreement. This means that a negative \$(7,000) is allocated to each partner. In this case, Zayn ends up with \$32,000 and Perez with \$18,000. If BOARDS had experienced a net loss, Zayn and Perez would share it in the same manner as the \$50,000 income. The only difference is that they would have begun with a negative amount because of the loss. Specifically, the partners would still have been

**Point:** When allowances exceed income, the amount of this negative balance often is referred to as a *sharing agreement loss* or *deficit*.

**Point:** Check to make sure the sum of the dollar amounts allocated to each partner equals net income or loss.

	Zayn	Perez	Total
Net income . . . . .			<u>\$70,000</u>
<b>Salary allowances</b>			
Zayn . . . . .	\$ 36,000		
Perez . . . . .		\$ 24,000	
<b>Interest allowances</b>			
Zayn (10% × \$30,000) . . . . .	3,000		
Perez (10% × \$10,000) . . . . .		1,000	
Total salaries and interest . . . . .	39,000	25,000	64,000
<b>Balance of income</b> . . . . .			<b>6,000</b>
Balance allocated equally			
Zayn . . . . .	3,000 ←		
Perez . . . . .		3,000 ←	
Total allocated . . . . .			6,000
<b>Balance of income</b> . . . . .			<u>\$ 0</u>
Income of each partner . . . . .	<u>\$42,000</u>	<u>\$28,000</u>	

**EXHIBIT D.1**

Dividing Income When Income Exceeds Allowances

	Zayn	Perez	Total
Net income . . . . .			<u>\$50,000</u>
<b>Salary allowances</b>			
Zayn . . . . .	\$ 36,000		
Perez . . . . .		\$ 24,000	
<b>Interest allowances</b>			
Zayn (10% × \$30,000) . . . . .	3,000		
Perez (10% × \$10,000) . . . . .		1,000	
Total salaries and interest . . . . .	39,000	25,000	64,000
<b>Balance of income</b> . . . . .			<b>(14,000)</b>
Balance allocated equally			
Zayn . . . . .	(7,000) ←		
Perez . . . . .		(7,000) ←	
Total allocated . . . . .			(14,000)
<b>Balance of income</b> . . . . .			<u>\$ 0</u>
Income of each partner . . . . .	<u>\$32,000</u>	<u>\$18,000</u>	

**EXHIBIT D.2**

Dividing Income When Allowances Exceed Income

allocated their salary and interest allowances, further adding to the negative balance of the loss. This *total* negative balance *after* salary and interest allowances would have been allocated equally between the partners. These allocations would have been applied against the positive numbers from any allowances to determine each partner's share of the loss.

**Point:** When a loss occurs, it is possible for a specific partner's capital to increase (when closing income summary) if that partner's allowance is in excess of his or her share of the negative balance. This implies that decreases to the capital balances of other partners exceed the partnership's loss amount.

**Quick Check**

Answer — p. D-17



4. Denzel and Shantell form a partnership by contributing \$70,000 and \$35,000, respectively. They agree to an interest allowance equal to 10% of each partner's capital balance at the beginning of the year, with the remaining income shared equally. Allocate first-year income of \$40,000 to each partner.

## Partnership Financial Statements

Partnership financial statements are similar to those of other organizations. The **statement of partners' equity**, also called *statement of partners' capital*, is one exception. It shows *each* partner's beginning capital balance, additional investments, allocated income or loss, withdrawals, and ending capital balance. To illustrate, Exhibit D.3 shows the statement of partners' equity for BOARDS prepared using the sharing agreement of Exhibit D.1. Recall that BOARDS' income was \$70,000; also, assume that Zayn withdrew \$20,000 and Perez \$12,000 at year-end.

**EXHIBIT D.3**

Statement of Partners' Equity

<b>BOARDS</b>			
<b>Statement of Partners' Equity</b>			
<b>For Year Ended December 31, 2013</b>			
	<u>Zayn</u>	<u>Perez</u>	<u>Total</u>
Beginning capital balances . . . . .	\$ 0	\$ 0	\$ 0
Plus			
Investments by owners . . . . .	30,000	10,000	40,000
Net income			
Salary allowances . . . . .	\$36,000	\$24,000	
Interest allowances . . . . .	3,000	1,000	
Balance allocated . . . . .	3,000	3,000	
Total net income . . . . .	<u>42,000</u>	<u>28,000</u>	<u>70,000</u>
	72,000	38,000	110,000
Less partners' withdrawals . . . . .	<u>(20,000)</u>	<u>(12,000)</u>	<u>(32,000)</u>
<b>Ending capital balances . . . . .</b>	<b><u>\$52,000</u></b>	<b><u>\$26,000</u></b>	<b><u>\$78,000</u></b>

The equity section of the balance sheet of a partnership usually shows the separate capital account balance of each partner. In the case of BOARDS, both K. Zayn, Capital, and H. Perez, Capital, are listed in the equity section along with their balances of \$52,000 and \$26,000, respectively.

### Decision Insight



**Double Draw** Partnerships sometimes use two accounts to reflect a partner's withdrawal of cash from a partnership. For example, a "Drawing" account might be used for regular withdrawals such as for a monthly salary allowance. A second "Withdrawals" account might be used for infrequent or personal draws such as to help pay for a daughter/son's wedding or a lake home. ■



## ADMISSION AND WITHDRAWAL OF PARTNERS

**P3** Account for the admission and withdrawal of partners.

A partnership is based on a contract between individuals. When a partner is admitted or withdraws, the present partnership ends. Still, the business can continue to operate as a new partnership consisting of the remaining partners. This section considers how to account for the admission and withdrawal of partners.

### Admission of a Partner

A new partner is admitted in one of two ways: by purchasing an interest from one or more current partners or by investing cash or other assets in the partnership.

**Purchase of Partnership Interest** The purchase of partnership interest is a *personal transaction between one or more current partners and the new partner*. To become a partner, the current partners must accept the purchaser. Accounting for the purchase of partnership interest involves reallocating current partners' capital to reflect the transaction. To illustrate, at the end of BOARDS' first year, H. Perez sells one-half of his partnership interest to Tyrell Rasheed for \$18,000. This means that Perez gives up a \$13,000 recorded interest ( $\$26,000 \times 1/2$ ) in the partnership (see the ending capital balance in Exhibit D.3). The partnership records this January 4 transaction as follows.

Assets = Liabilities + Equity  
 -13,000  
 +13,000

Jan. 4	H. Perez, Capital . . . . .	13,000	
	T. Rasheed, Capital . . . . .		13,000
	<i>To record admission of Rasheed by purchase.</i>		



After this entry is posted, BOARDS' equity shows K. Zayn, Capital; H. Perez, Capital; and T. Rasheed, Capital, and their respective balances of \$52,000, \$13,000, and \$13,000.

Two aspects of this transaction are important. First, the partnership does *not* record the \$18,000 Rasheed paid Perez. The partnership's assets, liabilities, and *total equity* are unaffected by this transaction among partners. Second, Zayn and Perez must agree that Rasheed is to become a partner. If they agree to accept Rasheed, a new partnership is formed and a new contract with a new income-and-loss-sharing agreement is prepared. If Zayn or Perez refuses to accept Rasheed as a partner, then (under the Uniform Partnership Act) Rasheed gets Perez's sold share of partnership income and loss. If the partnership is liquidated, Rasheed gets Perez's sold share of partnership assets. Rasheed gets no voice in managing the company unless Rasheed is admitted as a partner.

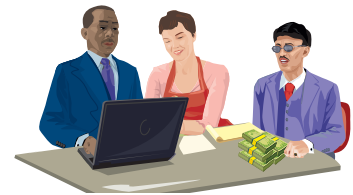
**Point:** Partners' withdrawals are not constrained by the partnership's annual income or loss.

**Investing Assets in a Partnership** Admitting a partner by accepting assets is a *transaction between the new partner and the partnership*. The invested assets become partnership property. To illustrate, if Zayn (with a \$52,000 interest) and Perez (with a \$26,000 interest) agree to accept Rasheed as a partner in BOARDS after an investment of \$22,000 cash, this is recorded as follows.

Jan. 4	Cash .....	22,000	
	T. Rasheed, Capital .....		22,000
	<i>To record admission of Rasheed by investment.</i>		

$$\begin{array}{rcl}
 \text{Assets} & = & \text{Liabilities} + \text{Equity} \\
 +22,000 & & \phantom{+} +22,000
 \end{array}$$

After this entry is posted, both assets (cash) and equity (T. Rasheed, Capital) increase by \$22,000. Rasheed now has a 22% equity in the assets of the business, computed as \$22,000 divided by the entire partnership equity (\$52,000 + \$26,000 + \$22,000). Rasheed does not necessarily have a right to 22% of income. Dividing income and loss is a separate matter on which partners must agree.



**Bonus to old partners.** When the current value of a partnership is greater than the recorded amounts of equity, the partners usually require a new partner to pay a bonus for the privilege of joining. To illustrate, assume that Zayn and Perez agree to accept Rasheed as a partner with a 25% interest in BOARDS if Rasheed invests \$42,000. Recall that the partnership's accounting records show that Zayn's recorded equity in the business is \$52,000 and Perez's recorded equity is \$26,000 (see Exhibit D.3). Rasheed's equity is determined as follows.

Equities of existing partners (\$52,000 + \$26,000) .....	\$ 78,000
Investment of new partner .....	42,000
Total partnership equity .....	<u>\$120,000</u>
Equity of Rasheed (25% × \$120,000) .....	<u>\$ 30,000</u>

Although Rasheed invests \$42,000, the equity attributed to Rasheed in the new partnership is only \$30,000. The \$12,000 difference is called a *bonus* and is allocated to existing partners (Zayn and Perez) according to their income-and-loss-sharing agreement. A bonus is shared in this way because it is viewed as reflecting a higher value of the partnership that is not yet reflected in income. The entry to record this transaction follows.

Jan. 4	Cash .....	42,000	
	T. Rasheed, Capital .....		30,000
	K. Zayn, Capital (\$12,000 × 1/2) .....		6,000
	H. Perez, Capital (\$12,000 × 1/2) .....		6,000
	<i>To record admission of Rasheed and bonus.</i>		

$$\begin{array}{rcl}
 \text{Assets} & = & \text{Liabilities} + \text{Equity} \\
 +42,000 & & +30,000 \\
 & & +6,000 \\
 & & +6,000
 \end{array}$$

**Bonus to new partner.** Alternatively, existing partners can grant a bonus to a new partner. This usually occurs when they need additional cash or the new partner has exceptional talents. The bonus to the new partner is in the form of a larger share of equity than the amount invested. To illustrate, assume that Zayn and Perez agree to accept Rasheed as a partner with a

25% interest in the partnership, but they require Rasheed to invest only \$18,000. Rasheed's equity is determined as follows.

Equities of existing partners (\$52,000 + \$26,000) .....	\$78,000
Investment of new partner .....	<u>18,000</u>
Total partnership equity .....	<u>\$96,000</u>
Equity of Rasheed (25% × \$96,000) .....	<u>\$24,000</u>

The old partners contribute the \$6,000 bonus (computed as \$24,000 minus \$18,000) to Rasheed according to their income-and-loss-sharing ratio. Moreover, Rasheed's 25% equity does not necessarily entitle Rasheed to 25% of future income or loss. This is a separate matter for agreement by the partners. The entry to record the admission and investment of Rasheed is

Assets	=	Liabilities	+	Equity
+18,000				-3,000
				-3,000
				+24,000

Jan. 4	Cash .....	18,000	
	K. Zayn, Capital (\$6,000 × 1/2) .....	3,000	
	H. Perez, Capital (\$6,000 × 1/2) .....	3,000	
	T. Rasheed, Capital .....		24,000
	<i>To record Rasheed's admission and bonus.</i>		

### Withdrawal of a Partner

A partner generally withdraws from a partnership in one of two ways. (1) First, the withdrawing partner can sell his or her interest to another person who pays for it in cash or other assets. For this, we need only debit the withdrawing partner's capital account and credit the new partner's capital account. (2) The second case is when cash or other assets of the partnership are distributed to the withdrawing partner in settlement of his or her interest. To illustrate these cases, assume that Perez withdraws from the partnership of BOARDS in some future period. The partnership shows the following capital balances at the date of Perez's withdrawal: K. Zayn, \$84,000; H. Perez, \$38,000; and T. Rasheed, \$38,000. The partners (Zayn, Perez, and Rasheed) share income and loss equally. Accounting for Perez's withdrawal depends on whether a bonus is paid. We describe three possibilities.

**No Bonus** If Perez withdraws and takes cash equal to Perez's capital balance, the entry is

Assets	=	Liabilities	+	Equity
-38,000				-38,000

Oct. 31	H. Perez, Capital .....	38,000	
	Cash .....		38,000
	<i>To record withdrawal of Perez from partnership with no bonus.</i>		

Perez can take any combination of assets to which the partners agree to settle Perez's equity. Perez's withdrawal creates a new partnership between the remaining partners. A new partnership contract and a new income-and-loss-sharing agreement are required.

**Bonus to Remaining Partners** A withdrawing partner is sometimes willing to take less than the recorded value of his or her equity to get out of the partnership or because the recorded value is overstated. Whatever the reason, when this occurs, the withdrawing partner in effect gives the remaining partners a bonus equal to the equity left behind. The remaining partners share this unwithdrawn equity according to their income-and-loss-sharing ratio. To illustrate, if Perez withdraws and agrees to take \$34,000 cash in settlement of Perez's capital balance, the entry is

Assets	=	Liabilities	+	Equity
-34,000				-38,000
				+2,000
				+2,000

Oct. 31	H. Perez, Capital .....	38,000	
	Cash .....		34,000
	K. Zayn, Capital .....		2,000
	T. Rasheed, Capital .....		2,000
	<i>To record withdrawal of Perez and bonus to remaining partners.</i>		

Perez withdrew \$4,000 less than Perez's recorded equity of \$38,000. This \$4,000 is divided between Zayn and Rasheed according to their income-and-loss-sharing ratio.

**Bonus to Withdrawing Partner** A withdrawing partner may be able to receive more than his or her recorded equity for at least two reasons. First, the recorded equity may be understated. Second, the remaining partners may agree to remove this partner by giving assets of greater value than this partner's recorded equity. In either case, the withdrawing partner receives a bonus. The remaining partners reduce their equity by the amount of this bonus according to their income-and-loss-sharing ratio. To illustrate, if Perez withdraws and receives \$40,000 cash in settlement of Perez's capital balance, the entry is

Oct. 31	H. Perez, Capital .....	38,000		Assets	=	Liabilities	+	Equity
	K. Zayn, Capital .....	1,000		-40,000				-38,000
	T. Rasheed, Capital .....	1,000						-1,000
	Cash .....		40,000					-1,000
	To record Perez's withdrawal from partnership with a bonus to Perez.							

**Falcon Cable Communications** set up a partnership withdrawal agreement. Falcon owns and operates cable television systems and had two managing general partners. The partnership agreement stated that either partner "can offer to sell to the other partner the offering partner's entire partnership interest . . . for a negotiated price. If the partner receiving such an offer rejects it, the offering partner may elect to cause [the partnership] . . . to be liquidated and dissolved."

## Death of a Partner

A partner's death dissolves a partnership. A deceased partner's estate is entitled to receive his or her equity. The partnership contract should contain provisions for settlement in this case. These provisions usually require (1) closing the books to determine income or loss since the end of the previous period and (2) determining and recording current market values for both assets and liabilities. The remaining partners and the deceased partner's estate then must agree to a settlement of the deceased partner's equity. This can involve selling the equity to remaining partners or to an outsider, or it can involve withdrawing assets.

## Decision Ethics



**Financial Planner** You are hired by the two remaining partners of a three-member partnership after the third partner's death. The partnership agreement states that a deceased partner's estate is entitled to a "share of partnership assets equal to the partner's relative equity balance" (partners' equity balances are equal). The estate argues that it is entitled to one-third of the current value of partnership assets. The remaining partners say the distribution should use asset book values, which are 75% of current value. They also point to partnership liabilities, which equal 40% of total asset book value and 30% of current value. How would you resolve this situation? ■ [Answer—p. D-17]

## LIQUIDATION OF A PARTNERSHIP

When a partnership is liquidated, its business ends and three concluding steps are required.

1. Record the sale of noncash assets for cash, and any gain or loss from liquidation is allocated to partners *using their income-and-loss-sharing agreement*.
2. Pay or settle all partner liabilities.
3. Distribute any remaining cash to partners *based on their capital balances*.

**Partnership liquidation** usually falls into one of two cases, as described in this section.

**P4** Prepare entries for partnership liquidation.

### No Capital Deficiency

No capital deficiency means that all partners have a zero or credit balance in their capital accounts for final distribution of cash. To illustrate, assume that Zayn, Perez, and Rasheed operate their partnership in BOARDS for several years, sharing income and loss equally. The partners then decide to liquidate. On the liquidation date, the current period's income or loss is transferred to the partners' capital accounts according to the sharing agreement. After that transfer, assume the partners' recorded account balances (immediately prior to liquidation) are:

Cash	\$178,000	Accounts payable	\$20,000	H. Perez, Capital	\$66,000
Land	40,000	K. Zayn, Capital	70,000	T. Rasheed, Capital	62,000

We apply three steps for liquidation. ① *The partnership sells its noncash assets, and any losses or gains from liquidation are shared among partners according to their income-and-loss-sharing agreement* (equal for these partners). Assume that BOARDS sells its noncash assets consisting of \$40,000 in land for \$46,000 cash, yielding a net gain of \$6,000. In a liquidation, gains or losses usually result from the sale of noncash assets, which are called *losses and gains from liquidation*. The entry to sell its assets for \$46,000 follows.

Assets	=	Liabilities	+	Equity
-40,000				+6,000
+46,000				

Jan. 15	Cash	46,000	
	Land		40,000
	Gain from Liquidation		6,000
	<i>Sold noncash assets at a gain.</i>		

Allocation of the gain from liquidation per the partners' income-and-loss-sharing agreement follows.

Assets	=	Liabilities	+	Equity
				-6,000
				+2,000
				+2,000
				+2,000

Jan. 15	Gain from Liquidation	6,000	
	K. Zayn, Capital		2,000
	H. Perez, Capital		2,000
	T. Rasheed, Capital		2,000
	<i>To allocate liquidation gain to partners.</i>		

② *The partnership pays its liabilities, and any losses or gains from liquidation of liabilities are shared among partners according to their income-and-loss-sharing agreement.* BOARDS' only liability is \$20,000 in accounts payable, and no gain or loss occurred.

Assets	=	Liabilities	+	Equity
-20,000		-20,000		

Jan. 15	Accounts Payable	20,000	
	Cash		20,000
	<i>To pay claims of creditors.</i>		

After step 2, we have the following capital balances along with the remaining cash balance.

K. Zayn		H. Perez, Capital		T. Rasheed, Capital		Cash	
Bal.	70,000	Bal.	66,000	Bal.	62,000	Bal.	178,000
(2)	2,000	(2)	2,000	(2)	2,000	(1)	46,000
Bal.	72,000	Bal.	68,000	Bal.	64,000	Bal.	204,000
						(3)	20,000

③ *Any remaining cash is divided among the partners according to their capital account balances.* The entry to record the final distribution of cash to partners follows.

Assets	=	Liabilities	+	Equity
-204,000				-72,000
				-68,000
				-64,000

Jan. 15	K. Zayn, Capital	72,000	
	H. Perez, Capital	68,000	
	T. Rasheed, Capital	64,000	
	Cash		204,000
	<i>To distribute remaining cash to partners.</i>		

It is important to remember that the final cash payment is distributed to partners according to their capital account balances, whereas gains and losses from liquidation are allocated according to the income-and-loss-sharing ratio. The following *statement of liquidation* summarizes the three steps in this section.

Statement of Liquidation	Cash	Noncash Assets	= Liabilities	K. Zayn, Capital	H. Perez, Capital	T. Rasheed, Capital
Balances prior to liquidation . . .	\$178,000	\$ 40,000	\$ 20,000	\$ 70,000	\$66,000	\$62,000
① Sale of noncash assets . . . . .	46,000	(40,000)		2,000	2,000	2,000
② Payment of liabilities . . . . .	(20,000)		(20,000)	0	0	0
Balances for distribution . . . . .	204,000	\$ 0	\$ 0	72,000	68,000	64,000
③ Distribution of cash to partners	(204,000)			(72,000)	(68,000)	(64,000)
	<u>\$ 0</u>			<u>\$ 0</u>	<u>\$ 0</u>	<u>\$ 0</u>

## Capital Deficiency

*Capital deficiency* means that at least one partner has a debit balance in his or her capital account at the point of final cash distribution (during step ③ as explained in the prior section). This can arise from liquidation losses, excessive withdrawals before liquidation, or recurring losses in prior periods. A partner with a capital deficiency must, if possible, cover the deficit by paying cash into the partnership.

To illustrate, assume that Zayn, Perez, and Rasheed operate their partnership in BOARDS for several years, sharing income and losses equally. The partners then decide to liquidate. Immediately prior to the final distribution of cash, the partners' recorded capital balances are Zayn, \$19,000; Perez, \$8,000; and Rasheed, \$(3,000). Rasheed's capital deficiency means that Rasheed owes the partnership \$3,000. Both Zayn and Perez have a legal claim against Rasheed's personal assets. The final distribution of cash in this case depends on how this capital deficiency is handled. Two possibilities exist: the partner pays the deficiency or the partner cannot pay the deficiency.

**Partner Pays Deficiency** Rasheed is obligated to pay \$3,000 into the partnership to cover the deficiency. If Rasheed is willing and able to pay, the entry to record receipt of payment from Rasheed follows.

Jan. 15	Cash . . . . .	3,000		Assets = Liabilities + Equity
	T. Rasheed, Capital . . . . .		3,000	+3,000
	<i>To record payment of deficiency by Rasheed.</i>			

After the \$3,000 payment, the partners' capital balances are Zayn, \$19,000; Perez, \$8,000; and Rasheed, \$0. The entry to record the final cash distributions to partners is

Jan. 15	K. Zayn, Capital . . . . .	19,000		Assets = Liabilities + Equity
	H. Perez, Capital . . . . .	8,000		-27,000
	Cash . . . . .		27,000	-19,000
	<i>To distribute remaining cash to partners.</i>			
				-8,000

**Partner Cannot Pay Deficiency** The remaining partners with credit balances absorb any partner's unpaid deficiency according to their income-and-loss-sharing ratio. To illustrate, if Rasheed is unable to pay the \$3,000 deficiency, Zayn and Perez absorb it. Since they share income and loss equally, Zayn and Perez each absorb \$1,500 of the deficiency. This is recorded as follows.

Jan. 15	K. Zayn, Capital . . . . .	1,500		Assets = Liabilities + Equity
	H. Perez, Capital . . . . .	1,500		-1,500
	T. Rasheed, Capital . . . . .		3,000	-1,500
	<i>To transfer Rasheed deficiency to Zayn and Perez.</i>			
				+3,000

After Zayn and Perez absorb Rasheed's deficiency, the capital accounts of the partners are Zayn, \$17,500; Perez, \$6,500; and Rasheed, \$0. The entry to record the final cash distribution to the partners is

Jan. 15	K. Zayn, Capital . . . . .	17,500		Assets = Liabilities + Equity
	H. Perez, Capital . . . . .	6,500		-24,000
	Cash . . . . .		24,000	-17,500
	<i>To distribute remaining cash to partners.</i>			
				-6,500

Rasheed's inability to cover this deficiency does not relieve Rasheed of the liability. If Rasheed becomes able to pay at a future date, Zayn and Perez can each collect \$1,500 from Rasheed.



## GLOBAL VIEW

Partnership accounting according to U.S. GAAP is similar, but not identical, to that under IFRS. This section discusses broad differences in partnership accounting, organization, admission, withdrawal, and liquidation.

Both U.S. GAAP and IFRS include broad and similar guidance for partnership accounting. Further, partnership organization is similar worldwide; however, different legal and tax systems dictate different implications and motivations for how a partnership is effectively set up.

The accounting for partnership admission, withdrawal, and liquidation is likewise similar worldwide. Specifically, procedures for admission, withdrawal, and liquidation depend on the partnership agreements constructed by all parties involved. However, different legal and tax systems impact those agreements and their implications to the parties.



## Decision Analysis ■ ■ ■ Partner Return on Equity

**A1** Compute partner return on equity and use it to evaluate partnership performance.

An important role of partnership financial statements is to aid current and potential partners in evaluating partnership success compared with other opportunities. One measure of this success is the **partner return on equity** ratio:

$$\text{Partner return on equity} = \frac{\text{Partner net income}}{\text{Average partner equity}}$$

This measure is separately computed for each partner. To illustrate, Exhibit D.4 reports selected data from the **Boston Celtics LP**. The return on equity for the *total* partnership is computed as  $\$216/[(\$85 + \$253)/2] = 127.8\%$ . However, return on equity is quite different across the partners. For example, the **Boston Celtics LP I** partner return on equity is computed as  $\$44/[(\$122 + \$166)/2] = 30.6\%$ , whereas the **Celtics LP** partner return on equity is computed as  $\$111/[(\$270 + \$333)/2] = 36.8\%$ . Partner return on equity provides *each* partner an assessment of its return on its equity invested in the partnership. A specific partner often uses this return to decide whether additional investment or withdrawal of resources is best for that partner. Exhibit D.4 reveals that the year shown produced good returns for all partners (the Boston Celtics LP II return is not computed because its average equity is negative due to an unusual and large distribution in the prior year).

### EXHIBIT D.4

Selected Data from  
Boston Celtics LP

(\$ thousands)	Total*	Boston Celtics LP I	Boston Celtics LP II	Celtics LP
Beginning-year balance	\$ 85	\$122	\$(307)	\$270
Net income (loss) for year	216	44	61	111
Cash distribution	(48)	—	—	(48)
Ending-year balance	<u>\$253</u>	<u>\$166</u>	<u>\$(246)</u>	<u>\$333</u>
<b>Partner return on equity</b>	<b>127.8%</b>	<b>30.6%</b>	<b>n.a.</b>	<b>36.8%</b>

\* Totals may not add up due to rounding.

## DEMONSTRATION PROBLEM

The following transactions and events affect the partners' capital accounts in several successive partnerships. Prepare a table with six columns, one for each of the five partners along with a total column to show the effects of the following events on the five partners' capital accounts.

### Part 1

- 4/13/2011 Ries and Bax create R&B Company. Each invests \$10,000, and they agree to share income and losses equally.
- 12/31/2011 R&B Co. earns \$15,000 in income for its first year. Ries withdraws \$4,000 from the partnership, and Bax withdraws \$7,000.
- 1/1/2012 Royce is made a partner in RB&R Company after contributing \$12,000 cash. The partners agree that a 10% interest allowance will be given on each partner's beginning-year capital

- balance. In addition, Bax and Royce are to receive \$5,000 salary allowances. The remainder of the income or loss is to be divided evenly.
- 12/31/2012 The partnership's income for the year is \$40,000, and withdrawals at year-end are Ries, \$5,000; Bax, \$12,500; and Royce, \$11,000.
- 1/1/2013 Ries sells her interest for \$20,000 to Murdock, whom Bax and Royce accept as a partner in the new BR&M Co. Income or loss is to be shared equally after Bax and Royce receive \$25,000 salary allowances.
- 12/31/2013 The partnership's income for the year is \$35,000, and year-end withdrawals are Bax, \$2,500, and Royce, \$2,000.
- 1/1/2014 Elway is admitted as a partner after investing \$60,000 cash in the new Elway & Associates partnership. He is given a 50% interest in capital after the other partners transfer \$3,000 to his account from each of theirs. A 20% interest allowance (on the beginning-year capital balances) will be used in sharing any income or loss, there will be no salary allowances, and Elway will receive 40% of the remaining balance—the other three partners will each get 20%.
- 12/31/2014 Elway & Associates earns \$127,600 in income for the year, and year-end withdrawals are Bax, \$25,000; Royce, \$27,000; Murdock, \$15,000; and Elway, \$40,000.
- 1/1/2015 Elway buys out Bax and Royce for the balances of their capital accounts after a revaluation of the partnership assets. The revaluation gain is \$50,000, which is divided in using a 1:1:1:2 ratio (Bax:Royce:Murdock:Elway). Elway pays the others from personal funds. Murdock and Elway will share income on a 1:9 ratio.
- 2/28/2015 The partnership earns \$10,000 of income since the beginning of the year. Murdock retires and receives partnership cash equal to her capital balance. Elway takes possession of the partnership assets in his own name, and the partnership is dissolved.

**Part 2**

Journalize the events affecting the partnership for the year ended December 31, 2012.

**PLANNING THE SOLUTION**

- Evaluate each transaction's effects on the capital accounts of the partners.
- Each time a new partner is admitted or a partner withdraws, allocate any bonus based on the income-or-loss-sharing agreement.
- Each time a new partner is admitted or a partner withdraws, allocate subsequent net income or loss in accordance with the new partnership agreement.
- Prepare entries to (1) record Royce's initial investment; (2) record the allocation of interest, salaries, and remainder; (3) show the cash withdrawals from the partnership; and (4) close the withdrawal accounts on December 31, 2012.

**SOLUTION TO DEMONSTRATION PROBLEM****Part 1**

Event	Ries	Bax	Royce	Murdock	Elway	Total
<b>4/13/2011</b>						
Initial investment . . . . .	\$10,000	\$10,000				\$ 20,000
<b>12/31/2011</b>						
Income (equal) . . . . .	7,500	7,500				15,000
Withdrawals . . . . .	(4,000)	(7,000)				(11,000)
Ending balance . . . . .	\$13,500	\$10,500				\$ 24,000
<b>1/1/2012</b>						
New investment . . . . .			\$12,000			\$ 12,000
<b>12/31/2012</b>						
10% interest . . . . .	1,350	1,050	1,200			3,600
Salaries . . . . .		5,000	5,000			10,000
Remainder (equal) . . . . .	8,800	8,800	8,800			26,400
Withdrawals . . . . .	(5,000)	(12,500)	(11,000)			(28,500)
Ending balance . . . . .	\$18,650	\$12,850	\$16,000			\$ 47,500

[continued on next page]

[continued from previous page]

Event	Ries	Bax	Royce	Murdock	Elway	Total
<b>1/1/2013</b>						
Transfer interest . . . . .	(18,650)			\$18,650		\$ 0
<b>12/31/2013</b>						
Salaries . . . . .		25,000	25,000			50,000
Remainder (equal) . . . . .		(5,000)	(5,000)	(5,000)		(15,000)
Withdrawals . . . . .		(2,500)	(2,000)			(4,500)
Ending balance . . . . .	<u>\$ 0</u>	<u>\$30,350</u>	<u>\$34,000</u>	<u>\$13,650</u>		<u>\$ 78,000</u>
<b>1/1/2014</b>						
New investment . . . . .					\$ 60,000	60,000
Bonuses to Elway . . . . .		(3,000)	(3,000)	(3,000)	9,000	0
Adjusted balance . . . . .		<u>\$27,350</u>	<u>\$31,000</u>	<u>\$10,650</u>	<u>\$ 69,000</u>	<u>\$138,000</u>
<b>12/31/2014</b>						
20% interest . . . . .		5,470	6,200	2,130	13,800	27,600
Remainder (1:1:1:2) . . . . .		20,000	20,000	20,000	40,000	100,000
Withdrawals . . . . .		(25,000)	(27,000)	(15,000)	(40,000)	(107,000)
Ending balance . . . . .		<u>\$27,820</u>	<u>\$30,200</u>	<u>\$17,780</u>	<u>\$ 82,800</u>	<u>\$158,600</u>
<b>1/1/2015</b>						
Gain (1:1:1:2) . . . . .		10,000	10,000	10,000	20,000	50,000
Adjusted balance . . . . .		<u>\$37,820</u>	<u>\$40,200</u>	<u>\$27,780</u>	<u>\$102,800</u>	<u>\$208,600</u>
Transfer interests . . . . .		(37,820)	(40,200)		78,020	0
Adjusted balance . . . . .		<u>\$ 0</u>	<u>\$ 0</u>	<u>\$27,780</u>	<u>\$180,820</u>	<u>\$208,600</u>
<b>2/28/2015</b>						
Income (1:9) . . . . .				1,000	9,000	10,000
Adjusted balance . . . . .				<u>\$28,780</u>	<u>\$189,820</u>	<u>\$218,600</u>
Settlements . . . . .				(28,780)	(189,820)	(218,600)
Final balance . . . . .				<u>\$ 0</u>	<u>\$ 0</u>	<u>\$ 0</u>

**Part 2**

2012			
Jan. 1	Cash . . . . .	12,000	
	Royce, Capital . . . . .		12,000
	<i>To record investment of Royce.</i>		
Dec. 31	Income Summary . . . . .	40,000	
	Ries, Capital . . . . .		10,150
	Bax, Capital . . . . .		14,850
	Royce, Capital . . . . .		15,000
	<i>To allocate interest, salaries, and remainders.</i>		
Dec. 31	Ries, Withdrawals . . . . .	5,000	
	Bax, Withdrawals . . . . .	12,500	
	Royce, Withdrawals . . . . .	11,000	
	Cash . . . . .		28,500
	<i>To record cash withdrawals by partners.</i>		
Dec. 31	Ries, Capital . . . . .	5,000	
	Bax, Capital . . . . .	12,500	
	Royce, Capital . . . . .	11,000	
	Ries, Withdrawals . . . . .		5,000
	Bax, Withdrawals . . . . .		12,500
	Royce, Withdrawals . . . . .		11,000
	<i>To close withdrawal accounts.</i>		



# Summary

**C1 Identify characteristics of partnerships and similar organizations.** Partnerships are voluntary associations, involve partnership agreements, have limited life, are not subject to income tax, include mutual agency, and have unlimited liability. Organizations that combine selected characteristics of partnerships and corporations include limited partnerships, limited liability partnerships, S corporations, and limited liability companies.

**A1 Compute partner return on equity and use it to evaluate partnership performance.** Partner return on equity provides each partner an assessment of his or her return on equity invested in the partnership.

**P1 Prepare entries for partnership formation.** A partner's initial investment is recorded at the market value of the assets contributed to the partnership.

**P2 Allocate and record income and loss among partners.** A partnership agreement should specify how to allocate partnership income or loss among partners. Allocation can be based on a stated ratio, capital balances, or salary and interest allowances to

compensate partners for differences in their service and capital contributions.

**P3 Account for the admission and withdrawal of partners.** When a new partner buys a partnership interest directly from one or more existing partners, the amount of cash paid from one partner to another does not affect the partnership total recorded equity. When a new partner purchases equity by investing additional assets in the partnership, the new partner's investment can yield a bonus either to existing partners or to the new partner. The entry to record a withdrawal can involve payment from either (1) the existing partners' personal assets or (2) partnership assets. The latter can yield a bonus to either the withdrawing or remaining partners.

**P4 Prepare entries for partnership liquidation.** When a partnership is liquidated, losses and gains from selling partnership assets are allocated to the partners according to their income-and-loss-sharing ratio. If a partner's capital account has a deficiency that the partner cannot pay, the other partners share the deficit according to their relative income-and-loss-sharing ratio.

## Guidance Answers to Decision Ethics



**Financial Planner** The partnership agreement apparently fails to mention liabilities or use the term *net assets*. To give the estate one-third of total assets is not fair to the remaining partners because if the partner had lived and the partners had decided to liquidate, the liabilities would need to be paid out of assets before any liquidation. Also, a

settlement based on the deceased partner's recorded equity would fail to recognize excess of current value over book value. This value increase would be realized if the partnership were liquidated. A fair settlement would seem to be a payment to the estate for the balance of the deceased partner's equity based on the *current value of net assets*.

## Guidance Answers to Quick Checks



- (b)
- Unlimited liability* means that the creditors of a partnership require each partner to be personally responsible for all partnership debts.
- (c)

4.

	Denzel	Shantell	Total
Net income .....			\$40,000
Interest allowance (10%) .....	\$ 7,000	\$ 3,500	10,500
<b>Balance of income</b> .....			<b>\$29,500</b>
Balance allocated equally .....	14,750	14,750	29,500
Balance of income .....			\$ 0
<b>Income of partners</b> .....	<b>\$21,750</b>	<b>\$18,250</b>	

## Key Terms

**C corporation** (p. D-4)

**General partner** (p. D-3)

**General partnership** (p. D-3)

**Limited liability company (LLC)** (p. D-4)

**Limited liability partnership** (p. D-3)

**Limited partners** (p. D-3)

**Limited partnership** (p. D-3)

**Mutual agency** (p. D-2)

**Partner return on equity** (p. D-14)

**Partnership** (p. D-2)

**Partnership contract** (p. D-2)

**Partnership liquidation** (p. D-11)

**S corporation** (p. D-3)

**Statement of partners' equity** (p. D-7)

**Unlimited liability** (p. D-3)

## Multiple Choice Quiz







Answers on p. D-27

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- Stokely and Leder are forming a partnership. Stokely invests a building that has a market value of \$250,000; and the partnership assumes responsibility for a \$50,000 note secured by a mortgage on that building. Leder invests \$100,000 cash. For the partnership, the amounts recorded for the building and for Stokely's Capital account are these:
  - Building, \$250,000; Stokely, Capital, \$250,000.
  - Building, \$200,000; Stokely, Capital, \$200,000.
  - Building, \$200,000; Stokely, Capital, \$100,000.
  - Building, \$200,000; Stokely, Capital, \$250,000.
  - Building, \$250,000; Stokely, Capital, \$200,000.
- Katherine, Alliah, and Paulina form a partnership. Katherine contributes \$150,000, Alliah contributes \$150,000, and Paulina contributes \$100,000. Their partnership agreement calls for the income or loss division to be based on the ratio of capital invested. If the partnership reports income of \$90,000 for its first year of operations, what amount of income is credited to Paulina's capital account?
  - \$22,500
  - \$25,000
  - \$45,000
  - \$30,000
  - \$90,000
- Jamison and Blue form a partnership with capital contributions of \$600,000 and \$800,000, respectively. Their partnership agreement calls for Jamison to receive \$120,000 per year in salary. Also, each partner is to receive an interest allowance equal to 10% of the partner's beginning capital contributions, with any remaining income or loss divided equally. If net income for its initial year is \$270,000, then Jamison's and Blue's respective shares are
  - \$135,000; \$135,000.
  - \$154,286; \$115,714.
  - \$120,000; \$150,000.
  - \$185,000; \$85,000.
  - \$85,000; \$185,000.
- Hansen and Fleming are partners and share equally in income or loss. Hansen's current capital balance in the partnership is \$125,000 and Fleming's is \$124,000. Hansen and Fleming agree to accept Black with a 20% interest. Black invests \$75,000 in the partnership. The bonus granted to Hansen and Fleming equals
  - \$13,000 each.
  - \$5,100 each.
  - \$4,000 each.
  - \$5,285 to Hansen; \$4,915 to Fleming.
  - \$0; Hansen and Fleming grant a bonus to Black.
- Mee Su is a partner in Hartford Partners, LLC. Her partnership capital balance at the beginning of the current year was \$110,000, and her ending balance was \$124,000. Her share of the partnership income is \$10,500. What is her partner return on equity?
  - 8.97%
  - 1060.00%
  - 9.54%
  - 1047.00%
  - 8.47%

 Icon denotes assignments that involve decision making.

## Discussion Questions

-  If a partnership contract does not state the period of time the partnership is to exist, when does the partnership end?
- What does the term *mutual agency* mean when applied to a partnership?
- How does a general partnership differ from a limited partnership?
-  Can partners limit the right of a partner to commit their partnership to contracts? Would such an agreement be binding (a) on the partners and (b) on outsiders?
-  Assume that Amey and Lacey are partners. Lacey dies, and her son claims the right to take his mother's place in the partnership. Does he have this right? Why or why not?
-  Assume that the Barnes and Ardmore partnership agreement provides for a two-third/one-third sharing of income but says nothing about losses. The first year of partnership operation resulted in a loss, and Barnes argues that the loss should be shared equally because the partnership agreement said nothing about sharing losses. Is Barnes correct? Explain.
- Allocation of partnership income among the partners appears on what financial statement?
- What does the term *unlimited liability* mean when it is applied to partnership members?
-  George, Burton, and Dillman have been partners for three years. The partnership is being dissolved. George is leaving the firm, but Burton and Dillman plan to carry on the business. In the final settlement, George places a \$75,000 salary claim against the partnership. He contends that he has a claim for a salary of \$25,000 for each year because he devoted all of his time for three years to the affairs of the partnership. Is his claim valid? Why or why not?
-  Kay, Kat, and Kim are partners. In a liquidation, Kay's share of partnership losses exceeds her capital account balance. Moreover, she is unable to meet the deficit from her personal assets, and her partners shared the excess losses. Does this relieve Kay of liability?
- After all partnership assets have been converted to cash and all liabilities paid, the remaining cash should equal the sum of the balances of the partners' capital accounts. Why?
- Assume a partner withdraws from a partnership and receives assets of greater value than the book value of his equity. Should the remaining partners share the resulting reduction in their equities in the ratio of their relative capital balances or according to their income-and-loss-sharing ratio?



Amy and Lester are partners in operating a store. Without consulting Amy, Lester enters into a contract to purchase merchandise for the store. Amy contends that she did not authorize the order and refuses to pay for it. The vendor sues the partners for the contract price of the merchandise. (a) Must the partnership pay for the merchandise? Why? (b) Does your answer differ if Amy and Lester are partners in a public accounting firm? Explain.

## QUICK STUDY

### QS D-1

Partnership liability

C1



Ann Stolton and Susie Bright are partners in a business they started two years ago. The partnership agreement states that Stolton should receive a salary allowance of \$15,000 and that Bright should receive a \$20,000 salary allowance. Any remaining income or loss is to be shared equally. Determine each partner's share of the current year's net income of \$52,000.

### QS D-2

Partnership income allocation

P2

Blake and Matthew are partners who agree that Blake will receive a \$100,000 salary allowance and that any remaining income or loss will be shared equally. If Matthew's capital account is credited for \$2,000 as his share of the net income in a given period, how much net income did the partnership earn in that period?

### QS D-3

Partnership income allocation

P2



Fancher organized a limited partnership and is the only general partner. Carley invested \$20,000 in the partnership and was admitted as a limited partner with the understanding that she would receive 10% of the profits. After two unprofitable years, the partnership ceased doing business. At that point, partnership liabilities were \$85,000 larger than partnership assets. How much money can the partnership's creditors obtain from Carley's personal assets to satisfy the unpaid partnership debts?

### QS D-4

Liability in limited partnerships

P1



Stein agrees to pay Choi and Amal \$10,000 each for a one-third (33⅓%) interest in the Choi and Amal partnership. Immediately prior to Stein's admission, each partner had a \$30,000 capital balance. Make the journal entry to record Stein's purchase of the partners' interest.

### QS D-5

Partner admission through purchase of interest

P3

Jules and Johnson are partners, each with \$40,000 in their partnership capital accounts. Kwon is admitted to the partnership by investing \$40,000 cash. Make the entry to show Kwon's admission to the partnership.

### QS D-6

Admission of a partner

P3

The Field, Brown & Snow partnership was begun with investments by the partners as follows: Field, \$131,250; Brown, \$165,000; and Snow, \$153,750. The operations did not go well, and the partners eventually decided to liquidate the partnership, sharing all losses equally. On May 31, after all assets were converted to cash and all creditors were paid, only \$45,000 in partnership cash remained.

### QS D-7

Liquidation of partnership

P4

1. Compute the capital account balance of each partner after the liquidation of assets and the payment of creditors.
2. Assume that any partner with a deficit agrees to pay cash to the partnership to cover the deficit. Present the journal entries on May 31 to record (a) the cash receipt from the deficient partner(s) and (b) the final disbursement of cash to the partners.
3. Assume that any partner with a deficit is not able to reimburse the partnership. Present journal entries (a) to transfer the deficit of any deficient partners to the other partners and (b) to record the final disbursement of cash to the partners.

**Check** (1) Field, \$(3,750)

Howe and Duley's company is organized as a partnership. At the prior year-end, partnership equity totaled \$150,000 (\$100,000 from Howe and \$50,000 from Duley). For the current year, partnership net income is \$24,990 (\$20,040 allocated to Howe and \$4,950 allocated to Duley), and year-end total partnership equity is \$200,000 (\$140,000 from Howe and \$60,000 from Duley). Compute the total partnership return on equity and the individual partner return on equity ratios.

### QS D-8

Partner return on equity

A1



## EXERCISES

Next to the following list of eight characteristics of business organizations, enter a brief description of how each characteristic applies to general partnerships.

### Exercise D-1

Characteristics of partnerships

C1

Characteristic	Application to General Partnerships
1. Life .....	
2. Owners' liability .....	
3. Legal status .....	
4. Tax status of income .....	
5. Owners' authority .....	
6. Ease of formation .....	
7. Transferability of ownership .....	
8. Ability to raise large amounts of capital .....	

### Exercise D-2

Forms of organization

C1



For each of the following separate cases, recommend a form of business organization. With each recommendation, explain how business income would be taxed if the owners adopt the form of organization recommended. Also list several advantages that the owners will enjoy from the form of business organization that you recommend.

- Sharif, Henry and Korb are recent college graduates in computer science. They want to start a Website development company. They all have college debts and currently do not own any substantial computer equipment needed to get the company started.
- Dr. Ward and Dr. Liu are recent graduates from medical residency programs. Both are family practice physicians and would like to open a clinic in an underserved rural area. Although neither has any funds to bring to the new venture, an investor has expressed interest in making a loan to provide start-up funds for their practice.
- Munson has been out of school for about five years and has become quite knowledgeable about the residential real estate market. He would like to organize a company that buys and sells real estate. Munson believes he has the expertise to manage the company but needs funds to invest in residential property.

### Exercise D-3

Journalizing partnership transactions

P2

On March 1, 2013, Eckert and Kelley formed a partnership. Eckert contributed \$82,500 cash and Kelley contributed land valued at \$60,000 and a building valued at \$100,000. The partnership also assumed responsibility for Kelley's \$92,500 long-term note payable associated with the land and building. The partners agreed to share income as follows: Eckert is to receive an annual salary allowance of \$25,000, both are to receive an annual interest allowance of 10% of their beginning-year capital investment, and any remaining income or loss is to be shared equally. On October 20, 2013, Eckert withdrew \$34,000 cash and Kelley withdrew \$20,000 cash. After the adjusting and closing entries are made to the revenue and expense accounts at December 31, 2013, the Income Summary account had a credit balance of \$90,000.

- Prepare journal entries to record (a) the partners' initial capital investments, (b) their cash withdrawals, and (c) the December 31 closing of both the Withdrawals and Income Summary accounts.
- Determine the balances of the partners' capital accounts as of December 31, 2013.

**Check** (2) Kelley, \$79,250

### Exercise D-4

Journalizing partnership formation

P2

Angela Moss and Autumn Barber organize a partnership on January 1. Moss's initial net investment is \$75,000, consisting of cash (\$17,500), equipment (\$82,500), and a note payable reflecting a bank loan for the new business (\$25,000). Barber's initial investment is cash of \$31,250. These amounts are the values agreed on by both partners. Prepare journal entries to record (1) Moss's investment and (2) Barber's investment.

### Exercise D-5

Income allocation in a partnership

P2

Kramer and Knox began a partnership by investing \$60,000 and \$80,000, respectively. During its first year, the partnership earned \$160,000. Prepare calculations showing how the \$160,000 income should be allocated to the partners under each of the following three separate plans for sharing income and loss: (1) the partners failed to agree on a method to share income; (2) the partners agreed to share income and loss in proportion to their initial investments (round amounts to the nearest dollar); and (3) the partners agreed to share income by granting a \$50,000 per year salary allowance to Kramer, a \$40,000 per year salary allowance to Knox, 10% interest on their initial capital investments, and the remaining balance shared equally.

**Check** Plan 3, Kramer, \$84,000

Assume that the partners of Exercise D-5 agreed to share net income and loss by granting annual salary allowances of \$50,000 to Kramer and \$40,000 to Knox, 10% interest allowances on their investments, and any remaining balance shared equally.

1. Determine the partners' shares of Kramer and Knox given a first-year net income of \$98,800.
2. Determine the partners' shares of Kramer and Knox given a first-year net loss of \$16,800.

**Exercise D-6**

Income allocation in a partnership

P2

**Check** (2) Kramer, \$(4,400)

The Struter Partnership has total partners' equity of \$510,000, which is made up of Main, Capital, \$400,000, and Frist, Capital, \$110,000. The partners share net income and loss in a ratio of 80% to Main and 20% to Frist. On November 1, Madison is admitted to the partnership and given a 15% interest in equity and a 15% share in any income and loss. Prepare the journal entry to record the admission of Madison under each of the following separate assumptions: Madison invests cash of (1) \$90,000; (2) \$120,000; and (3) \$80,000.

**Exercise D-7**

Admission of new partner

P3

Hunter, Folgers, and Tulip have been partners while sharing net income and loss in a 5:3:2 ratio. On January 31, the date Tulip retires from the partnership, the equities of the partners are Hunter, \$150,000; Folgers, \$90,000; and Tulip, \$60,000. Present journal entries to record Tulip's retirement under each of the following separate assumptions: Tulip is paid for her equity using partnership cash of (1) \$60,000; (2) \$80,000; and (3) \$30,000.

**Exercise D-8**

Retirement of partner

P3

The partners in the Biz Partnership have agreed that partner Mandy may sell her \$100,000 equity in the partnership to Brittney, for which Brittney will pay Mandy \$85,000. Present the partnership's journal entry to record the sale of Mandy's interest to Brittney on September 30.

**Exercise D-9**

Sale of partnership interest

P3

Turner, Roth, and Lowe are partners who share income and loss in a 1:4:5 ratio. After lengthy disagreements among the partners and several unprofitable periods, the partners decide to liquidate the partnership. Immediately before liquidation, the partnership balance sheet shows total assets, \$126,000; total liabilities, \$78,000; Turner, Capital, \$2,500; Roth, Capital, \$14,000; and Lowe, Capital, \$31,500. The cash proceeds from selling the assets were sufficient to repay all but \$28,000 to the creditors. (a) Calculate the loss from selling the assets. (b) Allocate the loss to the partners. (c) Determine how much of the remaining liability should be paid by each partner.

**Exercise D-10**

Liquidation of partnership

P4

**Check** (b) Lowe, Capital after allocation, \$(6,500)

Assume that the Turner, Roth, and Lowe partnership of Exercise D-10 is a limited partnership. Turner and Roth are general partners and Lowe is a limited partner. How much of the remaining \$28,000 liability should be paid by each partner? (Round amounts to the nearest dollar.)

**Exercise D-11**

Liquidation of limited partnership

P4

Rugged Sports Enterprises LP is organized as a limited partnership consisting of two individual partners: Hockey LP and Football LP. Both partners separately operate a minor league hockey team and a semipro football team. Compute partner return on equity for each limited partnership (and the total) for the year ended June 30, 2013, using the following selected data on partner capital balances from Rugged Sports Enterprises LP.

**Exercise D-12**

Partner return on equity

A1



	Hockey LP	Football LP	Total
Balance at 6/30/2012 . . . . .	\$189,000	\$ 758,000	\$ 947,000
Annual net income . . . . .	22,208	445,473	468,032
Cash distribution . . . . .	—	(50,000)	(50,000)
Balance at 6/30/2013 . . . . .	<u>\$211,134</u>	<u>\$1,153,898</u>	<u>\$1,365,032</u>

**PROBLEM SET A**

**Problem D-1A**

Allocating partnership income



**Check** (3) Thomas, Capital, \$97,800

Kara Ries, Tammy Bax, and Joe Thomas invested \$80,000, \$112,000, and \$128,000, respectively, in a partnership. During its first calendar year, the firm earned \$249,000.

**Required**

Prepare the entry to close the firm's Income Summary account as of its December 31 year-end and to allocate the \$249,000 net income to the partners under each of the following separate assumptions: The partners (1) have no agreement on the method of sharing income and loss; (2) agreed to share income and loss in the ratio of their beginning capital investments; and (3) agreed to share income and loss by providing annual salary allowances of \$66,000 to Ries, \$56,000 to Bax, and \$80,000 to Thomas; granting 10% interest on the partners' beginning capital investments; and sharing the remainder equally.

**Problem D-2A**

Allocating partnership income and loss; sequential years

P2



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Irene Watts and John Lyon are forming a partnership to which Watts will devote one-half time and Lyon will devote full time. They have discussed the following alternative plans for sharing income and loss: (a) in the ratio of their initial capital investments, which they have agreed will be \$42,000 for Watts and \$63,000 for Lyon; (b) in proportion to the time devoted to the business; (c) a salary allowance of \$6,000 per month to Lyon and the balance in accordance with the ratio of their initial capital investments; or (d) a salary allowance of \$6,000 per month to Lyon, 10% interest on their initial capital investments, and the balance shared equally. The partners expect the business to perform as follows: year 1, \$36,000 net loss; year 2, \$90,000 net income; and year 3, \$150,000 net income.

**Required**

Prepare three tables with the following column headings.

Income (Loss) Sharing Plan	Year _____		
	Calculations	Watts	Lyon

Complete the tables, one for each of the first three years, by showing how to allocate partnership income or loss to the partners under each of the four plans being considered. (Round answers to the nearest whole dollar.)

**Check** Plan d, year 1, Lyon's share, \$19,050

**Problem D-3A**

Partnership income allocation, statement of partners' equity, and closing entries

P2



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Bill Beck, Bruce Beck, and Barb Beck formed the BBB Partnership by making capital contributions of \$67,500, \$262,500, and \$420,000, respectively. They predict annual partnership net income of \$450,000 and are considering the following alternative plans of sharing income and loss: (a) equally; (b) in the ratio of their initial capital investments; or (c) salary allowances of \$80,000 to Bill, \$60,000 to Bruce, and \$90,000 to Barb; interest allowances of 10% on their initial capital investments; and the balance shared as follows: 20% to Bill, 40% to Bruce, and 40% to Barb..

**Required**

1. Prepare a table with the following column headings.

Income (Loss) Sharing Plan	Calculations	Year _____			Total
		Bill	Bruce	Barb	

Use the table to show how to distribute net income of \$450,000 for the calendar year under each of the alternative plans being considered. (Round answers to the nearest whole dollar.)

- Prepare a statement of partners' equity showing the allocation of income to the partners assuming they agree to use plan (c), that income earned is \$209,000, and that Bill, Bruce, and Barb withdraw \$34,000, \$48,000, and \$64,000, respectively, at year-end.
- Prepare the December 31 journal entry to close Income Summary assuming they agree to use plan (c) and that net income is \$209,000. Also close the withdrawals accounts.

**Check** (2) Barb, Ending Capital, \$449,600

**Part 1.** Meir, Benson, and Lau are partners and share income and loss in a 3:2:5 ratio. The partnership's capital balances are as follows: Meir, \$168,000; Benson, \$138,000; and Lau, \$294,000. Benson decides to withdraw from the partnership, and the partners agree to not have the assets revalued upon Benson's retirement. Prepare journal entries to record Benson's February 1 withdrawal from the partnership under each of the following separate assumptions: Benson (a) sells her interest to North for \$160,000 after Meir and Lau approve the entry of North as a partner; (b) gives her interest to a son-in-law, Schmidt, and thereafter Meir and Lau accept Schmidt as a partner; (c) is paid \$138,000 in partnership cash for her equity; (d) is paid \$214,000 in partnership cash for her equity; and (e) is paid \$30,000 in partnership cash plus equipment recorded on the partnership books at \$70,000 less its accumulated depreciation of \$23,200.

**Part 2.** Assume that Benson does not retire from the partnership described in Part 1. Instead, Rhode is admitted to the partnership on February 1 with a 25% equity. Prepare journal entries to record Rhode's entry into the partnership under each of the following separate assumptions: Rhode invests (a) \$200,000; (b) \$145,000; and (c) \$262,000.

**Problem D-4A**

Partner withdrawal and admission

P3

Sage 50 **Check** (1e) Cr. Lau, Capital, \$38,250

(2c) Cr. Benson, Capital, \$9,300

Kendra, Cogley, and Mei share income and loss in a 3:2:1 ratio. The partners have decided to liquidate their partnership. On the day of liquidation their balance sheet appears as follows.

KENDRA, COGLEY, AND MEI Balance Sheet May 31			
<b>Assets</b>		<b>Liabilities and Equity</b>	
Cash .....	\$180,800	Accounts payable .....	\$245,500
Inventory .....	537,200	Kendra, Capital .....	93,000
		Cogley, Capital .....	212,500
		Mei, Capital .....	167,000
Total assets .....	<u>\$718,000</u>	Total liabilities and equity .....	<u>\$718,000</u>

**Problem D-5A**

Liquidation of a partnership

P4

Sage 50 **Required**

Prepare journal entries for (a) the sale of inventory, (b) the allocation of its gain or loss, (c) the payment of liabilities at book value, and (d) the distribution of cash in each of the following separate cases: Inventory is sold for (1) \$600,000; (2) \$500,000; (3) \$320,000 and any partners with capital deficits pay in the amount of their deficits; and (4) \$250,000 and the partners have no assets other than those invested in the partnership. (Round to the nearest dollar.)

**Check** (4) Cash distribution: Mei, \$102,266

Mark Albin, Roland Peters and Sam Ramsey invested \$164,000, \$98,400 and \$65,600, respectively, in a partnership. During its first calendar year, the firm earned \$270,000.

**Required**

Prepare the entry to close the firm's Income Summary account as of its December 31 year-end and to allocate the \$270,000 net income to the partners under each of the following separate assumptions. (Round answers to whole dollars.) The partners (1) have no agreement on the method of sharing income and loss; (2) agreed to share income and loss in the ratio of their beginning capital investments; and (3) agreed to share income and loss by providing annual salary allowances of \$96,000 to Albin, \$72,000 to Peters, and \$50,000 to Ramsey; granting 10% interest on the partners' beginning capital investments; and sharing the remainder equally.

**PROBLEM SET B****Problem D-1B**

Allocating partnership income

P2

**Check** (3) Ramsey, Capital, \$62,960

Maria Bell and J.R. Green are forming a partnership to which Bell will devote one-third time and Green will devote full time. They have discussed the following alternative plans for sharing income and loss: (a) in the ratio of their initial capital investments, which they have agreed will be \$104,000 for Bell and \$156,000 for Green; (b) in proportion to the time devoted to the business; (c) a salary allowance of \$4,000 per month to Green and the balance in accordance with the ratio of their initial capital investments; or

**Problem D-2B**

Allocating partnership income and loss; sequential years

P2

(d) a salary allowance of \$4,000 per month to Green, 10% interest on their initial capital investments, and the balance shared equally. The partners expect the business to perform as follows: year 1, \$36,000 net loss; year 2, \$76,000 net income; and year 3, \$188,000 net income.

**Required**

Prepare three tables with the following column headings.

Income (Loss) Sharing Plan	Year _____		
	Calculations	Bell	Green

Complete the tables, one for each of the first three years, by showing how to allocate partnership income or loss to the partners under each of the four plans being considered. (Round answers to the nearest whole dollar.)

**Check** Plan d, year 1, Green's share, \$8,600

**Problem D-3B**

Partnership income allocation, statement of partners' equity, and closing entries

P2

Sally Cook, Lin Xi, and Ken Schwartz formed the CXS Partnership by making capital contributions of \$144,000, \$216,000, and \$120,000, respectively. They predict annual partnership net income of \$240,000 and are considering the following alternative plans of sharing income and loss: (a) equally; (b) in the ratio of their initial capital investments; or (c) salary allowances of \$40,000 to Cook, \$30,000 to Xi, and \$80,000 to Schwartz; interest allowances of 12% on their initial capital investments; and the balance shared equally.

**Required**

1. Prepare a table with the following column headings.

Income (Loss) Sharing Plan	Calculations	Cook	Xi	Schwartz	Total

Use the table to show how to distribute net income of \$240,000 for the calendar year under each of the alternative plans being considered. (Round answers to the nearest whole dollar.)

2. Prepare a statement of partners' equity showing the allocation of income to the partners assuming they agree to use plan (c), that income earned is \$87,600, and that Cook, Xi, and Schwartz withdraw \$18,000, \$38,000, and \$24,000, respectively, at year-end.
3. Prepare the December 31 journal entry to close Income Summary assuming they agree to use plan (c) and that net income is \$87,600. Also close the withdrawals accounts.

**Check** (2) Schwartz, Ending Capital, \$150,400

**Problem D-4B**

Partner withdrawal and admission

P3

**Part 1.** Gibbs, Cook, and Chan are partners and share income and loss in a 5:1:4 ratio. The partnership's capital balances are as follows: Gibbs, \$606,000; Cook, \$148,000; and Chan, \$446,000. Gibbs decides to withdraw from the partnership, and the partners agree not to have the assets revalued upon Gibbs's retirement. Prepare journal entries to record Gibbs's April 30 withdrawal from the partnership under each of the following separate assumptions: Gibbs (a) sells her interest to Brady for \$250,000 after Cook and Chan approve the entry of Brady as a partner; (b) gives her interest to a daughter-in-law, Cannon, and thereafter Cook and Chan accept Cannon as a partner; (c) is paid \$606,000 in partnership cash for her equity; (d) is paid \$350,000 in partnership cash for her equity; and (e) is paid \$200,000 in partnership cash plus manufacturing equipment recorded on the partnership books at \$538,000 less its accumulated depreciation of \$336,000.

**Part 2.** Assume that Gibbs does not retire from the partnership described in Part 1. Instead, Chip is admitted to the partnership on April 30 with a 20% equity. Prepare journal entries to record the entry of Brise under each of the following separate assumptions: Chip invests (a) \$300,000; (b) \$196,000; and (c) \$426,000.

**Check** (1e) Cr. Chan, Capital, \$163,200

**Check** (2c) Cr. Cook, Capital, \$10,080



Lasure, Ramirez, and Toney, who share income and loss in a 2:1:2 ratio, plan to liquidate their partnership. At liquidation, their balance sheet appears as follows.

LASURE, RAMIREZ, AND TONEY			
Balance Sheet			
January 18			
<b>Assets</b>		<b>Liabilities and Equity</b>	
Cash .....	\$348,600	Accounts payable .....	\$342,600
Equipment .....	617,200	Lasure, Capital .....	300,400
		Ramirez, Capital .....	195,800
		Toney, Capital .....	127,000
Total assets .....	<u>\$965,800</u>	Total liabilities and equity .....	<u>\$965,800</u>

### Required

Prepare journal entries for (a) the sale of equipment, (b) the allocation of its gain or loss, (c) the payment of liabilities at book value, and (d) the distribution of cash in each of the following separate cases: Equipment is sold for (1) \$650,000; (2) \$530,000; (3) \$200,000 and any partners with capital deficits pay in the amount of their deficits; and (4) \$150,000 and the partners have no assets other than those invested in the partnership. (Round amounts to the nearest dollar.)

### Problem D-5B

Liquidation of a partnership

P4

**Check** (4) Cash distribution:  
Lasure, \$73,600

(This serial problem began in Chapter 1 and continues through most of the book. If previous chapter segments were not completed, the serial problem can begin at this point. It is helpful, but not necessary, to use the Working Papers that accompany the book.)

**SP D** At the start of 2014, Adria Lopez is considering adding a partner to her business. She envisions the new partner taking the lead in generating sales of both services and merchandise for Success Systems. A. Lopez's equity in Success Systems as of January 1, 2014, is reflected in the following capital balance.

A. Lopez, Capital .....	\$90,148
-------------------------	----------

### Required

1. A. Lopez is evaluating whether the prospective partner should be an equal partner with respect to capital investment and profit sharing (1:1) or whether the agreement should be 4:1 with Lopez retaining four-fifths interest with rights to four-fifths of the net income or loss. What factors should she consider in deciding which partnership agreement to offer?
2. Prepare the January 1, 2014, journal entry(ies) necessary to admit a new partner to Success Systems through the purchase of a partnership interest for each of the following two separate cases: (a) 1:1 sharing agreement and (b) 4:1 sharing agreement.
3. Prepare the January 1, 2014, journal entry(ies) required to admit a new partner if the new partner invests cash of \$22,537.
4. After posting the entry in part 3, what would be the new partner's equity percentage?

### SERIAL PROBLEM

Success Systems

P3

## Beyond the Numbers

**BTN D-1** Take a step back in time and imagine **Polaris** in its infancy as a company. The year is 1954.

### Required

1. Read the history of Polaris at [www.Polaris.com](http://www.Polaris.com). Identify the founder of the company.
2. Assume that Polaris was originally organized as a partnership. Polaris's income statement in Appendix A varies in several key ways from what it would look like for a partnership. Identify at least two ways in which a corporate income statement differs from a partnership income statement.
3. Compare the Polaris balance sheet in Appendix A to what a partnership balance sheet would have shown. Identify and explain any account differences we would anticipate.

### REPORTING IN ACTION

C1



**Polaris**

## COMPARATIVE ANALYSIS



**Polaris**  
Arctic Cat

**BTN D-2** Over the years **Polaris** and **Arctic Cat** have evolved into large corporations. Today it is difficult to imagine them as fledgling start-ups. Research each company's history online.

### Required

1. Which company is older?
2. In what years did each company have its first public offering of stock?
3. Which stock exchange is each company listed under?

## ETHICS CHALLENGE



**BTN D-3** Doctors Mobey, Oak, and Chesterfield have been in a group practice for several years. Mobey and Oak are family practice physicians, and Chesterfield is a general surgeon. Chesterfield receives many referrals for surgery from his family practice partners. Upon the partnership's original formation, the three doctors agreed to a two-part formula to share income. Every month each doctor receives a salary allowance of \$3,000. Additional income is divided according to a percent of patient charges the doctors generate for the month. In the current month, Mobey generated 10% of the billings, Oak 30%, and Chesterfield 60%. The group's income for this month is \$50,000. Chesterfield has expressed dissatisfaction with the income-sharing formula and asks that income be split entirely on patient charge percents.

### Required

1. Compute the income allocation for the current month using the original agreement.
2. Compute the income allocation for the current month using Chesterfield's proposed agreement.
3. Identify the ethical components of this partnership decision for the doctors.

## COMMUNICATING IN PRACTICE

C1

**BTN D-4** Assume that you are studying for an upcoming accounting exam with a good friend. Your friend says that she has a solid understanding of general partnerships but is less sure that she understands organizations that combine certain characteristics of partnerships with other forms of business organization. You offer to make some study notes for your friend to help her learn about limited partnerships, limited liability partnerships, S corporations, and limited liability companies. Prepare a one-page set of well-organized, complete study notes on these four forms of business organization.

## TAKING IT TO THE NET



**BTN D-5** Access the March 14, 2011, filing of the December 31, 2010, 10-K of **America First Tax Exempt Investors LP**. This company deals with tax-exempt mortgage revenue bonds that, among other things, finance student housing properties.

1. Locate its December 31, 2010, balance sheet and list the account titles reported in the equity section of the balance sheet.
2. Locate its statement of partners' capital and comprehensive income (loss). How many units of limited partnership (known as "beneficial unit certificate holders") are outstanding at December 31, 2010?
3. What is the partnership's largest asset and its amount at December 31, 2010?

## TEAMWORK IN ACTION

P2

**BTN D-6** This activity requires teamwork to reinforce understanding of accounting for partnerships.

### Required

1. Assume that Baker, Warner, and Rice form the BWR Partnership by making capital contributions of \$200,000, \$300,000, and \$500,000, respectively. BWR predicts annual partnership net income of \$450,000. The partners are considering various plans for sharing income and loss. Assign a different team member to compute how the projected \$450,000 income would be shared under each of the following separate plans:
  - a. Shared equally.
  - b. In the ratio of the partners' initial capital investments.
  - c. Salary allowances of \$50,000 to Baker, \$60,000 to Warner, and \$70,000 to Rice, with the remaining balance shared equally.
  - d. Interest allowances of 10% on the partners' initial capital investments, with the remaining balance shared equally.

- In sequence, each member is to present his or her income-sharing calculations with the team.
- As a team, identify and discuss at least one other possible way that income could be shared.

**BTN D-7** Omar Soliman and Nick Friedman are founding partners of their company, **College Hunks Hauling Junk LLC**. Assume that Omar and Nick decide to expand their business with the help of general partners.

### ENTREPRENEURIAL DECISION



#### Required

- What details should Omar, Nick, and their future partners specify in the general partnership agreements?
- What advantages should Omar, Nick, and their future partners be aware of with respect to organizing as a general partnership?
- What disadvantages should Omar, Nick, and their future partners be aware of with respect to organizing as a general partnership?

**BTN D-8** Access **KTM's** Website ([www.KTM.com](http://www.KTM.com)) and research the company's history (profile).

- When did the company go public?
- What stock exchange is the company listed under?
- What are the companies that are part of KTM?

### GLOBAL DECISION



**KTM**

## ANSWERS TO MULTIPLE CHOICE QUIZ

- e; Capital = \$250,000 - \$50,000
- a;  $\$90,000 \times [\$100,000 / (\$150,000 + \$150,000 + \$100,000)] = \$22,500$
- d;
- b; Total partnership equity = \$125,000 + \$124,000 + \$75,000 = \$324,000  
Equity of Black = \$324,000 × 20% = \$64,800  
Bonus to old partners = \$75,000 - \$64,800 = \$10,200, split equally
- a;  $\$10,500 / [(\$110,000 + \$124,000) / 2] = \underline{8.97\%}$

	Jamison	Blue	Total
Net income . . . . .			\$ 270,000
Salary allowance . . . . .	\$120,000		(120,000)
Interest allowance . . . . .	60,000	\$80,000	(140,000)
Balance of income . . . . .			10,000
Balance divided equally . . . . .	5,000	5,000	(10,000)
Totals . . . . .	<u>\$185,000</u>	<u>\$85,000</u>	<u>\$ 0</u>