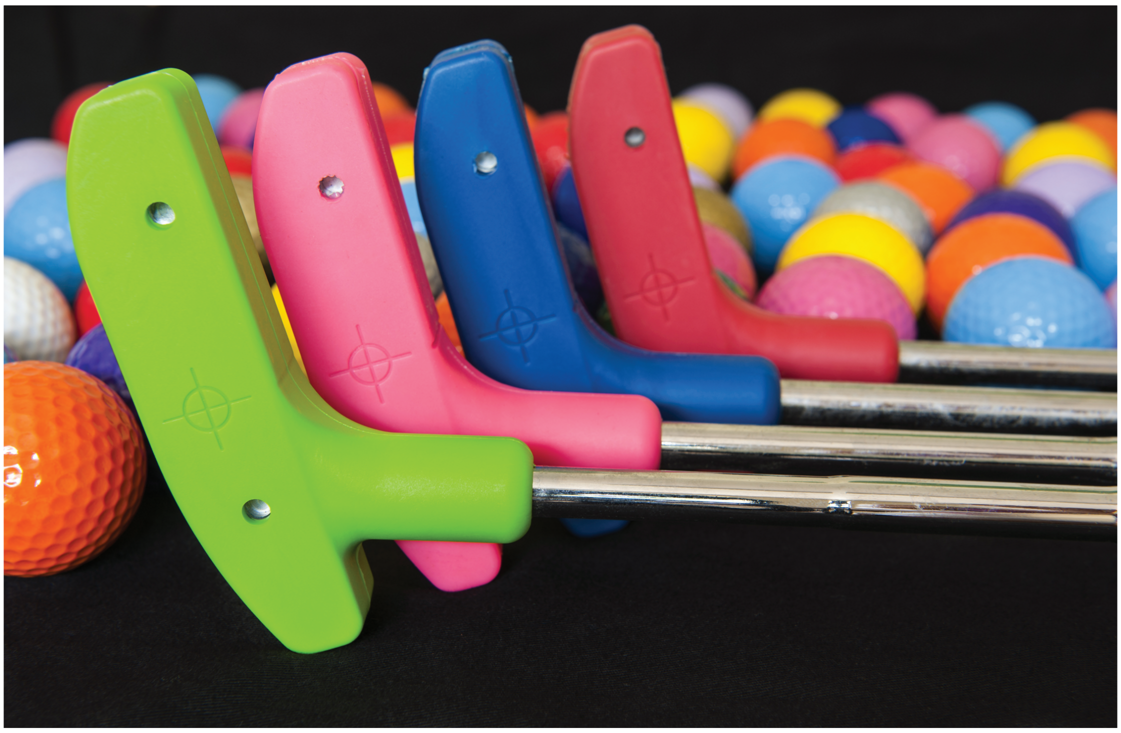
12 PARTNERSHIPS

CONNECTING CHAPTER 12

LEARNING OBJECTIVE 6 Account for the liquidation of a partnership

How do we account for the ending of a partnership?

MyAccountingLab The **Summary** for Chapter 12 appears on page xx. This lists all of the MyAccountingLab resources. **Accounting Vocabulary** with definitions for this chapter's material appears on page xx.



Jenny Lo and Sam Lachlan are considering opening a miniature golf course in Wasaga Beach, Ontario. The golf course will have 18 holes with dinosaurs, windmills, water features, and more. Jenny has been carefully evaluating the tourism industry in the town and believes that the golf course will be busy enough during the summer tourist season to close during the winter months, allowing Jenny and Sam plenty of time to ski and snowboard in the off season.

Jenny and Sam are considering organizing the business as a partnership. Jenny is willing to contribute a piece of property in the prime downtown area that she just inherited. She is also interested in managing the day-to-day operations of the business. Sam, with his degree in accounting, has agreed to handle the accounting and business aspects of the golf course.

Now all Jenny and Sam need to decide is how the partnership will be organized. Some questions they are considering include, What are the specific responsibilities of each partner? How should profits and losses be shared between the partners? What if one of the partners wants out of the partnership in the future? How would the partnership add a new partner?

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

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

A partnership combines the assets, talents, and experience of the partners. Business opportunities closed to an individual may open up to a partnership. As the chapter-opening story illustrates, this is an important characteristic of a partnership. The miniature golf course will likely be successful because it is able to combine the skills of its two owners. It is unlikely that Jenny or Sam would be able to operate the business as well if either tried to do it on his or her own.

Partnerships come in all sizes. Many partnerships have fewer than 10 partners. Some medical practices may have 10 or more partners, while some of the largest law firms in Canada have more than 500 partners. The largest accounting firm in Canada has more than 800 partners. Exhibit 12–1 lists the 10 largest public accounting firms in Canada. The majority of them are partnerships.

EXHIBIT 12–1 | The 10 Largest Accounting Firms in Canada (by Revenue)

Rank 2013	Firm	Partners	Professional Staff	Offices
1	Deloitte LLP	865	5,316	55
2	PricewaterhouseCoopers LLP	513	4,263	25
3	KPMG LLP	696	3,795	37
4	Ernst & Young LLP	358	2,992	17
5	Grant Thornton Canada	404	2,983	135
6	MNP LLP	357	1,026	58
7	BDO Canada LLP	392	2,229	111
8	Collins Barrow	207	541	41
9	Richter	58	415	2
10	Mallette	66	472	24

Source: "Canada's Accounting Top 30," *The Bottom Line*, April 2014, www.thebottomlinenews.ca/documents/Canadas_Accounting_Top_30.pdf, accessed August 1, 2014.

Why It's Done This Way

Objective of Financial Reporting

Beginning with this chapter, you will learn more about the different types of organization structures that were first introduced in Chapter 1. So far, we have only really looked at accounting for proprietorships.

The good news is that the principles and concepts in the accounting framework apply equally to all types of organizations, including partnerships. Accounting differences among types of organizations only relate to the equity section of the balance sheet.

[1] Smyth, J.E., D.A. Soberman, A.J. Easson, and S.S. McGill, *The Law and Business Administration in Canada*, 13th ed. (Toronto: Pearson Canada Inc., 2013), 598–602.

CHARACTERISTICS OF A PARTNERSHIP

Starting a partnership is voluntary. A person cannot be forced to join a partnership, and partners cannot be forced to accept another person as a partner (unless existing partners vote and the majority accept the new partner). The following characteristics distinguish partnerships from proprietorships and from corporations.

LO 1

What are the characteristics of a partnership?

The Written Partnership Agreement

A business partnership is somewhat like a marriage. To be successful, the partners must cooperate. However, business partners do not vow to remain together for life. To make certain that each partner fully understands how the partnership operates, partners should draw up a **partnership agreement**. Although the partnership agreement may be oral, a written agreement between the partners reduces the chance of a misunderstanding. This agreement is a contract between the partners, so transactions under the agreement are governed by contract law. The provincial legislatures in Canada have passed their respective versions of a partnership act, the terms of which apply in the absence of a partnership agreement or in the absence of particular matters in the partnership agreement.[2]

The partnership agreement should specify the following points:

- Name, location, and nature of the business
- Name, capital investment, and duties of each partner
- Procedures for admitting a new partner
- Method of sharing profits and losses among the partners
- Withdrawals of assets allowed to the partners
- Procedures for settling disputes among the partners
- Procedures for settling with a partner who withdraws from the firm
- Procedures for removing a partner who will not withdraw or retire from the partnership voluntarily
- Procedures for liquidating the partnership—selling the assets, paying the liabilities, and giving any remaining cash to the partners

KEY POINTS

A partnership is not required to have a formal written agreement. But a written agreement prevents confusion as to the sharing of profits and losses, partners' responsibilities, admission of new partners, how the partnership will be liquidated, and so on. However, there can still be disagreements even when there is a written agreement.

Limited Life

A partnership has a limited life. If one partner withdraws from the business or dies, the partnership dissolves and its books are closed. If the remaining partners want to continue as partners in the same business, they form a new partnership with a new set of financial records and a new partnership agreement. **Dissolution** is the ending of a partnership and does not require liquidation; that is, the assets need not be sold to outside parties for a new partnership to be created. Often the new partnership continues the former partnership's business, and the new partnership may choose to continue to use the dissolved partnership's name. Some types of large partnerships, such as PricewaterhouseCoopers LLP (PwC), retain the firm name even after partners resign from the firm.

Mutual Agency

Mutual agency means that every partner is a mutual agent of the firm. Any partner can bind the business to a contract within the scope of the partnership's regular business operations. If a partner enters into a contract with a person or another business to provide a service, then the firm—not just the partner who signed the contract—is bound to provide that service. If the partner signs a contract to buy her

[2] Ibid., 598–618.

own car, however, the partnership is not liable because the car is a personal matter; it is not within the scope of the regular business operations of the partnership.

The following example shows the impact mutual agency can have on a partnership. Richard Harding and Simon Davis formed a partnership to deal in lumber and other building materials. The partners agreed that their company should not handle brick or any stone materials and that neither partner had the right to purchase these commodities. While Harding was away during the summer, Davis purchased a quantity of these materials for the company because he could buy them at a cheap price. Two months later, when Harding returned, business was very slow, and brick and stone were selling at a price lower than Davis had paid for them. Harding, therefore, refused to accept any more deliveries under the contract. Harding argued that Davis had no authority to buy these goods since the partnership was not organized to deal in brick and stone. The supplier of the brick and stone said that he did not know the partnership was not in the brick and stone business. In fact, he believed that it did handle these goods since all of the other lumber companies in the area bought or sold brick and stone. Because the supplier acted in good faith, he claimed that Harding and Davis should accept the remaining deliveries of brick and stone according to the agreement that was made. Who is correct? Under normal circumstances, the brick and stone supplier is correct because the mutual agency characteristic of a partnership allows partners to bind each other in business contracts. The agreements made within the partnership would not be known by an outside party like the supplier, so the supplier would have a solid case and could sue the partnership to abide by the contract.[3]

LEARNING TIPS

Chapter 1 introduced these concepts for a sole proprietorship. You may want to go back and review them now.

Unlimited Liability

Each partner has **unlimited personal liability** for the debts of the business. When a partnership cannot pay its debts with business assets, the partners must pay with their personal assets. (There are exceptions, which are described in the next section, Types of Partnerships.) If either partner is unable to pay his or her part of the debt, the other partner (or partners) must make payment.

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

Co-ownership of Property

Any asset—cash, inventory, machinery, computers, and so on—that a partner invests into the partnership becomes the joint property of all the partners. The partner who invested the asset is no longer its sole owner.

No Partnership Income Tax

The partnership *reports* its income to the government tax authority (the Canada Revenue Agency), but the partnership pays *no* income tax. The net income of the partnership is divided and flows through the business to the partners, who pay personal income tax on their share.

For example, suppose that the Willis & Jones partnership earned net income of $150,000, shared equally by the two partners. The partnership would pay no income tax *as a business entity*. However, each partner would pay income tax *as an individual* on his or her $75,000 share of partnership income.

[3] This case is based on the scenario described at ChestofBooks.com, "B. Apparent Scope of Authority," http://chestofbooks.com/business/law/Case-Method/B-Apparent-Scope-Of-Authority.html#ixzz1qimHxY2o, accessed August 14, 2012.

Advantages/Disadvantages

Exhibit 12–2 lists the advantages and disadvantages of partnerships (compared with proprietorships and corporations). Most features of a proprietorship also apply to a partnership, most importantly:

- Limited life
- Unlimited liability
- No business income tax

EXHIBIT 12–2 | Advantages and Disadvantages of Partnerships

Partnership Advantages	Partnership Disadvantages
Versus Proprietorships: • A partnership can raise more capital since capital comes from more than one person. • A partnership brings together the abilities of more than one person. • Partners working well together can achieve more than by working alone: $1 + 1 >$ in a good partnership. ***Versus Corporations:*** • A partnership is less expensive to organize than a corporation, which requires articles of incorporation from a province or the federal government. • A partnership is subject to fewer governmental regulations and restrictions than is a corporation.	• A partnership agreement may be difficult to formulate. Each time a new partner is admitted or a partner leaves the partnership, the business needs a new partnership agreement. • Relationships among partners may be fragile. It is hard to find the right partner. • Mutual agency and unlimited liability create personal obligations for each partner. • Lack of continuity of the business is faced by a partnership but not a corporation.

TYPES OF PARTNERSHIPS

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

General Partnerships

A **general partnership** is the basic form of partnership organization. Each partner is a co-owner of the business with all the privileges and risks of ownership. The general partners share the profits, losses, and the risks of the business.

Limited Partnerships

Partners can avoid unlimited personal liability for partnership obligations by forming a *limited partnership*. A **limited partnership** has at least two classes of partners:

- There must be at least one *general partner,* who takes primary responsibility for the management of the business. The general partner also takes most of the risk of failure if the partnership goes bankrupt (liabilities exceed assets). In some limited partnerships, such as real estate limited partnerships, the general partner often invests little cash in the business. Instead, the general partner's contribution is her or his skill in managing the organization. Usually, the general partner is the last owner to receive a share of partnership profits and losses. But the general partner may earn all excess profits after the limited partners get their share of the income.
- The *limited partners* are so named because their personal obligation for the partnership's liabilities is limited to the amount they have invested in the business. Limited partners have limited liability similar to the limited liability that shareholders in a corporation have. Usually, the limited partners have invested the bulk of the partnership's assets and capital. They, therefore, usually have the first claim

KEY POINTS

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

to partnership profits and losses, but only up to a specified limit. In exchange for their limited liability, their potential for profits usually has a limit as well.

Limited Liability Partnerships Many professionals, such as doctors, lawyers, and most public accounting firms in Canada—including most of those in Exhibit 12–1—are now organized as **limited liability partnerships (LLPs)**. An LLP can only be used by eligible professions (such as accounting) and is designed to protect innocent partners from negligence damages that result from another partner's actions. This means that each partner's personal liability for other partners' negligence is limited to a certain dollar amount, although liability for a partner's own negligence is still unlimited. The LLP must carry an adequate amount of malpractice insurance or liability insurance to protect the public.

PARTNERSHIP FINANCIAL STATEMENTS

Partnership financial statements are much like those of a proprietorship. Exhibit 12–3 compares partnership statements (in Panel A) against the same reports for a sole proprietorship (in Panel B).

EXHIBIT 12–3 | Financial Statements of a Partnership and a Proprietorship (all amounts in thousands of dollars)

PANEL A—PARTNERSHIP

WILLIS & JONES
Income Statement
For the Year Ended December 31, 2017

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

WILLIS & JONES
Statement of Partners' Equity
For the Year Ended December 31, 2017

	Willis	Jones
Capital, January 1, 2017	$ 50	$40
Additional investments	10	—
Net income	114	76
Subtotal	174	116
Withdrawals	(72)	(48)
Capital, December 31, 2017	$102	$68

WILLIS & JONES
Balance Sheet
December 31, 2017

Assets	
Cash and other assets	$170
Partners' Equity	
Leslie Willis, capital	**$102**
Andrew Jones, capital	**68**
Total equity	$170

PANEL B—PROPRIETORSHIP

WILLIS CONSULTING
Income Statement
For the Year Ended December 31, 2017

Revenues	$460
Expenses	(270)
Net income	$190

WILLIS CONSULTING
Statement of Owner's Equity
For the Year Ended December 31, 2017

Capital, January 1, 2017	$ 90
Additional investments	10
Net income	190
Subtotal	290
Withdrawals	(120)
Capital, December 31, 2017	$170

WILLIS CONSULTING
Balance Sheet
December 31, 2017

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

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The key differences between a proprietorship's and a partnership's financial statements are as follows:

- A partnership income statement includes a section showing the division of net income to the partners.
- A partnership balance sheet reports a separate Capital account for each partner in the section now called Partners' Equity. Large partnerships may show one balance, the total for all partners, and provide the details in a separate report.

> Try It!

1. John Richards and Patricia Quinn would like to form a partnership to open up a night club—Endelay's. They each have $100,000 and have decided that since they have been lifelong friends they do not need a written partnership agreement. Detail the contents of a partnership agreement and explain the importance of a written agreement to Richards and Quinn.
2. Suppose you were giving the friends in the previous question advice on their decision to form a partnership. Detail the advantages and disadvantages of their decision.
3. Richards and Quinn may, at some point, want to bring in a partner who does not want any day-to-day responsibility for managing the operations; he or she may simply want to receive a return on his or her investment. Describe the type of partner this person would be.

Solutions appear at the end of this chapter and on MyAccountingLab

FORMING A PARTNERSHIP

Let's examine the start up of a partnership. Partners in a new partnership may invest assets and their related liabilities in the business. These contributions are journalized in the same way as for proprietorships, by debiting the assets and crediting the liabilities at their agreed-upon values. Each person's net contribution—assets minus liabilities—is credited to the equity account for that person. Often the partners hire an independent firm to *appraise* their assets and liabilities at current market value at the time a partnership is formed. This outside evaluation assures an objective valuation for what each partner brings into the business.

Suppose Katie Zheng and Dan Chao form a partnership on June 1, 2017, to develop and sell computer software. The partners agree on the following values based on an independent appraisal:

Zheng's contributions

- Cash, $10,000; inventory, $40,000; and accounts payable, $80,000
- Computer equipment: cost, $800,000; accumulated amortization, $200,000; current market value, $450,000

Chao's contributions

- Cash, $5,000
- Computer software: cost, $50,000; current market value, $100,000

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

LO 2

How do we account for partners' investments in a partnership?

REAL WORLD EXAMPLE

There is a way for a partner to allow the partnership to use a personal asset, such as a car or money, without losing his or her claim to that asset: The partner could lease the car to the partnership. If the partnership were liquidated, the car would have to be returned to its owner. The partner could also lend money to the partnership instead of investing it. Upon liquidation, the partnership would have to repay the loan to the lending partner before any distribution of capital to the partners.

The partnership entries are as follows:

Zheng's investment			
2017			
Jun. 1	Cash	10,000	
	Inventory	40,000*	
	Computer Equipment	450,000*	
	Accounts Payable		80,000*
	Katie Zheng, Capital		420,000
	To record Zheng's investment in the partnership ($500,000 − $80,000).		
Chao's investment			
2017			
Jun. 1	Cash	5,000	
	Computer Software	100,000*	
	Dan Chao, Capital		105,000
	To record Chao's investment in the partnership.		

*Current market values are used.

The initial partnership balance sheet appears in Exhibit 12–4.

EXHIBIT 12–4 | Partnership Balance Sheet

ZHENG AND CHAO Balance Sheet June 1, 2017			
Assets		**Liabilities**	
Cash	$ 15,000	Accounts payable	$ 80,000
Inventory	40,000	**Partners' Equity**	
Computer equipment	450,000	Katie Zheng, capital	420,000
Computer software	100,000	Dan Chao, capital	105,000
		Total partners' equity	525,000
Total assets	$605,000	Total liabilities and equity	$605,000

> Try It!

4. Marty Kaur invests land in a partnership with Lee Manors. Kaur purchased the land in 2011 for $20,000. Three independent real estate appraisers now value the land at $50,000. Kaur wants $50,000 capital in the new partnership, but Manors objects. Manors believes that Kaur's capital investment should be measured by the book value of his land. Manors and Kaur seek your advice.

a. Which value of the land is appropriate for measuring Kaur's capital: book value or current market value?

b. Give the partnership's journal entry to record Kaur's investment in the business on September 1.

Solutions appear at the end of this chapter and on MyAccountingLab

SHARING PARTNERSHIP PROFITS AND LOSSES

Allocating profits and losses among partners can be challenging and can be a major source of disputes. Any division of profits and losses is allowed as long as the partners agree and it is in the partnership agreement. Typical arrangements include the following:

- Sharing profits and losses based on a stated fraction for each partner, such as 50/50, or 2/3 and 1/3, or 4:3:3 (which means 40 percent to Partner A, 30 percent to Partner B, and 30 percent to Partner C)
- Sharing based on each partner's capital investment
- Sharing based on each partner's service
- Sharing based on a combination of stated fractions, investments, service, and other items

If the partners have not drawn up an agreement, or if the agreement does not state how the partners will divide profits and losses, then, by law, the partners must share profits and losses equally. If the agreement specifies a method for sharing profits but not losses, then losses are shared in the same proportion as profits. For example, a partner receiving 75 percent of the profits would likewise absorb 75 percent of any losses.

In some cases an equal division is not fair. One partner may perform more work for the business than the other partner, or one partner may make a larger capital contribution. In the preceding example, Dan Chao might agree to work longer hours for the partnership than Katie Zheng in order to earn a greater share of profits. Zheng could argue that she should receive more of the profits because she contributed more net assets ($420,000) than Chao did ($105,000). Chao might contend that his computer software program is the partnership's most important asset, and that his share of the profits should be greater than Zheng's share. Arriving at fair sharing of profits and losses in a partnership may be difficult. We now demonstrate how to account for some options available in determining partners' shares of profits and losses.

LO 3

How can we allocate profits and losses to the partners?

Sharing Based on a Stated Fraction

The partnership agreement may state each partner's fraction of the total profits and losses. Suppose the partnership agreement of Shannon Kerry and Raoul Calder allocates two-thirds of the business profits and losses to Kerry and one-third to Calder. This sharing rule can also be expressed as 2:1. If net income for the year is $60,000, and all revenue and expense accounts have been closed, the Income Summary account has a credit balance of $60,000 prior to its closing:

LEARNING TIPS

The ratio of 2:1 is equal to fractions of 2/3 and 1/3, where the denominator of the fraction is the sum of the numbers in the ratio. The ratio of 2:1 is also a 66.7 percent: 33.3 percent sharing ratio.

Income Summary

	Bal. 60,000

The entry to close this account and allocate the net income to the partners' Capital accounts is as follows

Dec. 31	Income Summary	60,000	
	Shannon Kerry, Capital		40,000
	Raoul Calder, Capital		20,000
	To allocate net income to partners. (Kerry: $60,000 × $^2/_3$; Calder: $60,000 × $^1/_3$)		

Suppose Kerry's beginning Capital balance was $50,000 and Calder's was $10,000. After posting, the accounts appear as follows:

Income Summary

Clo.	60,000	Beg.	60,000

Shannon Kerry, Capital

		Beg.	50,000
		Clo.	40,000
		End.	90,000

Raoul Calder, Capital

		Beg.	10,000
		Clo.	20,000
		End.	30,000

If the partnership had a net loss of $15,000, the Income Summary account would have a debit balance of $15,000. In that case, the closing entry to allocate the loss to the partners' Capital accounts would be:

Dec. 31	Shannon Kerry, Capital	10,000	
	Raoul Calder, Capital	5,000	
	Income Summary		15,000
	To allocate net loss to partners. (Kerry: $15,000 × $^{2}/_{3}$; Calder: $15,000 × $^{1}/_{3}$)		

A profit or loss will increase or decrease each partner's Capital account, but cash will not change hands. The Withdrawals account records the cash each partner takes from the partnership.

Sharing Based on Capital Investments

Profits and losses are often allocated in proportion to the partners' capital investments in the business. Suppose John Abbot, Erica Baxter, and Tony Craven are partners in ABC Company. Their Capital accounts at the end of the first year of business have the following balances, before closing entries. These amounts are equal to the original capital investments for each of the partners, since no earnings or withdrawals have yet been posted to these accounts.

John Abbot, Capital	$120,000
Erica Baxter, Capital	180,000
Tony Craven, Capital	150,000
Total Capital balances	$450,000

LEARNING TIPS

Do not round the interim percentages. For this chapter, round only the final dollar amount to the nearest whole dollar.

Assume that the partnership earned a profit of $300,000 for the year. To allocate this amount based on capital investments, each partner's percentage share of the partnership's total capital investment amount must be computed.

We divide each partner's investment by the total capital investment amount:

Abbot:	($120,000 ÷ $450,000)	= 26.6667%
Baxter:	($180,000 ÷ $450,000)	= 40%
Craven:	($150,000 ÷ $450,000)	= 33.3333%

These figures, multiplied by the $300,000 profit amount, yield each partner's share of the year's profits:

Abbot:	$300,000 × 26.6667%	= $80,000.10, round to $80,000
Baxter:	$300,000 × 40%	= $120,000
Craven:	$300,000 × 33.3333%	= $99.999.90. round to $100,000

Or it can be calculated in one step as follows:

Abbot:	($120,000 ÷ $450,000) × $300,000	=	$ 80,000
Baxter:	($180,000 ÷ $450,000) × $300,000	=	120,000
Craven:	($150,000 ÷ $450,000) × $300,000	=	100,000
	Net income allocated to partners	=	$300,000

The closing entry to allocate the profit to the partners' Capital accounts is:

Dec. 31	Income Summary	300,000	
	John Abbot, Capital		80,000
	Erica Baxter, Capital		120,000
	Tony Craven, Capital		100,000
	To allocate net income to partners.		

After this closing entry, the partners' Capital balances are:

John Abbot, Capital	($120,000 + $80,000)	$200,000
Erica Baxter, Capital	($180,000 + $120,000)	300,000
Tony Craven, Capital	($150,000 + $100,000)	250,000
Total Capital balances after allocation of net income		$750,000

Sharing Based on Capital Investments and on Service

One partner, regardless of his or her capital investment, may put more work into the business than the other partners. Even among partners who log equal service time, one person's superior experience and knowledge may be worth more to the firm. To reward the harder-working or more valuable person, the profit-and-loss-sharing method may be based on a combination of partner capital investments *and* **service** to the business. In this case, the partners are allocated predetermined sums to be withdrawn. These are *not* employee salaries but they are sometimes referred to as a **salary allowance**.

Assume Michelle Wallas and Carolyn Borugian formed a partnership in which Wallas invested $50,000 and Borugian invested $50,000, a total of $100,000. Borugian devotes more time to the partnership and earns the larger income allocation from the partnership. Accordingly, the two partners have agreed to share profit as follows:

1. The first $40,000 of partnership profit is to be allocated based on the partners' capital investments in the business.
2. The next $60,000 of profit is to be allocated based on service (Borugian works 60 percent of the time and Wallas 40 percent of the time), with Borugian receiving $36,000 and Wallas receiving $24,000.
3. Any remaining profit is allocated equally.

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

	Wallas	Borugian	Total
Total net income			$ 125,000
1 Sharing the first $40,000 of net income, based on capital investments:			
Wallas ($50,000 ÷ $100,000 × $40,000)	$20,000		
Borugian ($50,000 ÷ $100,000 × $40,000)		$20,000	
Total			40,000
Net income remaining for allocation			85,000
2 Sharing of next $60,000, based on service:			
Wallas	24,000		
Borugian		36,000	
Total			60,000
Net income left for allocation			25,000
3 Remainder shared equally:			
Wallas ($25,000 × $^1/_2$)	12,500		
Borugian ($25,000 × $^1/_2$)		12,500	
Total			25,000
Net income left for allocation			$ 0
Net income allocated to the partners	$56,500	$68,500	$ 125,000

On the basis of this allocation, the closing entry is as follows:

Dec. 31	Income Summary	125,000	
	Michelle Wallas, Capital		56,500
	Carolyn Borugian, Capital		68,500
	To allocate net income to partners.		

Sharing Based on Service and Interest

Partners may be rewarded for their service and their capital investments to the business in other ways. In the sharing plan we just saw, the capital investment was recognized with a lump-sum payment. Another option is to allocate an **interest allowance** calculated as a percentage of their Capital balances. It is important to remember that the service (salaries) and interest amounts discussed above are not the business expenses for salaries and interest in the usual sense. Service and interest in partnership agreements are ways of expressing the allocation of profits and losses to the partners. The service component rewards work done for the partnership. The interest component rewards a partner's investment of cash or other assets in the business. But the partners' service and interest amounts are *not* salary expense and interest expense in the partnership's accounting or tax records.

Allocation of Profit Assume Edward Meyers and Pierre Zrilladich form an oil-exploration partnership. Their partnership agreement outlines the following income allocation:

1. The partnership agreement allocates an annual "salary" of $107,000 to Meyers and $88,000 to Zrilladich.
2. After these amounts are allocated, each partner earns 8 percent interest on his beginning Capital balance. At the beginning of the year, their Capital balances are $200,000 and $250,000, respectively.
3. Any remaining net income is divided equally.

Partnership profit of $240,000 for 2017 will be allocated as follows:

	Meyers	Zrilladich	Total
Total net income			$240,000
1 Allocation for service:			
Meyers	$107,000		
Zrilladich		$ 88,000	
Total			195,000
Net income remaining for allocation			45,000
2 Interest on beginning capital balances:			
Meyers ($200,000 × 0.08)	16,000		
Zrilladich ($250,000 × 0.08)		20,000	
Total			36,000
Net income remaining for allocation			9,000
3 Remainder shared equally:			
Meyers ($9,000 × $^1/_2$)	4,500		
Zrilladich ($9,000 × $^1/_2$)		4,500	
Total			9,000
Net income remaining for allocation			$ 0
Net income allocated to the partners	$127,500	$112,500	$240,000

Allocation of a negative remainder In the preceding illustration, net income exceeded the sum of service and interest. If the partnership profit is less than the allocated sum of service and interest, a negative remainder will occur at some stage in the allocation process. Even so, the partners use the same method for allocation purposes. For example, assume that Meyers and Zrilladich Partnership earned only $205,000 in 2017.

	Meyers	Zrilladich	Total
Total net income			$205,000
1 Allocation for service:			
Meyers	$107,000		
Zrilladich		$88,000	
Total			195,000
Net income remaining for allocation			10,000
2 Interest on beginning capital balances:			
Meyers ($200,000 × 0.08)	16,000		
Zrilladich ($250,000 × 0.08)		20,000	
Total			36,000
Net income remaining for allocation			(26,000)
3 Remainder shared equally:			
Meyers ($26,000 × $^1/_2$)	(13,000)		
Zrilladich ($26,000 × $^1/_2$)		(13,000)	
Total			(26,000)
Net income remaining for allocation			$ 0
Net income allocated to the partners	$110,000	$95,000	$205,000

Allocation of a Net Loss

A net loss would be allocated to Meyers and Zrilladich in the same manner outlined for net income. The sharing procedure would begin with the net loss and then allocate service interest and any other specified amounts to the partners.

For example, assume that Meyers and Zrilladich Partnership had a loss of $30,000 in 2017.

	Meyers	Zrilladich	Total
Total net income (loss)			($30,000)
1 Allocation for service:			
Meyers	$107,000		
Zrilladich		$88,000	
Total			195,000
Net income (loss) remaining for allocation			(225,000)
2 Interest on beginning Capital balances:			
Meyers ($200,000 × 0.08)	16,000		
Zrilladich ($250,000 × 0.08)		20,000	
Total			36,000
Net income (loss) remaining for allocation			(261,000)
3 Remainder shared equally:			
Meyers ($261,000 × $^1/_2$)	(130,500)		
Zrilladich ($261,000 × $^1/_2$)		(130,500)	
Total			(261,000)
Net income remaining for allocation			$ 0
Net income (loss) allocated to the partners	($ 7,500)	($22,500)	($30,000)

In this case, Zrilladich might be surprised to be allocated such a large share of the loss. It is important for partners to understand the partnership agreement and what it might mean in case of a loss.

PARTNER WITHDRAWALS (DRAWINGS)

REAL WORLD EXAMPLE

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

Partners need cash for personal living expenses like anyone else. Partnership agreements usually allow partners to withdraw cash or other assets from the business. These withdrawals are sometimes called *drawings* and are recorded in a separate Withdrawals or Drawings account for each partner. (Drawings from a partnership are recorded exactly as they are for a proprietorship.) Assume that both Edward Meyers and Pierre Zrilladich are allowed a monthly withdrawal of $12,500. The partnership records the March 2017 withdrawal with this entry:

Mar. 31	Edward Meyers, Withdrawals	12,500	
	Cash		12,500
	Monthly partner withdrawal of cash—cheque #101.		
Mar. 31	Pierre Zrilladich, Withdrawals	12,500	
	Cash		12,500
	Monthly partner withdrawal of cash—cheque #102.		

During the year, each partner's Withdrawal account accumulates 12 such amounts, a total of $150,000 ($12,500 × 12). At the end of the year, the general ledger shows the following account balances immediately after net income has been closed to the partners' Capital accounts. Assume the January 1, 2017, balances for Meyers and Zrilladich are shown below, and that $205,000 of profit has been allocated on the basis of the illustration on page xxx.

Edward Meyers, Capital

	Jan. 1, 2017	Bal.	200,000
	Dec. 31, 2017 Net income		110,000

Pierre Zrilladich, Capital

	Jan. 1, 2017	Bal.	250,000
	Dec. 31, 2017 Net income		95,000

Edward Meyers, Withdrawals

Dec. 31, 2017 Bal. 150,000	

Pierre Zrilladich, Withdrawals

Dec. 31, 2017 Bal. 150,000	

$12,500 per month for 12 month

The Withdrawals accounts must be closed at the end of the period:

2017			
Dec. 31	Edward Meyers, Capital	150,000	
	Edward Meyers, Withdrawals		150,000
	To close the Withdrawals account to Capital.		
Dec. 31	Pierre Zrilladich, Capital	150,000	
	Pierre Zrilladich, Withdrawals		150,000
	To close the Withdrawals account to Capital.		

After posting the final closing entry, the balances in the capital accounts for each partner are as follows:

Edward Meyers, Capital

		Jan. 1, 2017 Bal.	200,000
		Dec. 31, 2017 Net income	110,000
Dec 31, 2017 Withdrawals	150,000		
		Balance	160,000

Pierre Zrilladich, Capital

		Jan. 1, 2017 Bal.	250,000
		Dec. 31, 2017 Net income	95,000
Dec 31, 2017 Withdrawals	150,000		
		Balance	195,000

The amount of the withdrawal does not depend on the partnership's income or loss for the year. In fact, it is possible for a partner to withdraw more than the balance in the Capital account if, for example, profits were expected to be higher than they proved to be and withdrawals were made in anticipation of these high profits. This situation can only occur if the partnership has the cash required for the withdrawal and the other partners agree with the withdrawal and the ending Capital balance.

> Try It!

5. Calculate the net income or net loss to be allocated to each partner under the following partnership agreements:

a. Burns and White share profits and losses 60/40. Net partnership income was $50,000.

b. Betty, Luella, and Pius share profits and losses 3:4:3. Net partnership loss was $200,000.

c. Locke and Barnel share profits 1/3 and 2/3. The partnership agreement does not address the sharing of losses. Net partnership loss was $60,000.

d. Hampton and Kirk do not have a partnership agreement. Hampton does one-third of the work and Kirk does two-thirds of the work. Partnership net income was $90,000.

Solutions appear at the end of this chapter and on MyAccountingLab

ADMISSION OF A PARTNER

LO 4
How do we account for a new partner?

A partnership lasts only as long as its current set of partners remain in the business. Admitting a new partner dissolves the old partnership and begins a new one.

Often the new partnership continues the former partnership's business. In fact, the new partnership may choose to retain the dissolved partnership's name, as is the case with accounting firms. PricewaterhouseCoopers LLP, for example, is an accounting firm that retires and admits many partners during the year. Thus the former partnership dissolves and a new partnership begins many times. The business, however, retains the name and continues operations. Other partnerships may dissolve and then re-form under a new name. Let's look at the ways that a new owner can be added to a partnership.

Admission by Purchasing a Partner's Interest

A person can become a member of a partnership by purchasing an existing partner's interest in the business. First, however, the new person must gain the approval of the other partners.

Let's assume that Stephanie Spelacy and Carlo Lowes have a partnership with the following account balances:

Cash	$ 40,000	Total liabilities	$120,000
Other assets	360,000	Stephanie Spelacy, capital	170,000
		Carlo Lowes, capital	110,000
Total assets	$400,000	Total liabilities and equity	$400,000

Business is so successful that Spelacy receives an offer from Linda Drake, an outside party, to buy her $170,000 interest in the business for $200,000. Lowes approves Drake as a new partner, and Spelacy agrees to accept $200,000. The firm records the transfer of capital with this entry:

Apr. 16	Stephanie Spelacy, Capital	170,000	
	Linda Drake, Capital		170,000
	To transfer Spelacy's equity to Drake.		

The debit closes Spelacy's Capital account because she is no longer a partner in the firm.

Stephanie Spelacy, Capital

Apr. 16 170,000	170,000

The credit opens Drake's Capital account because Spelacy's equity has been transferred to Drake.

Linda Drake, Capital

	170,000

Carlo Lowes, Capital

	110,000

The entry amount is Spelacy's Capital balance ($170,000) and not the $200,000 price that Drake paid Spelacy to buy into the business. The full $200,000 goes to Spelacy because the partnership does not receive cash. The transaction was between Drake and Spelacy, not between Drake and the partnership. Suppose Drake pays Spelacy less than Spelacy's Capital balance. The entry on the partnership books is not affected. Spelacy's equity is transferred to Drake at book value ($170,000).

KEY POINTS

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

Admission by Investing in the Partnership

A person may be admitted as a partner by investing directly in the partnership rather than by purchasing an existing partner's interest. The new partner invests assets—for example, cash, inventory, equipment, or a patent—in the business. Let's consider several possible independent investment scenarios for a new partner.

Admission by Investing in the Partnership at Book Value—No Bonus Assume that the partnership of Robin Hardy and Michael May has the following assets, liabilities, and capital:

Cash	$ 20,000	Total liabilities	$ 60,000
Other assets	200,000	Robin Hardy, capital	70,000
		Michael May, capital	90,000
Total assets	$220,000	Total liabilities and equity	$220,000

Devan Mann wants to join the Hardy and May partnership. Mann can invest equipment with a market value of $80,000. Hardy and May agree to dissolve their partnership and to start up a new one, giving Mann one-third interest in exchange for the contributed asset, as follows:

Partnership capital before Mann is admitted ($70,000 + $90,000)	$160,000
Mann's investment in the partnership	80,000
Partnership capital after Mann is admitted	$240,000
One-third interest is ($240,000 × $^{1}/_{3}$). Share to Mann.	$ 80,000

LEARNING TIPS

Always add the new partner's investment to the existing partners' capital total *first* before calculating the new partner's ownership interest amount in the partnership.

Notice that Mann is buying into the partnership at book value because her one-third investment ($80,000) equals one-third of the new partnership's total capital ($240,000).

The partnership's entry to record Mann's investment is:

Jul. 18	Equipment	80,000	
	Devan Mann, Capital		80,000
	To admit D. Mann as a partner with a one-third interest in the business.		

After this entry, the partnership books show the following:

Cash	$ 20,000	Total liabilities	$ 60,000
Equipment	80,000	Robin Hardy, capital	70,000
Other assets	200,000	Michael May, capital	90,000
		Devan Mann, capital	80,000
Total assets	$300,000	Total liabilities and equity	$300,000

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

Admission by Investing in the Partnership—Bonus to the Old Partners If the partnership is successful, a new partner may be required to make a higher payment to enter the business. The old partners may demand a bonus, which will increase their Capital accounts.

Suppose that Hiro Nagasawa and Lisa Wendt's partnership has earned above-average profits for 10 years. The two partners share profits and losses equally. The balance sheet carries these figures:

Cash	$ 40,000	Total liabilities	$100,000
Other assets	210,000	Hiro Nagasawa, capital	70,000
		Lisa Wendt, capital	80,000
Total assets	$250,000	Total liabilities and equity	$250,000

Nagasawa and Wendt agree to admit Alana Moor to a one-fourth interest in return for Moor's cash investment of $90,000. Moor's Capital balance on the new partnership books is only $60,000, computed as follows:

Partnership capital before Moor is admitted ($70,000 + $80,000)	$150,000
Moor's investment in the partnership	90,000
Partnership capital after Moor is admitted	$240,000
One-quarter interest ($240,000 × $^1/_4$). Share to Moor.	$ 60,000
Bonus to the old partners ($90,000 − $60,000)	$ 30,000

In effect, Moor had to buy into the partnership at a price ($90,000) above the book value of her one-fourth interest ($60,000). Moor's greater-than-book-value investment of $30,000 creates a *bonus* for Nagasawa and Wendt.

The entry on the partnership books to record Moor's investment is:

Mar. 1	Cash	90,000	
	Alana Moor, Capital		60,000
	Hiro Nagasawa, Capital		15,000
	Lisa Wendt, Capital		15,000
	To admit A. Moor as a partner with a one-fourth interest in the business. Nagasawa and Wendt each receive a bonus of \$15,000 (\$30,000 × $^1/_2$).		

KEY POINTS

Notice in the March 1 journal entry that Nagasawa's and Wendt's Capital accounts increased because of Moor's investment, but that Nagasawa and Wendt have not received cash. All the cash went into the partnership. Their increased Capital accounts include the bonus amount contributed by Moor, calculated according to the original partners' profit-and-loss ratio.

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

The new partnership's balance sheet reports these amounts:

Cash*	\$130,000	Total liabilities	\$100,000
Other assets	210,000	Hiro Nagasawa, capital**	85,000
		Lisa Wendt, capital†	95,000
		Alana Moor, capital	60,000
Total assets	\$340,000	Total liabilities and equity	\$340,000

*(\$40,000 + \$90,000)
**(\$70,000 + \$15,000)
†(\$80,000 + \$15,000)

Admission by Investing in the Partnership—Bonus to the New Partner A potential new partner may be so important that the old partners offer a partnership share that includes a bonus to the new partner. A law firm may strongly desire a former premier, cabinet minister, or other official as a partner because of the person's reputation. A restaurant owner may want to go into partnership with a famous sports personality like Sidney Crosby or a musician like Deadmau5.

Suppose Jan Page and Miko Goh have a restaurant. Their partnership balance sheet appears as follows:

Cash	\$140,000	Total liabilities	\$120,000
Other assets	360,000	Jan Page, capital	230,000
		Miko Goh, capital	150,000
Total assets	\$500,000	Total liabilities and equity	\$500,000

\$380,000

The partners admit Martin Santiago, a famous hockey player, as a partner with a one-third interest in exchange for Santiago's cash investment of \$100,000. At the time of Santiago's admission, the firm's capital is \$380,000. Page and Goh share profits and losses in the ratio of two-thirds to Page and one-third to Goh. The computation of Santiago's equity in the new partnership is as follows:

Partnership capital before Santiago is admitted ($230,000 + $150,000)	$380,000
Santiago's investment in the partnership	100,000
Partnership capital after Santiago is admitted	$480,000
One-third interest ($480,000 × $^1/_3$). Share to Santiago.	$160,000
Bonus to new partner ($160,000 − $100,000)	$ 60,000

In this case, Santiago entered the partnership at a price ($100,000) below the book value of his equity ($160,000). The Capital accounts of Page and Goh are debited for the $60,000 difference between the new partner's equity ($160,000) and his investment ($100,000). The old partners share this decrease in capital, which is accounted for as though it were a loss, based on their profit-and-loss ratio. The entry to record Santiago's investment is:

Aug. 24	Cash	100,000	
	Jan Page, Capital	40,000	
	Miko Goh, Capital	20,000	
	Martin Santiago, Capital		160,000
	To admit M. Santiago as a partner with a one-third interest in the business.		
	Split loss according to profit-and-loss ratio: Page = $60,000 × 2/3 and Goh = $60,000 × 1/3		

The new partnership's balance sheet reports these amounts:

Cash*	$240,000	Total liabilities	$120,000
Other assets	360,000	Jan Page, capital**	190,000
		Miko Goh, capital†	130,000
		Martin Santiago, capital	160,000
Total assets	$600,000	Total liabilities and equity	$600,000

*($140,000 + $100,000)
**($230,000 − $40,000)
†($150,000 − $20,000)

In the next section we will see how to account for the withdrawal of a partner from a business.

> Try It!

6. Tina and Jean are partners with Capital balances of $25,000 and $75,000, respectively. They share profits and losses in a 30:70 ratio. Tina and Jean admit Phyllis to a 10 percent interest in a new partnership when Phyllis invests $20,000 in the business.
   a. Compute the bonus to Tina and Jean.
   b. Journalize the partnership's receipt of Phyllis's investment on June 12.
   c. What is each partner's Capital in the new partnership?
7. Refer to the data in the previous question. If Phyllis had invested only $10,000 into the partnership for a 10 percent interest, journalize the partnership's receipt of Phyllis's investment.

Solutions appear at the end of this chapter and on MyAccountingLab

WITHDRAWAL OF A PARTNER FROM THE BUSINESS

A partner may leave the business for many reasons, including retirement or a dispute with the other partners. The withdrawal of a partner dissolves the old partnership. The partnership agreement should specify how to split the partnership assets and liabilities with a withdrawing partner.

In the simplest case, a partner may withdraw by selling his or her interest to another party in a personal transaction. This is the same as admitting a new person who purchases an old partner's interest, as we saw earlier. The journal entry simply debits the withdrawing partner's Capital account and credits the new partner's Capital account. The dollar amount of the entry is the old partner's Capital balance, regardless of the price paid by the purchaser, as illustrated for Spelacy and Drake on page xxx.

Another option would be for a current partner to buy a second partner's interest. This is recorded the same way as when an outside party buys a current partner's interest.

The two main steps that must be completed prior to identifying how much is owed to the withdrawing partner are as follows:

1. Close the books. If the partner withdraws in the middle of the accounting period, the partnership books should be updated to determine the withdrawing partner's Capital balance. The business must measure net income or net loss for the fraction of the year up to the withdrawal date and allocate profit or loss according to the existing ratio.
2. If it is in the partnership agreement, the settlement procedure may specify an independent appraisal of the assets to determine their current market value of the assets. In that case, the partnership must update the value of the assets in the accounting records. This is known as an **asset revaluation**. The partners share any market value changes according to their profit-and-loss ratio.

LO 5

How do we account for the withdrawal of a partner?

LEARNING TIPS

Terminology alert! Notice that here the term "withdrawal" refers to a partner who is leaving and not the "drawings" that were discussed earlier.

REAL WORLD EXAMPLE

When a partner leaves a partnership, she or he ceases to be an agent and no longer has the authority to bind the business to contracts. Third parties with whom the partnership has dealt should be notified that the exiting partner can no longer bind the partnership. All others can be informed with a newspaper advertisement.

Withdrawal at Book Value

Suppose Ben Wolfe is retiring in the middle of the year from the partnership of Sheldon, Greis, and Wolfe. After the books have been adjusted for partial-period income but before the asset appraisal, revaluation, and closing entries are recorded, the balance sheet reports the following:

Cash		$ 70,000	Total liabilities	$ 80,000
Inventory		40,000	Joan Sheldon, capital	50,000
Land		50,000	George Greis, capital	40,000
Building	$90,000		Ben Wolfe, capital	20,000
Less: Accumulated				
amortization	60,000	30,000	Total liabilities and equity	
Total assets		$190,000		$190,000

An independent appraiser revalues the inventory at $34,000 (down from $40,000) and the land at $100,000 (up from $50,000). The partners share the differences between market value and book value based on their profit-and-loss ratio of 1:2:1.

We identify what share each partner has for the revaluation:

The ratios of 1:2:1 is the same as a ¼, ½, ¼ fraction. It is also the same as a 25 percent, 50 percent, 25 percent sharing ratio.

These figures, multiplied by the gain or loss in value from the revaluation, yield each partner's share to be recorded:

The inventory has a \$6,000 decrease (\$40,000 − \$34,000) to allocate:

Sheldon:	\$6,000 × ¼ = \$1,500
Greis:	\$6,000 × ½ = \$3,000
Wolfe:	\$6,000 × ¼ = \$1,500

The land has a \$50,000 increase (\$100,000 − \$50,000) to allocate:

Sheldon:	\$50,000 × ¼ = \$12,500
Greis:	\$50,000 × ½ = \$25,000
Wolfe:	\$50,000 × ¼ = \$12,500

The entries to record the revaluation of the inventory and land are as follows:

Jun. 30	Joan Sheldon, Capital	1,500	
	George Greis, Capital	3,000	
	Ben Wolfe, Capital	1,500	
	Inventory		6,000
	To revalue the inventory and allocate the loss in value to the partners.		

Jun. 30	Land	50,000	
	Joan Sheldon, Capital		12,500
	George Greis, Capital		25,000
	Ben Wolfe, Capital		12,500
	To revalue the land and allocate the gain in value to the partners.		

After the revaluations, the partnership balance sheet reports the following:

Cash		\$ 70,000	Total liabilities	\$ 80,000
Inventory		34,000	Joan Sheldon, capital*	61,000
Land		100,000		
Building	\$90,000		George Greis, capital**	62,000
Less: Accumulated				
amortization	60,000	30,000	Ben Wolfe, capital†	31,000
Total assets		\$234,000	Total liabilities and equity	\$234,000

*(\$50,000 − \$1,500 + \$12,500)
**(\$40,000 − \$3,000 + \$25,000)
†(\$20,000 − \$1,500 + \$12,500)

As the balance sheet shows, Wolfe has a claim to \$31,000 in partnership assets. Now we can account for Wolfe's withdrawal from the business.

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

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

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

Withdrawal at Less than Book Value

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

Because Wolfe has withdrawn from the partnership, Wolfe's capital account is closed, and Greis and Sheldon may or may not continue the partnership. Assuming they agree to form a new partnership, a new agreement—and a new profit-and-loss ratio—is needed. In forming a new partnership, Greis and Sheldon may decide on any ratio they wish. Assume Greis and Sheldon agree on a profit-and-loss ratio of ⅔ for Greis and ⅓ for Sheldon.

The entry to record Wolfe's withdrawal at less than book value is as follows:

KEY POINTS

Whenever a new partnership is formed, a new partnership agreement and a new profit-and-loss ratio are needed and should be created.

Jun. 30	Ben Wolfe, Capital	31,000	
	Cash		10,000
	Note Payable to Ben Wolfe		15,000
	Joan Sheldon, Capital		2,000
	George Greis, Capital		4,000
	To record withdrawal of B. Wolfe from the partnership. Sheldon's bonus is $2,000 ($6,000 × 1/3) and Greis's bonus is $4,000 ($6,000 × 2/3).		

Withdrawal at More than Book Value

A withdrawing partner may receive assets worth more than the book value of her or his equity. This situation creates:

- A bonus to the withdrawing partner
- A decrease in the remaining partners' Capital accounts, shared in their profit-and-loss ratio

The accounting for this situation follows the pattern illustrated previously for withdrawal at less than book value—with one exception. In this situation, the remaining partners' Capital accounts are debited because they are paying a bonus to the withdrawing partner.

Refer back to our previous example. Suppose Wolfe withdraws from the partnership and agrees to receive $40,000 cash. Greis and Sheldon agree that Greis will get two-thirds of the new partnership's profits and losses and Sheldon one-third. The entry to record Wolfe's withdrawal at more than book value is:

Jun. 30	Ben Wolfe, Capital	31,000	
	Joan Sheldon, Capital	3,000	
	George Greis, Capital	6,000	
	Cash		40,000
	To record withdrawal of B. Wolfe from the partnership. Sheldon's Capital is reduced by \$3,000 (\$9,000 × $^1/_3$) and Greis's Capital is reduced by \$6,000 (\$9,000 × $^2/_3$).		

REAL WORLD EXAMPLE

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

Death of a Partner

As with any other form of partnership withdrawal, the death of a partner dissolves a partnership. The partnership accounts are adjusted to measure net income or loss for the fraction of the year up to the date of death. The accounts are then closed to determine all partners' Capital balances on that date. Settlement with the deceased partner's estate is based on the partnership agreement. There may or may not be an asset revaluation. The estate commonly receives partnership assets equal to the partner's Capital balance.

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

> Try It!

8. Suppose Ruth is withdrawing from the partnership of Ruth, Nick, and Adriana. The partners share profits and losses in a 1:2:3 ratio for Ruth, Nick, and Adriana, respectively. After the revaluation of assets, Ruth's Capital balance is \$40,000, and the other partners agree to pay her \$50,000. Nick and Adriana agree to a new profit-and-loss ratio of 2:3 for Nick and Adriana, respectively. Journalize the payment to Ruth for her withdrawal from the partnership on August 31.

9. Refer to the previous question. Suppose the situation is the same except that the other partners agree to pay Ruth \$30,000. Journalize the payment to Ruth for her withdrawal from the partnership.

Solutions appear at the end of this chapter and on MyAccountingLab

LIQUIDATION OF A PARTNERSHIP

LO 6

How do we account for the ending of a partnership?

As we have seen, the admission or withdrawal of a partner dissolves the partnership. However, the business may continue operating with no apparent change to outsiders such as customers and creditors. In contrast, business **liquidation** is the process of going out of business by selling the entity's assets and paying its liabilities. The business shuts down. Before the business is liquidated, the books should be adjusted and closed.

Liquidation of a partnership includes three basic steps:

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

The liquidation of a business can stretch over weeks or months, even years for a large company. Selling every asset and paying every liability of the entity takes time. For example, in early 2014 the law firm of Heenan Blaikie, which had over 500 lawyers at one time, failed and the firm estimated it would take a team of five lawyers "several months" to close.[1] In early 2015, the work still wasn't completed.

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

Assume that Ryan Lauren, Alexis Andrews, and Scott Benroudi have shared profits and losses in the ratio of 3:1:1. The partners decide to liquidate their partnership. After the books are adjusted and closed, these accounts remain:

LEARNING TIPS

The ratio of 3:1:1 is equal to 3/5, 1/5, 1/5, or a 60 percent, 20 percent, 20 percent sharing ratio.

Cash	$ 10,000	Liabilities	$ 30,000
Noncash assets	90,000	Ryan Lauren, capital	40,000
		Alexis Andrews, capital	20,000
		Scott Benroudi, capital	10,000
Total assets	$100,000	Total liabilities and equity	$100,000

Sale of Assets at a Gain

1 Sell the Assets Assume the Lauren, Andrews, and Benroudi partnership sells its noncash assets for $150,000 (book value, $90,000). The partnership realizes a gain of $60,000, which is allocated to the partners based on their profit-and-loss-sharing ratio.

This could be broken down into two steps: recording the gain or loss on liquidation, and recording the allocation of the gain or loss to the partners. The journal entries would be:

Oct. 31	Cash	150,000	
	Noncash Assets		90,000
	Gain on Liquidation		60,000
	To sell noncash assets in liquidation.		
31	Gain on Liquidation	60,000	
	Ryan Lauren, Capital		36,000
	Alexis Andrews, Capital		12,000
	Scott Benroudi, Capital		12,000
	To allocate gain to partners. Lauren's share of the gain is $36,000 ($60,000 × 0.60), Andrew's and Benroudi's are $12,000 each ($60,000 × 0.20)		

Now the partners' Capital accounts have the following balances:

Ryan Lauren, Capital		Alexis Andrews, Capital		Scott Benroudi, Capital	
	40,000		20,000		10,000
	Oct. 31 36,000		Oct. 31 12,000		Oct. 31 12,000
	Bal. 76,000		Bal. 32,000		Bal. 22,000

[1]Janet McFarland, Jeff Gray, Kathryn Blaze Carlson, and Sean Fine, "Storied Law Firm Heenan Blaikie Sunk by a Shifting Legal Landscape," *Globe and Mail*, February 5, 2014, accessed August 4, 2014, www.theglobeandmail.com/report-on-business/industry-news/the-law-page/pace-of-departures-from-struggling-heenan-blaikie-continues-to-escalate/article16708371.

❷ Pay All the Partnership Liabilities

Oct. 31	Liabilities	30,000	
	Cash		30,000
	To pay liabilities in liquidation.		

❸ Pay the Remaining Cash to the Partners in Proportion to Their Capital Balances (By contrast, *gains* and *losses* on the sale of assets are shared by the partners based on their profit-and-loss ratio.) The amount of cash left in the partnership is $130,000, as follows:

Cash

Beg. bal.	10,000	Payment of liabilities	30,000
Sale of assets	150,000		
End. bal.	130,000		

The partners divide the remaining cash according to their Capital balances:

Oct. 31	Ryan Lauren, Capital	76,000	
	Alexis Andrews, Capital	32,000	
	Scott Benroudi, Capital	22,000	
	Cash		130,000
	To disburse cash to partners in liquidation.		

A convenient way to summarize the transactions in a partnership liquidation is given in Exhibit 12–5. Remember:

- Upon liquidation, gains and losses on the sale of assets are divided according to the *profit-and-loss ratio.*
- The final cash payment to the partners is based on *Capital balances.*

EXHIBIT 12–5 | Partnership Liquidation—Sale of Assets at a Gain

								Capital			
							Lauren		Andrews		Benroudi
	Cash	+	Noncash Assets	=	Liabilities	+	(60%)	+	(20%)	+	(20%)
Balances before sale of assets	$ 10,000		$90,000		$30,000		$ 40,000		$ 20,000		$10,000
❶ Sale of assets and sharing of gain	150,000		(90,000)		—		36,000		12,000		12,000
Balances	160,000		0		30,000		76,000		32,000		22,000
❷ Payment of liabilities	(30,000)				(30,000)						
Balances	130,000		0		0		76,000		32,000		22,000
❸ Disbursement of cash to partners	(130,000)						(76,000)		(32,000)		(22,000)
Balances	$ 0		$ 0		$ 0		$ 0		$ 0		$ 0

After the disbursement of cash to the partners, the business has no assets, liabilities, or equity. All final balances are zero.

Sale of Assets at a Loss

Liquidation of a business often includes the sale of assets at a loss. When a loss occurs, the partners' Capital accounts are debited based on the profit-and-loss ratio. Otherwise, the accounting follows the pattern illustrated for the sale of assets at a gain.

Suppose the Lauren, Andrews, and Benroudi partnership sold its noncash assets for $30,000 and all other details in Exhibit 12–5 remained the same. This creates a loss of $60,000 on the sale of the noncash assets. Exhibit 12–6 summarizes the transactions in a partnership liquidation when the assets are sold at a loss.

EXHIBIT 12–6 | Partnership Liquidation—Sale of Assets at a Loss

							Capital				
							Lauren		Andrews		Benroudi
	Cash	+	Noncash Assets	=	Liabilities	+	(60%)	+	(20%)	+	(20%)
Balances before sale of assets	$ 10,000		$ 90,000		$ 30,000		$ 40,000		$ 20,000		$ 10,000
1 Sale of assets and sharing of loss	30,000		(90,000)				(36,000)		(12,000)		(12,000)
Balances	40,000		0		30,000		4,000		8,000		(2,000)
2 Payment of liabilities	(30,000)				(30,000)						
Balances	10,000		0		0		4,000		8,000		(2,000)
3 Disbursement of cash to partners	(10,000)						(4,000)		(8,000)		2,000
Balances	$ 0		$ 0		$ 0		$ 0		$ 0		$ 0

Capital Deficiencies

Notice that Benroudi's Capital account has a negative balance (follow the arrow). This is known as a **capital deficiency**. The capital deficiency must be dealt with *before* the ending cash is distributed. One way of dealing with the $2,000 capital deficiency in Benroudi's Capital account is for Benroudi to contribute $2,000 of assets to the partnership to erase his capital deficiency. If Benroudi contributes cash, the journal entry to record this is:

Oct. 31	Cash	2,000	
	Scott Benroudi, Capital		2,000
	Contributed cash to erase capital deficiency on liquidation.		

Another option for dealing with Benroudi's $2,000 capital deficiency is for Benroudi's partners, Lauren and Andrews, to agree to absorb Benroudi's capital deficiency by decreasing their own Capital balances in proportion to their remaining profit-sharing percentages: Lauren, 60/80; Andrews, 20/80. The journal entry to record this is:

Oct. 31	Ryan Lauren, Capital	1,500	
	Alexis Andrews, Capital	500	
	Scott Benroudi, Capital		2,000
	To absorb the Benroudi capital deficiency by decreasing remaining partners' Capital balances. Lauren $1,500 ($2,000 × 60/80) and Andrews $500 ($2,000 × 20/80)		

How do partners deal with a situation where two of the three partners have capital deficiencies? Both partners could contribute assets in the amount of their deficiencies to the third partner. However, if the deficient partners cannot contribute personal assets, then the deficits must be absorbed by the remaining partner. If the remaining partner then still has a balance in his or her Capital account, any remaining cash balance would be paid to that partner.

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

> Try It!

10. Refer to the Lauren, Andrews, and Benroudi partnership on page xxx. Suppose the partnership sold its noncash assets for $20,000 and all other details in Exhibit 12–5 remained the same.

a. What is the profit or loss created on the sale of the noncash assets?

b. Allocate the profit or loss calculated in part (a) to the partners.

c. How can the partnership deal with any capital deficiencies in this situation?

Solutions appear at the end of this chapter and on MyAccountingLab

SUMMARY PROBLEM FOR YOUR REVIEW

The partnership of Anderssen and Wang admits Sony Pappachan as a partner on January 2, 2017. The partnership has these balances on that date:

Cash	$ 9,000	Total liabilities	$ 50,000
Other assets	110,000	Magnus Anderssen, capital	45,000
		Songyao Wang, capital	24,000
Total assets	$119,000	Total liabilities and equity	$119,000

Magnus Anderssen's share of profits and losses is 60 percent and Songyao Wang's share is 40 percent.

Required

(Requirements 1 and 2 are independent.)

1. Suppose Pappachan pays Wang $30,000 to acquire Wang interest in the business after Anderssen approves Pappachan as a partner.
   a. Record the transfer of owner's equity on the partnership books.
   b. Prepare the partnership balance sheet immediately after Pappachan is admitted as a partner.

2. Suppose Pappachan becomes a partner by investing $31,000 cash to acquire a one-fourth interest in the business.
   a. Compute Pappachan's Capital balance and determine whether there is any bonus. If so, who gets the bonus?
   b. Record Pappachan's investment in the business.
   c. Prepare the partnership balance sheet immediately after Pappachan is admitted as a partner. Include the appropriate heading.
3. Which way of admitting Pappachan to the partnership increases its total assets? Give your reason.

SOLUTION

Requirement 1

a.

Jan. 2	Songyao Wang, Capital	24,000	
	Sony Pappachan, Capital		24,000
	To transfer Wang equity in the partnership to Pappachan.		

When a new partner acquires an old partner's interest, the new partner purchases the old partner's equity balance on the books and *replaces* the old partner. Any amount paid in excess goes to the old partner personally.

b. ***The balance sheet for the partnership of Anderssen and Pappachan is identical to the balance sheet given for Anderssen and Wang in the problem, except Sony Pappachan's name replaces Songyao Wang's name in the title and in the listing of Capital accounts.***

Requirement 2

a. Computation of Pappachan's Capital balance:

Partnership capital before Pappachan is admitted ($45,000 + $24,000)	$ 69,000
Pappachan's investment in the partnership	31,000
Partnership capital after Pappachan is admitted	$100,000
Pappachan's capital in the partnership ($100,000 × $^1/_4$)	$ 25,000
Bonus to the old partners ($31,000 − $25,000)	$ 6,000

When a new partner acquires an interest in a partnership, the new partner *joins the existing partners* by adding cash to the pool of capital, then dividing the pool among the old and new partners. Any amount paid in excess increases the old partners' Capital balances.

b.

Jan. 2	Cash	31,000	
	Sony Pappachan, Capital		25,000
	Magnus Anderssen, Capital		3,600
	Songyao Wang, Capital		2,400
	To admit Pappachan as a partner with a one-fourth interest in the business. Anderssen's bonus is $3,600 [($31,000 − $25,000) × 0.60] and Wang bonus is $2,400 [($31,000 − $25,000) × 0.40].		

Any amount paid in excess increases the old partners' Capital balances by giving each old partner a bonus. The bonus is based on the profit-and-loss-sharing percentage in place before the new partner joined.

The Cash and Capital accounts will change when a new partner joins existing partners. Add the bonus to each of the old partners' Capital balances and add the new partner's Capital balance, all from the January 2, 2017, journal entry.

ANDERSSEN, WANG, AND PAPPACHAN Balance Sheet January 2, 2017			
Cash*	$ 40,000	Total liabilities	$ 50,000
Other assets	110,000	Magnus Anderssen, capital**	48,600
		Songyao Wang, capital***	26,400
		Sony Pappachan, capital	25,000
Total assets	$150,000	Total liabilities and equity	$150,000

*$9,000 + $31,000 = $40,000

**$45,000 + $3,600 = $48,600

***$24,000 + $2,400 = $26,400

Requirement 3

A partnership's total assets are increased only when a new partner joins existing partners, not when a new partner "replaces" an old partner by purchasing the old partner's Capital.

Pappachan's investment in the partnership increases its total assets by the amount of his contribution. Total assets of the business are $150,000 after his investment, compared with $119,000 before. By contrast, Pappachan's purchase of Wang's interest in the business is a personal transaction between the two individuals. It does not affect the assets of the partnership, regardless of the amount Pappachan pays Wang.

SUMMARY

LEARNING OBJECTIVE 1 Identify the characteristics of a partnership

What are the characteristics of a partnership? **Pg. 675**

A *partnership* is a business co-owned by two or more persons for profit.

The characteristics of partnerships are:

- Ease of formation
- Limited life
- Mutual agency
- Unlimited liability
- No partnership income taxes
- In a *limited partnership,* the limited partners have limited personal liability for the obligations of the business.
- A written *partnership agreement* establishes procedures for admission of a new partner, withdrawal of a partner, and the sharing of profits and losses among the partners.
- When a new partner is admitted to the firm or an existing partner withdraws, the old partnership is *dissolved*, or ceases to exist. A new partnership may or may not emerge to continue the business.

LEARNING OBJECTIVE 2 Account for partners' initial investments in a partnership

How do we account for partners' investments in a partnership? **Pg. 679**

- Accounting for a partnership is similar to accounting for a proprietorship. However, a partnership has more than one owner.
- Each partner has an individual Capital account and a Withdrawal account; the Capital accounts for each partner are shown on the balance sheet.
- The partnership income statement includes a section showing the division of net income to the partners.

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

How can we allocate profits and losses to the partners? **Pg. 681**

Partners share net income or loss in any manner they choose.

Common sharing agreements base the *profit-and-loss ratio* on:

- A stated fraction
- Partners' capital investments
- Other methods, including a combination of service and interest, which, despite their name, are not expenses of the business.

Partner withdrawals reduce the partner capital accounts but are not a form of net income allocation.

LEARNING OBJECTIVE 4 Account for the admission of a new partner

How do we account for a new partner? **Pg. 688**

If the old partners agree to admit a new partner to the partnership, the old partnership is dissolved and a new partnership is created.

An outside person may become a partner by:

- Purchasing a current partner's interest (the transaction is between the partners and does not increase the total partnership equity)
- Investing in the partnership (the transaction increases the total partnership equity by the amount of the investment)

In some cases, the new partner must pay the current partners a bonus to join. In other situations, the new partner may receive a bonus to join.

LEARNING OBJECTIVE 5 Account for the withdrawal of a partner

How do we account for the withdrawal of a partner? **Pg. 693**

The two steps prior to accounting for the withdrawal of a partner are:

1. Adjust and close the books up to the date of the partner's withdrawal from the business.
2. Appraise the assets and the liabilities to determine their current market value. Allocate the gain or loss in value to the partners' Capital accounts based on their profit-and-loss ratio.

Then account for the partner's withdrawal

a. At book value (no change in remaining partners' Capital balances)
b. At less than book value (increase the remaining partners' Capital balances)
c. At greater than book value (decrease the remaining partners' Capital balances).

LEARNING OBJECTIVE 6 Account for the liquidation of a partnership

How do we account for the ending of a partnership? **Pg. 696**

In *liquidation*, a partnership goes out of business by:

1. Selling the assets
2. Paying the liabilities
3. Paying any remaining cash to the partners based on their capital balances.

Check **Accounting Vocabulary** on page xxx for all key terms used in Chapter 12 and the Glossary on page xxxx for all key terms used in the textbook.

MORE CHAPTER REVIEW MATERIAL

MyAccountingLab

DemoDoc covering Partnerships

Student PowerPoint Slides

Audio Chapter Summary

Note: All MyAccountingLab resources can be found in the Chapter Resources section and the Multimedia Library.

ACCOUNTING VOCABULARY

Asset revaluation Adjusting asset values to reflect current market values, usually based on an independent appraisal of the assets *(p. 693)*.

Capital deficiency A partnership's claim against a partner. Occurs when a partner's Capital account has a debit balance *(p. 699)*.

Dissolution Ending a partnership *(p. 675)*.

General partnership A form of partnership in which each partner is an owner of the business, with all the privileges and risks of ownership *(p. 677)*.

Interest allowance An interest component that rewards a partner with an allocation because of his or her investment in the business. This is not the same as interest expense paid on a loan *(p. 684)*.

Limited liability partnership (LLP) A partnership in which each partner's personal liability for the business's debts is limited to a certain dollar amount *(p. 678)*.

Limited partnership A partnership with at least two classes of partners: a general partner and limited partners *(p. 677)*.

Liquidation The process of going out of business by selling the entity's assets and paying its liabilities. The final step in liquidation of a business is the distribution of any remaining cash to the owners *(p. 696)*.

Mutual agency Every partner can bind the business to a contract within the scope of the partnership's regular business operations *(p. 675)*.

Partnership An unincorporated business with two or more owners *(p. 674)*.

Partnership agreement An agreement that is the contract between partners specifying such items as the name, location, and nature of the business; the name, capital investment, and duties of each partner; and the method of sharing profits and losses by the partners *(p. 675)*.

Salary allowance Another term for *service (p. 683)*.

Service An allocation to a partner based on his or her service to the partnership. This is not the same as salary expense for an employee *(p. 683)*.

Unlimited personal liability When a partnership (or a proprietorship) cannot pay its debts with business assets, the partners (or the proprietor) must use personal assets to meet the debt *(p. 676)*.

SIMILAR ACCOUNTING TERMS

Limited liability partnership	LLP
Liquidation	Shutting down the business; going out of business
Partners' equity	Partners' capital; Capital
Service	Salary allowance
Withdrawals	Drawings

SELF-STUDY QUESTIONS

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

1. Which of these characteristics identifies a partnership? (*pp. xx–xx*)
   a. Unlimited life
   b. No income tax paid by the business entity
   c. Limited personal liability
   d. All of the above
2. A partnership records a partner's investment of assets in the business at (*p. xx*)
   a. The partner's book value of the assets invested
   b. The market value of the assets invested
   c. A special value set by the partners
   d. Any of the above, depending upon the partnership agreement
3. The partnership of Hungerford, LaPlante, and Egly divides profits in the ratio of 4:5:3. There is no provision for losses. During 2017, the business earned $40,000. Egly's share of this income is (*pp. xx–xx*)
   a. $10,000
   b. $13,333
   c. $16,000
   d. $16,667
4. Suppose the partnership of Hungerford, LaPlante, and Egly in the preceding question lost $40,000 during 2017. LaPlante's share of this loss is (*p. xx*)
   a. Not determinable because the ratio applies only to profits
   b. $13,333
   c. $10,000
   d. $16,667

5. The partners of Martin, Short, and Chase share profits and losses 1/5, 1/6, and 19/30. During 2017, the first year of their partnership, the business earned $120,000, and each partner withdrew $50,000 for personal use. What is the balance in Chase's Capital account after all closing entries? (*p. xx*)
   a. Not determinable because Chase's beginning Capital balance is not given
   b. Minus $10,000
   c. Minus $50,000
   d. $26,000
6. Elaine Robinson buys into the partnership of Quantz and Goodwin by purchasing a one-third interest for $55,000. Prior to Robinson's entry, Edward Quantz's Capital balance was $46,000 and Louisa Goodwin's balance was $52,000; profits and losses were shared equally. The entry to record Robinson's buying into the business is (*pp. xx–xx*)

a.	Cash	55,000	
	Elaine Robinson, Capital		55,000
b.	Edward Quantz, Capital	27,500	
	Louisa Goodwin, Capital	27,500	
	Elaine Robinson, Capital		55,000
c.	Cash	55,000	
	Elaine Robinson, Capital		51,000
	Edward Quantz, Capital		2,000
	Louisa Goodwin, Capital		2,000
d.	Cash	51,000	
	Edward Quantz, Capital	2,000	
	Louisa Goodwin, Capital	2,000	
	Elaine Robinson, Capital		55,000

7. The partners of Tsui, Valik, and Wollenberg share profits and losses equally. Their Capital balances are $40,000, $50,000, and $60,000, respectively, when Wollenberg sells her interest in the partnership to Valik for $90,000. Tsui and Valik continue the business. Immediately after Wollenberg's retirement, the total assets of the partnership are (*pp. xx–xx*)
   a. Increased by $30,000
   b. Increased by $90,000
   c. Decreased by $60,000
   d. The same as before Wollenberg sold her interest to Valik
8. Prior to Bill Ching's withdrawal from the partnership of Ching, Han, and Lee, the partners' Capital balances were $140,000, $110,000 and $250,000, respectively. The partners share profits and losses 1/3, 1/4, and 5/12. The appraisal indicates that assets should be written down by $36,000. Arthur Han's share of the write-down is (*pp. xx–xx*)
   a. $7,920 c. $12,000
   b. $9,000 d. $18,000
9. The process of closing the business, selling the assets, paying the liabilities, and disbursing remaining cash to the owners is called (*p. xx*)
   a. Dissolution
   b. Forming a new partnership
   c. Withdrawal
   d. Liquidation
10. Mike Marr and Pamela Coombs have shared profits and losses equally. Immediately prior to the final cash disbursement in a liquidation of their partnership, the books show:
    Cash $100,000 = Liabilities $0 + Mike Marr, Capital $60,000 + Pamela Coombs, Capital $40,000
    How much cash should Marr receive? (*p. xx*)
    a. $40,000 c. $60,0000
    b. $50,000 d. None of the above

Answers to Self-Study Questions

1. b 2. b 3. a ($40,000 × 3/12 = $10,000) 4. d ($40,000 × 5/12 = $16,667) 5. a 6. c [($46,000 + $52,000 + $55,000) × 1/3 = $51,000; $55,000 − $51,000 = $4,000; $4,000 ÷ 2 = $2,000 each to Quantz and Goodwin] 7. d 8. b ($36,000 × 1/4 = $9,000) 9. d 10. c

ASSIGNMENT MATERIAL

QUESTIONS

1. List at least five items that the partnership agreement should specify.
2. Ron Montgomery, who is a partner in M&N Associates, commits the firm to a contract for a job within the scope of its regular business operations. What term describes Montgomery's ability to obligate the partnership?
3. If a partnership cannot pay a debt, who must make payment? What term describes this obligation of the partners?
4. How is income of a partnership taxed?
5. Identify the advantages and disadvantages of the partnership form of business organization.
6. Most professionals in Canada, such as doctors, lawyers, and public accounting firms, are organized as limited liability partnerships (LLPs). Explain the fundamental concept that governs an LLP.

7. Chris Higgins and Taylor Pyett's partnership agreement states that Higgins gets 60 percent of profits and Pyett gets 40 percent. If the agreement does not discuss the treatment of losses, how are losses shared? How do the partners share profits and losses if the agreement specifies no profit-and-loss-sharing ratio?
8. What determines the amount of the credit to a partner's Capital account when the partner contributes assets other than cash to the business?
9. Do partner withdrawals of cash for personal use affect the sharing of profits and losses by the partner? If so, explain how. If not, explain why not.
10. Name two events that can cause the dissolution of a partnership.
11. Briefly describe how to account for the purchase of an existing partner's interest in the business.
12. Jeff Malcolm purchases Sheila Wilson's interest in the Wilson & Conners partnership. What right does Malcolm obtain from the purchase? What is required for Malcolm to become Paula Conners' partner?
13. Sal Assissi and Hamza Zahari each have capital of $150,000 in their business. They share profits in the ratio of 55:45. Sheetal Kaur acquires a one-fifth share in the partnership by investing cash of $100,000. What are the Capital balances of the three partners immediately after Kaur is admitted?
14. When a partner resigns from the partnership and receives assets greater than her or his Capital balance, how is the difference shared by the other partners?
15. Distinguish between dissolution and liquidation of a partnership.
16. Name the three steps in liquidating a partnership.
17. The partnership of Ralls and Sauls is in the process of liquidation. How do the partners share (a) gains and losses on the sale of noncash assets, and (b) the final cash disbursement?
18. Compare and contrast the financial statements of a proprietorship and a partnership.
19. Summarize the situations in which partnership allocations are based on (a) the profit-and-loss ratio, and (b) the partners' Capital balances.

STARTERS

The partnership form of business
1

Starter 12–1 For each of the three independent situations below, indicate if you would recommend the partnership form of business organization. State the reasons for your recommendation.

1. Sarah, Alisha, and Connie just graduated from a two-year college program and would like to start a bookkeeping business called SAC Bookkeeping. They each have equivalent assets to bring to the business.
2. Philip Harcourt just joined the law practice of Osler and Hoskins. He thinks he will be making a huge salary and is worried about the tax effects of this income. He thinks the partners should incorporate the partnership and avoid the tax bill.
3. Fred Klaus and Felix Cadeau would like to form a construction company. Fred has the contacts, cash, and estimating skills, while Felix has equipment and field experience. There will be minimal profits until the business has a few projects.

Statement of equity
1
Asanti, $76,900

Starter 12–2 Asanti and Quall are partners. Using the following information, prepare a statement of equity on December 31, 2017, for the A&Q Partnership:

	Capital Jan. 1, 2017	Capital Contributions	Net Income Allocated	Partner Drawings
Asanti	$45,000	$10,000	$33,900	$12,000
Quall	$60,000	$10,000	$22,100	$12,000

Starter 12–3 Susan Knoll and Emerson Wyndon are forming a partnership to develop a craft beer brewing company. Knoll contributes cash of $300,000 and land appraised at $80,000 with a building that has a current market value of $200,000. When Knoll purchased the land and building in 2014, its cost was $250,000. The partnership will assume Knoll's mortgage on the property in the amount of $110,000. Wyndon contributes cash of $500,000 and equipment with a current market value of $90,000.

Partnership formation
2
2. Total assets, $1,170,000

1. Journalize the partnership's receipt of assets and liabilities on October 15. Record this as a compound journal entry for both partners.
2. Compute the partnership's total assets, total liabilities, and total partners' equity immediately after organizing.

Starter 12–4 On June 30, 2016, Rick Reeves, Jason Bateman, and Oliver Morali started a partnership called RJO Enterprises. Prepare an opening balance sheet showing their investments:

Partnership balance sheet
2
Total partners' equity, $400,000

R. Reeves	Land appraised at $150,000
J. Bateman	Cash, $175,000
O. Morali	Inventory, $105,000; accounts payable $30,000

Starter 12–5 Abel and Baker decided to form a partnership. Abel contributed equipment (book value $65,000), inventory (paid $20,000), and $10,000 cash. The equipment and inventory have a current market value of $40,000 and $15,000, respectively. Abel also had a debt of $20,000 for the equipment. Baker contributed office equipment (book value $20,000) and cash of $50,000. The current market value of the office equipment is $10,000. The two partners fail to agree on a profit-and-loss-sharing ratio. For the first month (June 2017), the partnership lost $4,000.

Partners' profits, losses, and Capital balances
3
2. Abe Capital, $43,000

1. How much of this loss goes to Abel? How much goes to Baker?
2. The partners withdrew no assets during June. What is each partner's Capital balance at June 30? Prepare a T-account for each partner's Capital.

Starter 12–6 Friesen, Walters, and Onley have Capital balances of $12,000, $6,000, and $6,000, respectively. The partners share profits and losses as follows:

Dividing partnership profits based on capital contributions and service
3
Friesen, $43,000

a. The first $40,000 is divided based on the partners' capital investments.
b. The next $30,000 is based on service, shared equally by Friesen and Onley.
c. The remainder is divided equally.

Compute each partner's share of the $94,000 net income for the year.

Starter 12–7 The partnership of Bosch and Cutler had these balances at September 30, 2017:

Partnership income statement
1 2 3
Net income for Bosch, $36,000

Cash	$ 20,000	Service Revenue	$145,000
Liabilities	40,000	Bosch, Capital	30,000
Cutler, Capital	10,000	Total expenses	85,000
Other assets	120,000		

Bosch gets 60 percent of profits and losses, and Cutler gets 40 percent. Prepare the partnership's income statement and ending Capital balances for the year ended September 30, 2017.

Starter 12–8 Todd has a Capital balance of $60,000; Carlson's balance is $50,000. Reynaldo pays $200,000 to purchase Carlson's interest in the Todd & Carlson partnership. Carlson gets the full $200,000.

Admitting a partner who purchases an existing partner's interest
4

Journalize the partnership's transaction to admit Reynaldo to the partnership on August 1.

Admitting a partner who invests in the business
4
1. No bonus

Starter 12–9 The partnership of Evans and Falconi has these Capital balances:

- Judy Evans $60,000
- Julie Falconi $80,000

Joan Gray invests cash of $70,000 to acquire a one-third interest in the partnership.

1. Does Gray's investment in the firm provide a bonus to the partners? Show your work.
2. Journalize the partnership's receipt of the $70,000 from Gray on February 1.

Admitting a new partner; bonus to the old partners
4
Bonus, $5,000

Starter 12–10 Bo and Go have partner Capital balances of $115,000 and $75,000, respectively. Bo gets 60 percent of profits and losses, and Go gets 40 percent. Assume Mo invests $70,000 to acquire a 25 percent interest in the new partnership of Bogomo. Is there a bonus? If so, who gets it? Journalize the partnership's receipt of cash from Mo on May 21.

Withdrawal of a partner
5

Starter 12–11 Adams, Everett, and Chapman each have a $75,000 Capital balance. They share profits and losses as follows: 25 percent to Adams, 50 percent to Everett, and 25 percent to Chapman. Suppose Chapman is withdrawing from the business, and the partners agree that no appraisal of assets is needed. How much in assets can Chapman take from the partnership? Give the reason for your answer. What role does the profit-and-loss ratio play in this situation?

Withdrawal of a partner; asset revaluation
5
(a) Debit Land, $20,000

Starter 12–12 Simpson, Locke, and Job each have a $27,000 Capital balance. Simpson is retiring from the business. The partners agree to revalue the assets at current market value. A real estate appraiser values the land at $70,000 (book value is $50,000). The profit-and-loss ratio is 1:2:1. Journalize (a) the revaluation of the land on July 31, and (b) a payment of $30,000 to Simpson upon his retirement the same day.

Liquidation of a partnership at a loss
6
Lauren, $34,000

Starter 12–13 Use the data in Exhibit 12–5. Suppose the partnership of Lauren, Andrews, and Benroudi liquidates by selling all noncash assets for $80,000. Complete the liquidation schedule as shown in Exhibit 12–5.

Liquidation of a partnership
6

Starter 12–14 This Starter builds on the solution to Starter 12–13. After completing the liquidation schedule in Starter 12–13, journalize the partnership's (a) sale of noncash assets for $80,000 (use a single account for Noncash Assets), (b) payment of liabilities, and (c) payment of cash to the partners on October 31. Include an explanation with each entry.

Capital deficit upon liquidation of a partnership
6

Starter 12–15 This Starter builds on the solution to Starter 12–13. After completing the liquidation schedule in Starter 12–13, you notice that Benroudi has a final balance of negative $8,000. What are the options for dealing with this capital deficit?

EXERCISES

MyAccountingLab

Exercise 12–1

Partnership characteristics
1

Mark Giltrow and Denise Chan are forming a business to imprint T-shirts. Giltrow suggests that they organize as a partnership to avoid the unlimited liability of a proprietorship. According to Giltrow, partnerships are not very risky.

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

Correct the errors in Giltrow's explanation.

Exercise 12–2

Organizing a business as a partnership

1

Joanna Volescu, a friend from college, approaches you about forming a partnership to export software. Since graduation, Joanna has worked for the World Bank, developing important contacts among government officials and business leaders in Poland and Hungary. Joanna believes she is in a unique position to capitalize on expanding markets. With your expertise in finance, you would have responsibility for accounting and finance in the partnership.

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

Exercise 12–3

Investments by partners

2

2. Total assets, $56 mil.

Jackson Cooke and Julia Bamber are forming a partnership to develop an amusement park near Ottawa. Cooke contributes cash of $3 million and land valued at $30 million. When Cooke purchased the land, its cost was $16 million. The partnership will assume Cooke's $6 million note payable on the land. Bamber invests cash of $15 million and construction equipment that she purchased for $14 million (accumulated amortization to date is $6 million). The equipment's market value is equal to its book value.

Required

1. Journalize the partnership's receipt of assets and liabilities from Cooke and Bamber on November 10. Record each asset at its current market value with no entry to accumulated amortization.
2. Compute the partnership's total assets, total liabilities, and total owners' equity immediately after organizing.

Exercise 12–4

Recording a partner's investment

2

Total capital, $350,000

On January 1, 2016, Chris Hunts and Carol Lo formed the Chris and Carol Partnership by investing the following assets and liabilities in the business:

	Chris's Book value	Carol's Book value
Cash	$12,000	$18,500
Equipment	38,000	53,500
Accumulated amort.—equipment	8,200	9,900
Buildings	84,000	95,000
Accumulated amort.—buildings	25,000	35,000
Land	60,000	66,000
Accounts payable	35,000	35,000
Note payable	17,000	28,000

An independent appraiser believes that Chris's equipment has a market value of $29,000 and Carol's equipment has a market value of $47,500. The appraiser indicates Chris's building has a current value of $90,000 and Carol's building has a current value of $110,000. The appraiser further indicates that Chris's land has a current value of $78,000 and Carol's land has a current value of $80,000. Chris and Carol agree to share profits and losses in a 60:40 ratio. During the first year of operations, the business net income is $74,000. Each partner withdrew $30,000 cash.

Required

1. Prepare the journal entries to record the initial investments in the business by Chris and Carol.
2. Prepare a balance sheet dated January 1, 2016, after the completion of the initial journal entries.

Computing partners' shares of net income and net loss

3

c. Danolo, $104,000

Exercise 12–5

Ken Danolo and Jim Goldman form a partnership, investing $96,000 and $168,000, respectively. Determine their shares of net income or net loss for each of the following situations:

a. Net loss is $124,800 and the partners have no written partnership agreement.
b. Net income is $105,600 and the partnership agreement states that the partners share profits and losses based on their capital investments.
c. Net income is $264,000. The first $132,000 is shared based on the partner's capital investments. The next $100,000 is shared based on partner service, with Danolo receiving 40 percent and Goldman receiving 60 percent. The remainder is shared equally.

Share of income or loss

3

Exercise 12–6

Harper, Cheves, and Calderon have capital investments of $20,000, $30,000, and $50,000, respectively. The partners share profits and losses as follows:

a. The first $40,000 is divided based on the partner's capital investments.
b. The next $40,000 is based on service, shared equally by Harper and Cheves.
c. The remainder is divided equally.

Compute each partner's share of the $92,000 net income for the year.

Computing partners' share of a loss

3

Elmo, ($6,000)

Exercise 12–7

Oscar and Elmo have formed a partnership and invested $50,000 and $70,000, respectively. They have agreed to share profits as follows:

a. Oscar is to receive a payment of $25,000 for his service and Elmo is to receive a payment of $15,000 for his service.
b. $12,000 is to be allocated according to their original capital contributions to the partnership.
c. The remainder is to be allocated 5:4 respectively.

Assuming that the business had a loss of $11,000, allocate the loss to Oscar and Elmo.

Computing partners' Capital balances

3

Overall effect, $4,000 decrease

Exercise 12–8

Ken Danolo withdrew cash of $148,000 for personal use, and Jim Goldman withdrew cash of $120,000 during the year. Using the data from situation (c) in Exercise 12–5, journalize the entries to close to each Capital account (a) the net income to the partners, and (b) the partners' Withdrawal accounts. Explanations are not required. Indicate the amount of increase or decrease in each partner's Capital balance. What was the overall effect on partnership capital?

Admitting a new partner

4

Neilson's equity, $14,100

Exercise 12–9

Goertz Accounting Services has a capital balance of $30,000 after adjusting assets to the fair market value. Leonard Goertz wants to form a partnership with Morley Neilson, who will receive a 30 percent interest in the new partnership. Neilson contributes $17,000 for his 30 percent interest. Determine Neilson's equity after admission and any bonus if applicable.

Admitting a new partner

4

1. Wang, $47,500

Exercise 12–10

Joanna Wang is admitted to a partnership. Prior to the admission of Wang, the partnership books show Tanya Wird's Capital balance at $79,000 and Alan Bales's Capital balance at $39,500. Wird and Bales share profits and losses equally.

Required

1. Compute the amount of each partner's equity on the books of the new partnership under each of the following plans:
   a. Wang purchases Bales's interest in the business, paying $47,250 directly to Bales.
   b. Wang invests $39,500 to acquire a one-fourth interest in the partnership.
   c. Wang invests $71,500 to acquire a one-fourth interest in the partnership.
2. Make the partnership journal entry to record the admission of Wang under plans (a), (b), and (c) in Requirement 1. Explanations are not required.

Using a partnership financial statement, admitting a new partner

1 3 4

1. Harry Simra 40%; Sunny Simra 60%

Exercise 12–11

The Simra Brothers Partnership had the following statement of partners' equity for the years ended December 31, 2016, and 2017. (This is similar to the statement of partners' equity shown in Exhibit 12–3 on page xx.)

Simra Brothers Partnership
Statement of Partners' Equity
For the Years Ended December 31, 2016 and 2017

	Harry Simra, Capital	Sunny Simra, Capital	Amin Simra, Capital	Total Partnership Capital
Balance, Jan. 1, 2016	$75,000	$ 50,000		$125,000
Net income for 2016	20,000	30,000		50,000
Balance, Dec. 31, 2016	95,000	80,000		175,000
Amin's contribution	2,000	3,000	$45,000	50,000
Net income for 2017	8,000	56,000	16,000	80,000
Less partner withdrawals	(12,000)	(16,000)	(10,000)	(38,000)
Balance, Dec. 31, 2017	**$93,000**	**$123,000**	**$51,000**	**$267,000**

Required

1. What was the profit-and-loss-sharing ratio in 2016?
2. Refer to Amin's contribution, which was made in cash. How much cash did Amin contribute to the partnership?
3. What percentage of interest did Amin obtain?
4. Why do Harry and Sunny have additions to their balances as a result of Amin's contribution?
5. What was the profit-and-loss-sharing ratio in 2017?

Exercise 12–12

Withdrawal of a partner from a business
5
2. $42,000

After closing the books, Stihl & Laksa's partnership balance sheet reports owner's equity of $40,500 for Stihl and $54,000 for Laksa. Stihl is withdrawing from (leaving) the firm. He and Laksa agree to write down partnership assets by $18,000. They have shared profits and losses in the ratio of one-third to Stihl and two-thirds to Laksa. The partnership agreement states that a partner withdrawing from the firm will receive assets equal to the book value of his owner's equity.

Required

1. How much will Stihl receive?
2. Laksa will continue to operate the business as a proprietorship. What is Laksa's beginning Capital on the proprietorship books?

Exercise 12–13

Withdrawal of a partner
5
b. Debit Bruno, Capital, $122,400

Alana Bruno is retiring from the partnership of Bruno, Teale, and White on May 31. The partner Capital balances are Bruno, $108,000; Teale, $153,000; and White, $66,000. The partners agree to have the partnership assets revalued to current market values. The independent appraiser reports that the book value of the inventory should be decreased by $24,000, and the book value of the land should be increased by $96,000. The partners agree to these revaluations. The profit-and-loss ratio has been 2:4:4 for Bruno, Teale, and White, respectively. In retiring from the firm, Bruno received $150,000 cash.

Required Journalize (a) the asset revaluations and (b) Bruno's withdrawal from the firm.

Exercise 12–14

Liquidation of a partnership
6
2. Jonas, $53,500

Jonas, Teese, and Moyer are liquidating their partnership. Before selling the noncash assets and paying the liabilities, the Capital balances are Jonas, $57,500; Teese, $34,500; and Moyer, $23,000. The partnership agreement divides profits and losses equally.

Required

1. After selling the noncash assets and paying the liabilities, suppose the partnership has cash of $115,000. How much cash will each partner receive in final liquidation?
2. After selling the noncash assets and paying the liabilities, suppose the partnership has cash of $103,000. How much cash will each partner receive in final liquidation?

Exercise 12–15

Liquidation of a partnership

6

Payment of cash: Garcia, $26,400

Prior to liquidation, the accounting records of Garcia, Woods, and Mickelson included the following balances and profit-and-loss-sharing percentages:

							Capital				
			Noncash				Garcia		Woods		Mickelson
	Cash	+	Assets	=	Liabilities	+	(40%)	+	(30%)	+	(30%)
Balances before sale of assets	$10,000		$62,500		$26,500		$20,000		$15,000		$11,000

The partnership sold the noncash assets for $78,500, paid the liabilities, and disbursed the remaining cash to the partners. Complete the summary of transactions in the liquidation of the partnership. Use the format illustrated in Exhibit 12–5.

Exercise 12–16

Liquidation of a partnership

6

Shelly Linus, Capital, $29,600

The partnership of Linus, Lebrun, and Beale is liquidating. Business assets, liabilities, and partners' Capital balances prior to dissolution are shown below.. The partners share profits and losses as follows: Shelly Linus, 20 percent; Peter Lebrun, 30 percent; and Cathy Beale, 50 percent.

Required Create a spreadsheet or solve manually—as directed by your instructor—to show the ending balances in all accounts after the noncash assets are sold for $280,000. Determine the unknown amounts, represented by (?).

	A	B	C	D	E	F
1			LINUS, LEBRUN, AND BEALE			
2			Sale of Noncash Assets			
3			(For $280,000)			
4				Shelly	Peter	Cathy
5		Noncash		Linus,	Lebrun,	Beale,
6	Cash	Assets	Liabilities	Capital	Capital	Capital
7						
8	$ 12,000	$252,000	$154,000	$24,000	$74,000	$12,000
9	280,000	(252,000)		? †	?	?
10						
11	$292,000	$ 0	$154,000	$?	$?	$?
12						

† ($A9 – $B8) * .2

SERIAL EXERCISE

This exercise continues the Lee Management Consulting situation from Chapter 11, which will continue in Volume 2. If you did not complete any Serial Exercises in earlier chapters, you can still complete Exercise 12–17 as it is presented.

Exercise 12–17

Preparing a partnership balance sheet

2

Total assets, $211,021

Michael Lee has been running Lee Management Consulting as a proprietorship but is planning to expand operations in the near future. The Lee Management Consulting July 31, 2016, balance sheet appears on the next page, with all amounts reflected at current market value before any of the adjustments that were made in Chapters 8–11. Michael Lee is considering forming a partnership with Jill Monroe, who provides the market value financial information shown on the next page. Create the Lee and Monroe Consulting partnership balance sheet at July 31, 2016 , assuming there are no payables or receivables between Lee and Monroe.

	Lee Management Consulting	Monroe's Business
Assets		
Cash	$21,650	$100,000
Accounts receivable	5,900	50,000
Inventory	2,713	5,000
Supplies	100	1,000
Prepaid rent	6,000	0
Equipment	1,000	10,000
Accumulated amortization—equipment	(75)	(100)
Furniture	5,000	4,000
Accumulated amortization—furniture	(267)	(900)
Total assets	$42,021	$169,000
Liabilities and Equity		
Accounts payable	$9,600	$ 20,000
Salary payable	1,000	0
Unearned service revenue	1,200	0
Notes payable	0	50,000
Michael Lee, capital	30,221	—
Jill Monroe, capital	—	99,000
Total liabilities and equity	$42,021	$169,000

CHALLENGE EXERCISE

Exercise 12–18

On December 31, 2017, Jim Austin and Mike Mundy agree to combine their proprietorships as a partnership. Their balance sheets on December 31 are as follows:

Preparing a partnership balance sheet

2

Total assets, $1,425,000

	Austin's Business		Mundy's Business	
	Book Value	***Current Market Value***	***Book Value***	***Current Market Value***
Assets				
Cash	$ 30,000	$ 30,000	$ 25,000	$ 25,000
Accounts receivable (net)	110,000	100,000	40,000	35,000
Inventory	255,000	230,000	170,000	180,000
Capital assets (net)	610,000	525,000	270,000	300,000
Total assets	$1,005,000	$885,000	$505,000	$540,000
Liabilities and Capital				
Accounts payable	$ 120,000	$120,000	$ 50,000	$ 50,000
Accrued expenses payable	10,000	10,000	10,000	10,000
Notes payable	275,000	275,000		
Jim Austin, capital	600,000	480,000		
Mike Mundy, capital			445,000	480,000
Total liabilities and capital	$1,005,000	$885,000	$505,000	$540,000

Required

1. Prepare the partnership balance sheet at December 31, 2017.
2. Assume John Allen wants to join the partnership by paying $212,000 for a 1/4 interest. The partnership equity before John joins is $960,000, and Jim Austin and Mike Mundy shared profits 60 percent for Austin and 40 percent for Mundy. Prepare the journal entry to record Allen's admission to the partnership on January 1, 2018.
3. What percent of the profits will John Allen receive after becoming a partner?

BEYOND THE NUMBERS

Beyond the Numbers 12–1

Partnership issues

1 5

The following questions relate to issues faced by partnerships:

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

ETHICAL ISSUE

Feng Li and Tanya Ng operate The Party Centre, a party supply store in Red Deer, Alberta. The partners split profits and losses equally, and each takes an annual withdrawal of $90,000. To even out the workload, Ng does the buying and Li serves as the accountant. From time to time, they use small amounts of store merchandise for personal use. In preparing for a large private party, Li took engraved invitations, napkins, place mats, and other goods that cost $3,000. She recorded the transaction as follows:

Cost of Goods Sold	3,000	
Inventory		3,000

Required

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

PROBLEMS (GROUP A)

MyAccountingLab

Problem 12–1A

Investments by partners

2

2. Total assets, $252,000

Vince Sharma and Klaus Warsteiner formed a partnership on January 1, 2017. The partners agreed to invest equal amounts of capital. Sharma invested his proprietorship's assets and liabilities (all accounts have normal balances):

	Sharma's Book Value	Current Market Value
Accounts receivable	$24,000	$20,000
Inventory	86,000	62,000
Prepaid expenses	13,000	12,000
Store equipment	72,000	52,000
Accounts payable	40,000	40,000

On January 1, Warsteiner invested cash in an amount equal to the current market value of Sharma's partnership capital. The partners decided that Sharma would earn 70 percent of partnership profits because he would manage the business. Warsteiner agreed to accept 30 percent of profits. During the period ended December 31, 2017, the partnership earned $432,000. Warsteiner's withdrawals were $128,000 and Sharma's withdrawals were $172,800.

Required

1. Journalize the partners' initial investments.
2. Prepare the partnership balance sheet immediately after its formation on January 1, 2017.
3. Calculate the partners' Capital balances on December 31, 2017.

Problem 12–2A

Computing partners' shares of net income and net loss

3

1. b. Net income allocated to Sasso, $58,000

Sheila Sasso, Karen Schwimmer, and Jim Perry have formed a partnership. Sasso invested $60,000, Schwimmer $120,000, and Perry $180,000. Sasso will manage the store, Schwimmer will work in the store three-quarters of the time, and Perry will not work in the business.

Required

1. Compute the partners' shares of profits and losses under each of the following plans:
   a. Net loss is $70,500, and the partnership agreement allocates 45 percent of profits to Sasso, 35 percent to Schwimmer, and 20 percent to Perry. The agreement does not discuss the sharing of losses.
   b. Net income for the year is $136,500. The first $45,000 is allocated on the basis of partners' Capital investments. The next $75,000 is based on service, with $45,000 going to Sasso and $30,000 going to Schwimmer. Any remainder is shared equally.
   c. Net loss for the year is $136,500. The first $45,000 is allocated on the basis of partners' Capital investments. The next $75,000 is based on service, with $45,000 going to Sasso and $30,000 going to Schwimmer. Any remainder is shared equally.
2. Revenues for the year were $858,000 and expenses were $721,500. Under plan (b), prepare the partnership income statement for the year. Assume a year end of September 30, 2017.
3. How will what you have learned in this problem help you manage a partnership?

Problem 12–3A

Capital amounts for the balance sheet of a partnership

2 3

2. K. Santiago, Capital, $41,500

SAC & Company is a partnership owned by K. Santiago, R. Astorga, and J. Camino, who share profits and losses in the ratio of 1:3:4. The adjusted trial balance of the partnership (in condensed form) at June 30, 2017, follows:

SAC & COMPANY Adjusted Trial Balance June 30, 2017		
Cash	$ 166,000	
Noncash assets	800,000	
Liabilities		$ 690,000
K. Santiago, capital		152,000
R. Astorga, capital		282,000
J. Camino, capital		428,000
K. Santiago, withdrawals	126,000	
R. Astorga, withdrawals	272,000	
J. Camino, withdrawals	312,000	
Revenues		748,000
Expenses	624,000	
Totals	$2,300,000	$2,300,000

Required

1. Prepare the June 30, 2017, entries to close the Revenue, Expense, Income Summary, and Withdrawals accounts.
2. Using T-accounts, insert the opening balances in the partners' Capital accounts, post the closing entries to the Capital accounts, and determine each partner's ending Capital balance.

Problem 12–4A

Admitting a new partner

4

c. B. Peller, Capital, $20,000

Sudden Valley Resort is a partnership, and its owners are considering admitting Ben Peller as a new partner. On July 31, 2017, the Capital accounts of the three existing partners and their shares of profits and losses are as follows:

	Capital	Profit-and-Loss Percentage
Eleanor Craven..............	$20,000	20%
Amy Osler......................	30,000	30
Brian Harmon................	40,000	50

Required Journalize the admission of Peller as a partner on July 31, 2017, for each of the following independent situations:

a. Peller pays Harmon $55,000 cash to purchase Harmon's interest.

b. Peller invests $30,000 in the partnership, acquiring a one-quarter interest in the business.

c. Peller invests $30,000 in the partnership, acquiring a one-sixth interest in the business.

Problem 12–5A

Recording changes in partnership Capital

4 5

c. Debit Karen Tenne, Capital, $248,000

Trail Equipment is a partnership owned by three individuals. The partners share profits and losses in the ratio of 30 percent to Karen Tenne, 40 percent to Frank Durn, and 30 percent to Erin Hana. At December 31, 2017, the firm has the following balance sheet amounts:

Cash		$ 354,000	Total liabilities	$ 520,000
Accounts receivable	$ 88,000			
Less: Allowance				
for uncollectibles	4,000	84,000		
Inventory		432,000	Karen Tenne, capital	248,000
Equipment	460,000		Frank Durn, capital	160,000
Less: Accumulated			Erin Hana, capital	270,000
amortization	132,000	328,000	Total liabilities	
Total assets		$1,198,000	and capital	$1,198,000

Karen Tenne withdraws from the partnership on December 31.

Required Record Tenne's withdrawal from the partnership under the following independent plans:

a. In a personal transaction, Tenne sells her equity in the partnership to Michael Adams, who pays Tenne $176,000 for her interest. Durn and Hana agree to accept Adams as a partner.

b. The partnership pays Tenne cash of $72,000 and gives her a note payable for the remainder of her book equity in settlement of her partnership interest.

c. The partnership pays Tenne $260,000 cash for her equity in the partnership.

d. The partners agree that the equipment is worth $548,000 (net). After the revaluation, the partnership settles with Tenne by giving her cash of $44,000 and inventory for the remainder of her book equity.

Problem 12–6A

Liquidation of a partnership

6

1. b. Cash distributed to partners, $228,000

The partnership of Malkin, Neale, & Staal has experienced operating losses for three consecutive years. The partners, who have shared profits and losses in the ratio of Lisa Malkin, 20 percent, John Neale, 40 percent, and Brian Staal, 40 percent, are considering liquidating the business. They ask you to analyze the effects of liquidation under various assumptions about the sale of the noncash assets. They present the following partnership balance sheet amounts at December 31, 2017:

Cash	$ 41,000	Liabilities	$151,000
Noncash assets	367,000	Lisa Malkin, capital	57,500
		John Neale, capital	158,500
		Brian Staal, capital	41,000
Total assets	$408,000	Total liabilities and capital	$408,000

Required

1. Prepare a summary of liquidation transactions (as illustrated in the chapter) for each of the following situations:
   a. The noncash assets are sold for $420,000.
   b. The noncash assets are sold for $338,000.
2. Make the journal entries to record the liquidation transactions in Requirement 1(b).

Problem 12–7A

Liquidation of a partnership (deficits)

6

1. a. Loss allocated to Telliher, $49,500

The partnership of Telliher, Bachra, and Lang has experienced operating losses for three consecutive years. The partners, who have shared profits and losses in the ratio of Thea Telliher, 60 percent, Denis Bachra, 20 percent, and Alan Lang, 20 percent, are considering liquidating of the business. They ask you to analyze the effects of liquidation under various possibilities about the sale of the noncash assets. *None of the partners have personal assets if they go into a deficit financial position.* They present the following partnership balance sheet amounts at December 31, 2017:

Cash	$ 6,750	Liabilities	$ 28,350
Noncash assets	118,800	Thea Telliher, capital	46,600
		Denis Bachra, capital	30,000
		Alan Lang, capital	20,600
Total assets	$125,550	Total liabilities and capital	$125,550

Required

1. Prepare a summary of liquidation transactions (as illustrated in Exhibits 12–5 or 12–6) for each of the following situations:
   a. The noncash assets are sold for $36,300.
   b. The noncash assets are sold for $27,600.
2. What legal recourse do the remaining partners have to be reimbursed for deficit balances?
3. Suppose, after allocating Telliher's deficit balance, Lang now has a deficit balance. How would the partnership deal with this deficiency?

Problem 12–8A

Accounting for partners' investments; allocating profits and losses; accounting for the admission of a new partner; accounting for the withdrawal of a partner; preparing a partnership balance sheet

2 3 4 5

2. A. Buckner, Capital, $387,209

2014

Jun. 10 Adam Buckner and Amber Kwan have agreed to pool their assets and form a partnership to be called B&K Consulting. They agree to share all profits equally and make the following initial investments:

	Buckner	Kwan
Cash	$15,000	$30,000
Accounts receivable (net)	33,000	27,000
Office furniture	36,000	24,000

Dec. 31 The partnership's reported net income was $195,000 for the year ended December 31, 2014.

2015

Jan. 1 Buckner and Kwan agree to accept Heidi Nguen into the partnership with a $180,000 investment for 30 percent of the business. The partnership agreement is amended to provide for the following sharing of profits and losses:

	Buckner	Kwan	Nguen
Service	$90,000	$120,000	$75,000
Interest on capital balance	5%	5%	5%
Balance in ratio of	3 :	2 :	5

Dec. 31 The partnership's reported net income was $480,000.

2016

Oct. 10 Buckner withdrew $84,000 cash from the partnership and Kwan withdrew $57,000 (Nguen did not make any withdrawals).

Dec. 31 The partnership's reported net income was $255,000.

2017

Jan. 2 After a disagreement as to the direction in which the partnership should be moving, Nguen decided to withdraw from the partnership. The three partners agreed that Nguen could take cash of $300,000 in exchange for her equity in the partnership.

Required

1. Journalize all of the transactions for the partnership.
2. Prepare the partners' equity section of the B&K Consulting balance sheet as of January 2, 2017.

Problem 12–9A

Accounting for partners' investments; allocating profits and losses; accounting for the admission of a new partner; accounting for the liquidation of a partnership

2 3 4 5 6

Dec. 31, 2016, Debit Dennis Devlin, Capital, $90,000

Dennis Devlin, Gary Freemont, and Jean London started a partnership to operate a management consulting business. The partnership (DFL Partners) had the following transactions:

2015

Jan. 2 Devlin, Freemont, and London formed the partnership by signing an agreement that stated that all profits would be shared in a 3:2:5 ratio and by making the following investments:

	Devlin	Freemont	London
Cash	$ 24,000	$ 42,000	$138,000
Accounts receivable (net)	84,000	126,000	180,000
Office furniture	0	66,000	0
Computer equipment	156,000	0	54,000

Dec. 31 The partnership reported net income of $252,000 for the year.

2016

Jun. 7 Devlin and London agreed that Freemont could sell his share of the partnership to André Hughes for $390,000. The new partners agreed to keep the same profit-sharing arrangement (3:2:5 for Devlin:Hughes:London).

Dec. 31 The partnership reported a net loss of $300,000 for the year.

2017

Jan. 3 The partners agreed to liquidate the partnership. On this date the balance sheet showed the following items, all at their normal balances:

Cash	$ 78,000
Accounts receivable	1,476,000
Allowance for uncollectible accounts	72,000
Office furniture	360,000

Computer equipment	600,000
Accumulated amortization (total)	180,000
Accounts payable	1,440,000

The assets were sold for the following amounts:

Accounts receivable	$ 720,000
Office furniture	390,000
Computer equipment	360,000

Devlin and Hughes both have personal assets, but London does not.

Required Journalize all the transactions for the partnership.

PROBLEMS (GROUP B)

MyAccountingLab

Problem 12–1B

Investments by partners
2

On January 1, 2017, Svitlana Yaeger and Val Havlac formed a partnership. The partners agreed to invest equal amounts of capital. Havlac invested her proprietorship's assets and liabilities (all accounts have normal balances) as follows:

	Havlac's Book Value	Current Market Value
Accounts receivable	$20,200	$20,000
Inventory	44,000	48,000
Prepaid expenses	4,800	4,000
Office equipment	92,000	56,000
Accounts payable	48,000	48,000

On January 1, 2017, Yaeger invested cash in an amount equal to the current market value of Havlac's partnership capital. The partners decided that Havlac would earn two-thirds of partnership profits because she would manage the business. Yaeger agreed to accept one-third of profits. During the remainder of the year, the partnership earned $276,000. Havlac's withdrawals were $76,000, and Yaeger's withdrawals were $56,000.

Required

1. Journalize the partners' initial investments.
2. Prepare the partnership balance sheet immediately after its formation on January 1, 2017.
3. Calculate the partners' Capital balances at December 31, 2017.

Problem 12–2B

Computing partners' shares of net income and net loss
2 3

Sav Berlo, Silvio Felini, and Louis Valente have formed a partnership. Berlo invested $30,000, Felini $40,000, and Valente $50,000. Berlo will manage the store, Felini will work in the store half time, and Valente will not work in the business.

Required

1. Compute the partners' shares of profits and losses under each of the following plans:
   a. Net loss is $200,000, and the partnership agreement allocates 40 percent of profits to Berlo, 25 percent to Felini, and 35 percent to Valente. The agreement does not discuss the sharing of losses.

b. Net income for the year is $354,000. The first $150,000 is allocated based on partner capital investments. The next $72,000 is based on service, with Berlo receiving $56,000 and Felini receiving $16,000. Any remainder is shared equally.

2. Revenues for the year were $1,014,000 and expenses were $660,000. Under plan (b), prepare the partnership income statement for the year. Assume a January 31, 2017, year end.
3. How will what you learned in this problem help you manage a partnership?

Problem 12–3B

Capital amounts for the balance sheet of a partnership

2 3

SY&I is a partnership owned by T. Shitang, D. Yamamoto, and J. Ishikawa, who share profits and losses in the ratio of 2:3:5. The adjusted trial balance of the partnership (in condensed form) at September 30, 2017, follows:

SY&I Adjusted Trial Balance September 30, 2017		
Cash	$ 110,000	
Noncash assets	389,000	
Liabilities		$ 319,000
T. Shitang, capital		125,000
D. Yamamoto, capital		97,000
J. Ishikawa, capital		46,000
T. Shitang, withdrawals	99,000	
D. Yamamoto, withdrawals	81,000	
J. Ishikawa, withdrawals	40,000	
Revenues		928,000
Expenses	796,000	
Totals	$1,515,000	$1,515,000

Required

1. Prepare the September 30, 2017, entries to close the Revenue, Expense, Income Summary, and Withdrawals accounts.
2. Using T-accounts, insert the opening Capital balances in the partner Capital accounts, post the closing entries to the Capital accounts and determine each partner's ending Capital balance.

Problem 12–4B

Admitting a new partner

4

Pineridge Consulting Associates is a partnership, and its owners are considering admitting Helen Fluery as a new partner. On March 31, 2017, the Capital accounts of the three existing partners and their shares of profits and losses are as follows:

	Capital	Profit-and-Loss Ratio
Jim Zook....................................	$ 50,000	40%
Richard Land............................	100,000	20
Jennifer Lowe............................	150,000	40

Required Journalize the admission of Fluery as a partner on March 31, 2017, for each of the following independent situations:

a. Fluery pays Lowe $200,000 cash to purchase Lowe's interest in the partnership.
b. Fluery invests $100,000 in the partnership, acquiring a one-fourth interest in the business.
c. Fluery invests $80,000 in the partnership, acquiring a one-fourth interest in the business.

Problem 12–5B

Recording changes in partnership capital

4 5

Vector Financial Planning is a partnership owned by three individuals. The partners share profits and losses in the ratio of 20 percent to Katherine Depatie, 40 percent to Sam Seamus, and 40 percent to Emily Hudson. At December 31, 2017, the firm has the following balance sheet amounts:

Cash		$ 350,400	Total liabilities	$ 573,000
Accounts receivable	$ 92,400			
Less: Allowance				
for uncollectibles	16,800	75,600		
Building	1,102,000		Katherine Depatie, capital	390,600
Less: Accumulated			Sam Seamus, capital	210,000
amortization	294,000	808,000	Emily Hudson, capital	260,400
Land		200,000	Total liabilities	
Total assets		$1,434,000	and capital	$1,434,000

Seamus withdraws from the partnership on December 31, 2017, to establish his own consulting practice.

Required Record Seamus's withdrawal from the partnership under the following independent plans:

a. In a personal transaction, Seamus sells his equity in the partnership to Rea Pearlman, who pays Seamus $120,000 for one-half of his interest. Depatie and Hudson agree to accept Pearlman as a partner.

b. The partnership pays Seamus cash of $163,000 and gives him a note payable for the remainder of his book equity in settlement of his partnership interest.

c. The partnership pays Seamus cash of $336,000.

d. The partners agree that the building is worth $682,000 (net). After the revaluation, the partnership settles with Seamus by giving him cash of $82,000 and a note payable for the remainder of his book equity.

Problem 12–6B

Liquidation of a partnership

6

The partnership of Du, Chong, and Quing has experienced operating losses for three consecutive years. The partners, who have shared profits and losses in the ratio of Jia Du, 10 percent, Denis Chong, 30 percent, and Alan Quing, 60 percent, are considering liquidating the business. They ask you to analyze the effects of liquidation under various possibilities about the sale of the noncash assets. They present the following partnership balance sheet amounts at December 31, 2017:

Cash	$ 70,000	Liabilities	$316,000
Noncash assets	526,000	Jia Du, capital	80,000
		Denis Chong, capital	102,000
		Alan Quing, capital	98,000
Total assets	$596,000	Total liabilities and capital	$596,000

Required

1. Prepare a summary of liquidation transactions (as illustrated in the chapter) for each of the following situations:
   a. The noncash assets are sold for $552,000.
   b. The noncash assets are sold for $448,000.
2. Make the journal entries to record the liquidation transactions in Requirement 1(b).

Problem 12–7B

Liquidation of a partnership (deficit)

6

The partnership of Pavelski, Ovechin, and Oh has experienced operating losses for three consecutive years. The partners, who have shared profits and losses in the ratio of Steven Pavelski, 60 percent, Eddie Ovechin, 20 percent, and Kwan Oh, 20 percent, are considering liquidating the business. They ask you to analyze the effects of liquidation under various possibilities about the sale of the noncash assets. *None of the partners has personal assets if they go into a deficit financial position.* They present the following partnership balance sheet amounts at December 31, 2017:

Cash	$ 27,000	Liabilities	$113,400
Noncash assets	475,200	Steven Pavelski, capital	186,400
		Eddie Ovechin, capital	120,000
		Kwan Oh, capital	82,400
Total assets	$502,200	Total liabilities and capital	$502,200

Required

1. Prepare a summary of liquidation transactions (as illustrated in Exhibits 12–5 or 12–6) for each of the following situations:
   a. The noncash assets are sold for $145,200.
   b. The noncash assets are sold for $110,400.
2. What legal recourse do the remaining partners have to be reimbursed for deficit balances?

Problem 12–8B

Accounting for partners' investments; allocating profits and losses; accounting for the admission of a new partner; accounting for the withdrawal of a partner; preparing a partnership balance sheet

2 3 4 5

2014

Jun. 10 Steven Hodgson and Sarah Asham have agreed to pool their assets and form a partnership to be called H&A Distributors. They agree to share all profits equally and make the following initial investments:

	Hodgson	Asham
Cash	$21,000	$36,000
Accounts receivable (net)	42,000	21,000
Office furniture (net)	48,000	27,000

Dec. 31 The partnership's reported net income was $228,000 for the year.

2015

Jan. 1 Hodgson and Asham agree to accept Myra Sirroca into the partnership with a $210,000 investment for 40 percent of the business. The partnership agreement is amended to provide for the following sharing of profits and losses:

	Hodgson	Asham	Sirroca
Service	$120,000	$90,000	$80,000
Interest on end-of-period capitial balance	10%	10%	10%
Balance in ratio of	2 :	3 :	5

Dec. 31 The partnership's reported net income is $570,000.

2016

Oct. 10 Hodgson withdrew $90,000 cash from the partnership and Asham withdrew $60,000 (Sirroca did not make any withdrawals).

Dec. 31 The partnership's reported net income is $225,000.

2017

Jan. 2 After a disagreement as to the direction in which the partnership should be moving, Sirroca decided to withdraw from the partnership. The three partners

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agreed that Sirroca could take cash of $510,000 in exchange for her equity in the partnership.

Required

1. Journalize all of the transactions for the partnership.
2. Prepare the partners' equity section of the balance sheet as of January 2, 2017.

Problem 12–9B

Accounting for partners' investments; allocating profits and losses; accounting for the admission of a new partner; accounting for the liquidation of a partnership

2 3 4 5 6

William Dione, Julie Porter, and Regina Westlake started a partnership to operate a courier service. The partnership (DP&W Couriers) had the following transactions:

2015

Jan. 2 Dione, Porter, and Westlake formed the partnership by signing an agreement that stated that all profits would be shared in a 2:3:5 ratio and by making the following investments:

	Dione	Porter	Westlake
Cash	$12,000	$ 8,000	$14,000
Accounts receivable (net)	20,000	14,500	60,000
Office furniture (net)	0	0	15,000
Vehicles (net)	21,000	38,500	0

Dec. 31 The partnership reported net income of $53,500 for the year.

2016

Jun. 7 Dione and Westlake agreed that Porter could sell her share of the partnership to Ray Ewing for $82,500. The new partners agreed to keep the same profit-sharing arrangement (2:3:5 for Dione:Ewing:Westlake).

Dec. 31 The partnership reported a net loss of $67,000 for the year.

2017

Jan. 3 The partners agreed to liquidate the partnership. On this date, the balance sheet showed the following items (all accounts have their normal balances):

Cash	$ 17,500
Accounts receivable	316,000
Allowance for uncollectible accounts	22,500
Office furniture	74,500
Vehicles	240,000
Accumulated amortization (total)	49,500
Accounts payable	386,500

The assets were sold for the following amounts:

Accounts receivable	$190,000
Office furniture	82,500
Vehicles	106,000

Dione and Ewing both have personal assets, but Westlake does not.

Required Journalize all of the transactions for the partnership.

CHALLENGE PROBLEMS

Problem 12–1C

Deciding on a capital structure

1 2

Nancy Wesla and Jordon Dugger have been in a partnership for five years. The principal business of the partnership is systems design for financial institutions. Gross revenues have increased from $330,000 in 2013 to $3,800,000 in 2017, the year just ended. The number of employees has increased from two in the first year to nine in the most recent year. Wesla and Dugger realized that they had to build up the partnership's capital and have withdrawn only part of the annual profits. As a result, their Capital accounts have increased from $200,000 (Wesla, $140,000; Dugger, $60,000) in 2010 to $2,000,000 (Wesla, $1,080,000; Dugger, $920,000) in 2017.

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

Required Wesla and Dugger have come to you to ask for advice. Provide an analysis of the situation and make a recommendation. In response to your questions, they indicate they will need additional capital of $1,600,000 to $2,000,000.

Problem 12–2C

The effects of accounting decisions on profits

3

Simone Perrier, Mary Salter, and Sean Patten have been partners in a systems design business for the past eight years. Perrier and Patten work full time in the business; Salter has a public accounting practice and works about 5 to 10 hours per week on the administrative side of the business. The business has been successful and the partners are considering expansion.

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

1. Partners will get 6 percent interest on their average Capital balances.
2. Perrier will get a payment of $75,000 for her service; Salter will get a payment of $9,375 for her service; and Patten will get a payment of $75,000 for his service.
3. The balance remaining will be distributed on the basis of Perrier, 40 percent; Salter, 20 percent; and Patten, 40 percent.

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

The capital structure was as follows at December 31, 2017, and reflects the average Capital balances for 2017:

Perrier	$ 228,750
Salter	1,091,250
Patten	491,250
Total	$1,811,250

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

Required Perrier, Salter, and Patten have come to you to ask for advice as to how they might amicably settle the present dispute. Analyze the situation and make a recommendation. Assume net income in 2017 was $400,000.

EXTENDING YOUR KNOWLEDGE

DECISION PROBLEM

Settling disagreements among partners 3

Lori Barclay invested $30,000 and Vanesa Resultan invested $15,000 in a public relations firm that has operated for 10 years. Neither partner has made an additional investment. They have shared profits and losses in the ratio of 2:1, which is the ratio of their investments in the business. Barclay manages the office, supervises the 16 employees, and does the accounting. Resultan, the moderator of a television talk show, is responsible for marketing. Her high profile generates important revenue for the business. During the year ended December 2017, the partnership earned net income of $75,000, shared in the 2:1 ratio. On December 31, 2017, Barclay's Capital balance was $152,500 and Resultan's Capital balance was $105,000.

Required

Respond to each of the following situations:

1. What explains the difference between the ratio of partner Capital balances at December 31, 2017, and the 2:1 ratio of partner investments and profit sharing?
2. Resultan believes the profit-and-loss-sharing ratio is unfair. She proposes a change, but Barclay insists on keeping the 2:1 ratio. What two factors may underlie Resultan's unhappiness?
3. During January 2017, Barclay learned that revenues of $24,000 were omitted from the reported 2016 income. She brings this to Resultan's attention, pointing out that her share of this added income is two-thirds, or $16,000, and Resultan's share is one-third, or $8,000. Resultan believes they should share this added income based on their Capital balances: 60 percent (or $14,400) to Barclay, and 40 percent (or $9,600) to Resultan. Which partner is correct? Why?
4. Assume that an account payable of $18,000 for an operating expense in 2016 was omitted from 2016 reported income. On what basis would the partners share this amount?

FINANCIAL STATEMENT CASE

Lisogar, Philip, & Walters (LPW) is a regional accounting firm with four offices. Summary data from the partnership's annual report follow:

	Years Ended June 30 (Dollars in thousands, except where indicated)				
	2017	2016	2015	2014	2013
Revenues					
Assurance services	$1,234	$1,122	$1,064	$1,093	$1,070
Consulting services	1,007	775	658	473	349
Tax services	743	628	567	515	557
Total Revenues	$2,984	$2,525	$2,289	$2,081	$1,976
Operating Summary					
Revenues	$2,984	$2,525	$2,289	$2,081	$1,976
Personnel costs	1,215	1,004	887	805	726
Other costs	712	630	517	458	415
Income to Partners	$1,057	$ 891	$ 885	$ 818	$ 835
Statistical Data					
Average number of partners	9	9	9	8	8

Required

1. What percentages of total revenues did LPW earn by performing assurance services (similar to auditing), consulting services, and tax services during 2013? What were the percentages in 2017? Which type of service grew the most from 2013 to 2017?
2. Compute the average revenue per partner in 2017. Assume each partner works 1,900 hours per year. On average, how much does each partner charge a client for one hour of time?
3. How much net income did each LPW partner earn, on average, in 2017?

>Try It! SOLUTIONS FOR CHAPTER 12

1. The partnership agreement is a contract, so transactions under the agreement are governed by contract law. If or when disputes arise, both partners are legally protected. A partnership agreement should contain the following items:
   - Name, location, and nature of the business
   - Name, capital investment, and duties of each partner
   - Procedures for admitting a new partner
   - Method of sharing profits and losses among the partners
   - Withdrawals of assets allowed to the partners
   - Procedures for settling disputes among the partners
   - Procedures for settling with a partner who withdraws from the firm
   - Procedures for removing a partner who will not withdraw or retire from the partnership voluntarily
   - Procedures for liquidating the partnership
2. Advantages as compared to proprietorships are that partnerships can raise more capital, partnerships bring together the abilities of more than one person, and partners working well together can achieve more than by working alone. Compared to corporations, partnerships are less expensive to organize and are subject to fewer governmental regulations and restrictions.

   The main disadvantage of partnerships is that partnership agreements may be difficult to formulate. Each time a new partner is admitted or a partner leaves the partnership, the business needs a new partnership agreement. Other disadvantages are that relationships among partners may be fragile, and mutual agency and unlimited liability create personal obligations for each partner.
3. This person would be a limited partner, so named because his or her personal obligation for the partnership's liabilities is limited to the amount he or she invested in the business.
4. a. The appraised value or current market value is the appropriate value to use because that is what the land is worth now, and the current market value was verified by independent professionals.

   b.

Land	50,000	
Marty Kaur, Capital		50,000

5. a. Burns: $50,000 × 60% = $30,000 net income
   White: $50,000 × 40% = $20,000 net income

   b. Betty: $200,000 × 3/10 = $60,000 net loss
   Luella: $200,000 × 4/10 = $80,000 net loss
   Pius: $200,000 × 3/10 = $60,000 net loss

   c. Losses are shared the same way as profits.
   Locke: $60,000 × 1/3 = $20,000 net loss
   Barnel: $60,000 × 2/3 = $40,000 net loss

   d. When there is no agreement, profits and losses are shared equally.
   Hampton: $90,000 × 1/2 = $45,000 net income
   Kirk: $90,000 × 1/2 = $45,000 net income

6. a.

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

   b.

Jun. 12	Cash	20,000	
	Phyllis, Capital		12,000
	Tina, Capital ($8,000 × 0.30)		2,400
	Jean, Capital ($8,000 × 0.70)		5,600
	To admit Phyllis with a 10% interest in the business.		

   c.

Jun. 12	Partners' capital balances:		
	Tina, capital ($25,000 + $2,400)		$ 27,400
	Jean, capital ($75,000 + $5,600)		80,600
	Phyllis, capital		12,000
	Total partnership capital		$120,000

7.

Partnership capital before Phyllis is admitted ($25,000 + $75,000)	$ 100,000
Phyllis's investment in the partnership	10,000
Partnership capital after Phyllis is admitted	$ 110,000
Phyllis's capital in the partnership ($110,000 × 1/10)	$ 11,000
Bonus to the new partner ($11,000 − $10,000)	$ 1,000

Jun. 12	Cash	10,000	
	Tina, Capital ($1,000 × 0.30)	300	
	Jean, Capital ($1,000 × 0.70)	700	
	Phyllis, Capital		11,000
	To admit Phyllis with a 10% interest in the business.		

8.

Aug. 31	Ruth, Capital	40,000	
	Nick, Capital	4,000	
	Adriana, Capital	6,000	
	Cash		50,000
	To record withdrawal of Ruth from the business. Nick's Capital is reduced by $4,000 [($50,000 − $40,000) × 2/5] and Adriana's Capital is reduced by $6,000 [($50,000 − $40,000) × 3/5].		

9.

Aug. 31	Ruth, Capital	40,000	
	Nick, Capital		4,000
	Adriana, Capital		6,000
	Cash		30,000
	To record withdrawal of Ruth from the business. Nick's Capital is increased by $4,000 [($40,000 − $30,000) × 2/5] and Adriana's Capital is increased by $6,000 [($54,000 − $30,000) × 3/5].		

10. a. The sale of the noncash assets for $20,000 creates a loss of $70,000 on the sale of noncash assets ($90,000 − $20,000 = $70,000).

b.

							Capital				
	Cash	+	Noncash Assets	=	Liabilities	+	Lauren (60%)	+	Andrews (20%)	+	Benroudi (20%)
Balances before sale of assets	$10,000		$90,000		$30,000		$40,000		$20,000		$ 10,000
Sale of assets and sharing of loss	20,000		(90,000)				(42,000)		(14,000)		(14,000)
Balances	30,000		0		30,000		(2,000)		6,000		(4,000)
Payment of liabilities	(30,000)				(30,000)						
Balances	0		0		0		(2,000)		6,000		(4,000)
Disbursement of cash to partners	0						2,000		(6,000)		4,000
Balances	$ 0		$ 0		$ 0		$ 0		$ 0		$ 0

c. Lauren and Benroudi both have capital deficiencies. Both of these partners could contribute assets in the amount of their deficiencies to Andrews. However, if the deficient partners cannot contribute personal assets, then the deficits must be absorbed by Andrews. If Andrews absorbs the deficits, then she has a zero balance in her capital account. Since there is no remaining cash balance to distribute, she would be paid nothing more at liquidation.