CHAPTER 04

Accounting for Partnerships

Study Objectives

- Nature of a Partnership
- Formation of a Partnership
- Division of Income or Loss
- Dissolution of a Partnership
- Liquidation of a Partnership

Partnership Form of Organization

Partnership, an association of two or more persons to carry on as co-owners of a business for profit.

Characteristics of Partnerships

Association of Individuals

- Legal entity – artificial person
- Accounting entity – separate/own books & accounts
- Economic entity – undertake production & supply of goods and services

Mutual Agency [joint or common]

- Act of any partner is binding on all other partners, so long as the act appears to be appropriate for the partnership.

Partnership Form of Organization

Characteristics of Partnerships

Limited Life

- Dissolution occurs whenever a partner withdraws or a new partner is admitted.
- Dissolution does not mean the business ends or liquidation.

Unlimited Liability

- Each partner is personally, jointly and individually/severally liable for all partnership liabilities.

Partnership Form of Organization

Characteristics of Partnerships

Co-ownership of Property

- Each partner has a claim on total assets.
- This claim does not attach to specific assets.
- All net income or net loss is shared equally by the partners, unless otherwise stated in the partnership agreement.

Equity Reporting for Partnerships

- Use a separate capital account to record the investments of each partner in the partnership.
- Use a separate drawing account to record the withdrawals of assets by each partner from the partnership.

Equity Reporting for Partnerships

Comparison of the owners' equity accounts reported on a balance sheet for a proprietorship, a partnership, and a corporation.

Proprietorship

Able, Capital	
	Normal bal.

Partnership

Able, Capital	
	Normal bal.

Baker, Capital	
	Normal bal.

Corporation

Common Stock	
	Normal bal.

Retained Earnings	
	Normal bal.

Life Cycle of a Business

BUSINESS STAGE	PRINCIPAL ADVANTAGE
Formation as Proprietorship		**Is formed easily:** Jacobi forms a business by obtaining a local business license and opening a bank account.
Formation as Partnership		**Expands capital and expertise:** Jacobi admits a new partner that contributes capital and expertise.
Formation as Limited Liability Corporation		**Has limited legal liability:** The partnership is changed to an LLC to limit the legal liability of owners.

Life Cycle of a Business

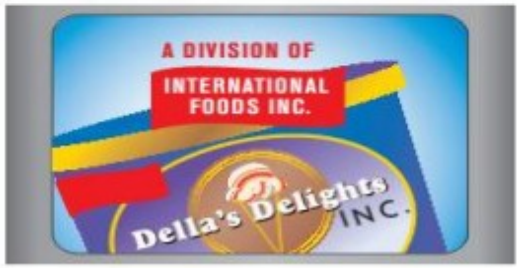
Formation as Corporation



Exit by Sale of Corporation



Simplifies raising capital: The LLC is changed to a corporation to raise capital from the public.



Provides exit: The company is sold for cash.

Partnership Form of Organization

Partnership Agreement

Should specify relationships among the partners:

1. Names and capital contributions of partners.
2. Rights and duties of partners.
3. Basis for sharing net income or net loss.
4. Provision for withdrawals of assets.
5. Procedures for submitting disputes to arbitration.
6. Procedures for the withdrawal or addition of a partner.
7. Rights and duties of surviving partners in the event of a partner's death.

Forming a Partnership

Illustration: A and B combine their proprietorships to start a partnership named A.B. Software. A and B have the following assets prior to the formation of the partnership.

	Book Value		Fair Value	
	A	B	A	B
Cash	**8,000.00**	**9,000.00**	**8,000.00**	**9,000.00**
Equipment	**5,000.00**		**4,000.00**	
Accumulated depreciation	**(2,000.00)**			
Accounts receivable		**4,000.00**		**4,000.00**
Allowance for doubtful				**(1,000.0**

Forming a Partnership

Illustration: Prepare the entry to record the investment of A

Cash		8,000
Equipment	4,000	
A, Capital	12,000	

Prepare the entry to record the investment of B.

Cash		9,000
Accounts receivable	4,000	
Allowance for doubtful accounts		1,000
B, Capital	12,000	

Forming a Partnership

Dividing Net Income or Net Loss

Partners equally share net income or net loss unless the partnership contract indicates otherwise.

Closing Entries:

- **Close all Revenue and Expense** accounts to Income Summary.
- **Close Income Summary** to each partner's Capital account for his or her share of net income or loss.
- **Close each partners Drawing** account to his or her respective Capital account.

Dividing Net Income or Net Loss

Income Ratios

Partnership agreement should specify the basis for sharing net income or net loss. Typical income ratios:

- Fixed ratio.
- Ratio based on capital balances.
- Salaries to partners and remainder on a fixed ratio.
- Interest on partners' capital balances & the remainder on a fixed ratio.
- Salaries to partners, interest on partners' capital, and the remainder on a fixed ratio.

N.B.

1. Bonus factor not applicable in case of loss situations.
2. Apply income sharing plans with multiple factors exactly as in the order indicated in the agreement .

Dividing Net Income or Net Loss

Illustration: King and Lee are co-partners in the Kingslee Company. The partnership agreement provides for: (1) salary allowances of $8,400 to King and $6,000 to Lee, (2) interest allowances of 10% on capital balances at the beginning of the year, and (3) the remainder equally. Capital balances on January 1 were King $28,000, and Lee $24,000. In 2012, partnership net income is $22,000. The division of net income is as follows.

Instructions

(a) Prepare a schedule showing the distribution of net income.

(b) Journalize the allocation of net income.

Dividing Net Income or Net Loss

Illustration: (a) Prepare a schedule showing the distribution of net income.

Division of Net Income

	Sara King	Ray Lee	Total
Salary allowance	$ 8,400	$6,000	$14,400
Interest allowance on partners' capital			
Sara King ($28,000 × 10%)	2,800		
Ray Lee ($24,000 × 10%)		2,400	
Total interest allowance			5,200
Total salaries and interest	11,200	8,400	19,600
Remaining income, $2,400			
($22,000 − $19,600)			
Sara King ($2,400 × 50%)	1,200		
Ray Lee ($2,400 × 50%)		1,200	
Total remainder			2,400
Total division of net income	**$12,400**	**$9,600**	**$22,000**

Dividing Net Income or Net Loss

Illustration: (b) Journalize the allocation of income.

Dec. 31

Income summary		22,000
Sara King, Capital		12,400
Ray Lee, Capital		9,600

Dividing Net Income or Net Loss

Illustration: Prepare a schedule showing the distribution of net income assuming net income is only $18,000.

	Sara King	Ray Lee	Total
Total salaries and interest	$11,200	$8,400	$19,600
Remaining deficiency ($1,600)			
($18,000 − $19,600)			
Sara King ($1,600 × 50%)	(800)		
Ray Lee ($1,600 × 50%)		(800)	
Total remainder			(1,600)
Total division	**$10,400**	**$7,600**	**$18,000**

Partnership Financial Statements

Kingslee Company
Partners' Capital Statement
For the Year Ended December 31, 2012

	Sara King	Ray Lee	Total
Capital, January 1	$28,000	$24,000	$52,000
Add: Additional investment	2,000		2,000
Net income	12,400	9,600	22,000
	42,400	33,600	76,000
Less: Drawings	7,000	5,000	12,000
Capital, December 31	**$35,400**	**$28,600**	**$64,000**

Partners' capital may change due to (1) additional investment, (2) drawing, and (3) net income or net loss.

Partnership Financial Statements

Kingslee Company
Balance Sheet (partial)
December 31, 2012

Total liabilities (assumed amount)		$115,000
Owners' equity		
Sara King, Capital	$35,400	
Ray Lee, Capital	28,600	
Total owners' equity		64,000
Total liabilities and owners' equity		$179,000

The balance sheet for a partnership is the same as for a proprietorship except for the owner's equity section.

Liquidation of a Partnership

Ends both the legal and economic life of the entity.

To liquidate, it is necessary to:

1. Sell noncash assets for cash and recognize a gain or loss on realization.
2. Allocate gain/loss on realization to the partners based on their **income ratios**.
3. Pay partnership liabilities in cash.
4. Distribute remaining cash to partners on the basis of their **capital balances**.

Liquidation of a Partnership

Illustration I: Ace Company is liquidated when its ledger shows the following assets, liabilities, and owners' equity accounts.

Assets		Liabilities and Owners' Equity	
Cash	$ 5,000	Notes payable	$15,000
Accounts receivable	15,000	Accounts payable	16,000
Inventory	18,000	R. Arnet, Capital	15,000
Equipment	35,000	P. Carey, Capital	17,800
Accum. depr.—equipment	(8,000)	W. Eaton, Capital	1,200
	$65,000		$65,000

Liquidation of a Partnership

The partners of Ace Company agree to liquidate the partnership on the following terms:

(1) The partnership will sell its noncash assets to Jackson Enterprises for $75,000 cash.

(2) The partnership will pay its partnership liabilities. The income ratios of the partners are 3:2:1, respectively.

Liquidation of a Partnership

Prepare a cash payments schedule.

ACE COMPANY
Schedule of Cash Payments

Item		Cash	+	Noncash Assets	=	Liabilities	+	R. Arnet Capital	+	P. Carey Capital	+	W. Eaton Capital

Liquidation of a Partnership

Prepare a cash payments schedule.

ACE COMPANY
Schedule of Cash Payments

Item		Cash	+	Noncash Assets	=	Liabilities	+	R. Arnet Capital	+	P. Carey Capital	+	W. Eaton Capital
Balances before liquidation		5,000	+	60,000	=	31,000	+	15,000	+	17,800	+	1,200

Assets		Liabilities and Owners' Equity	
Cash	$ 5,000	Notes payable	$15,000
Accounts receivable	15,000	Accounts payable	16,000
Inventory	18,000	R. Arnet, Capital	15,000
Equipment	35,000	P. Carey, Capital	17,800
Accum. depr.—equipment	(8,000)	W. Eaton, Capital	1,200
	$65,000		$65,000

Liquidation of a Partnership

Prepare a cash payments schedule.

ACE COMPANY
Schedule of Cash Payments

Item		Cash	+	Noncash Assets	=	Liabilities	+	R. Arnet Capital	+	P. Carey Capital	+	W. Eaton Capital
Balances before liquidation		5,000	+	60,000	=	31,000	+	15,000	+	17,800	+	1,200
Sales of noncash assets and allocation of gain	(1)&(2)	75,000	+	(60,000)	=			7,500	+	5,000	+	2,500

It is given that the partnership will sell its noncash assets to Jackson Enterprises for $75,000 cash & income sharing ratio of 3:2:1

Liquidation of a Partnership

Prepare a cash payments schedule.

ACE COMPANY
Schedule of Cash Payments

Item		Cash	+	Noncash Assets	=	Liabilities	+	R. Arnet Capital	+	P. Carey Capital	+	W. Eaton Capital
Balances before liquidation		5,000	+	60,000	=	31,000	+	15,000	+	17,800	+	1,200
Sales of noncash assets and allocation of gain	(1)&(2)	75,000	+	(60,000)	=			7,500	+	5,000	+	2,500
New balances		80,000	+	−0−	=	31,000	+	22,500	+	22,800	+	3,700

Liquidation of a Partnership

Prepare a cash payments schedule.

ACE COMPANY
Schedule of Cash Payments

Item		Cash	+	Noncash Assets	=	Liabilities	+	R. Arnet Capital	+	P. Carey Capital	+	W. Eaton Capital
Balances before liquidation		5,000	+	60,000	=	31,000	+	15,000	+	17,800	+	1,200
Sales of noncash assets and allocation of gain	(1)&(2)	75,000	+	(60,000)	=			7,500	+	5,000	+	2,500
New balances		80,000	+	−0−	=	31,000	+	22,500	+	22,800	+	3,700
Pay liabilities	(3)	(31,000)			=	(31,000)						

Liquidation of a Partnership

Prepare a cash payments schedule.

ACE COMPANY
Schedule of Cash Payments

Item		Cash	+	Noncash Assets	=	Liabilities	+	R. Arnet Capital	+	P. Carey Capital	+	W. Eaton Capital
Balances before liquidation		5,000	+	60,000	=	31,000	+	15,000	+	17,800	+	1,200
Sales of noncash assets and allocation of gain	(1)&(2)	75,000	+	(60,000)	=			7,500	+	5,000	+	2,500
New balances		80,000	+	−0−	=	31,000	+	22,500	+	22,800	+	3,700
Pay liabilities	(3)	(31,000)			=	(31,000)						
New balances		49,000	+	−0−	=	−0−	+	22,500	+	22,800	+	3,700

Liquidation of a Partnership

Prepare a cash payments schedule.

ACE COMPANY
Schedule of Cash Payments

Item		Cash	+	Noncash Assets	=	Liabilities	+	R. Arnet Capital	+	P. Carey Capital	+	W. Eaton Capital
Balances before liquidation		5,000	+	60,000	=	31,000	+	15,000	+	17,800	+	1,200
Sales of noncash assets and allocation of gain	(1)&(2)	75,000	+	(60,000)	=			7,500	+	5,000	+	2,500
New balances		80,000	+	−0−	=	31,000	+	22,500	+	22,800	+	3,700
Pay liabilities	(3)	(31,000)			=	(31,000)						
New balances		49,000	+	−0−	=	−0−	+	22,500	+	22,800	+	3,700
Cash distribution to partners	(4)	(49,000)			=			(22,500)	+	(22,800)	+	(3,700)

Liquidation of a Partnership

Prepare a cash payments schedule.

ACE COMPANY
Schedule of Cash Payments

Item		Cash	+	Noncash Assets	=	Liabilities	+	R. Arnet Capital	+	P. Carey Capital	+	W. Eaton Capital
Balances before liquidation		5,000	+	60,000	=	31,000	+	15,000	+	17,800	+	1,200
Sales of noncash assets and allocation of gain	(1)&(2)	75,000	+	(60,000)	=			7,500	+	5,000	+	2,500
New balances		80,000	+	−0−	=	31,000	+	22,500	+	22,800	+	3,700
Pay liabilities	(3)	(31,000)			=	(31,000)						
New balances		49,000	+	−0−	=	−0−	+	22,500	+	22,800	+	3,700
Cash distribution to partners	(4)	(49,000)			=			(22,500)	+	(22,800)	+	(3,700)
Final balances		−0−		−0−		−0−		−0−		−0−		−0−

Liquidation of a Partnership

(1) Ace sells the noncash assets (accounts receivable, inventory, and equipment) for $75,000. The book value of these assets is $60,000 ($15,000 + $18,000 + $35,000 - $8,000). Prepare the entry to record the sale of the noncash assets.

(1)	Cash	75,000	
	Accumulated depreciation	8,000	
	Accounts receivable		15,000
	Inventory		18,000
	Equipment		35,000
	Gain on realization		15,000

Liquidation of a Partnership

(2) Prepare the entry to record the allocation of the gain on liquidation to the partners.

(2)	Gain on realization		15,000
	R. Arnet, Capital ($15,000 x 3/6)		7,500
	P. Carey, Capital ($15,000 x 2/6)		5,000
	W. Eaton, Capital ($15,000 x 1/6)		2,500

Liquidation of a Partnership

(3) Prepare the entry to record the payment in full to the creditors.

(3)	Notes payable		15,000
	Accounts payable		16,000
	Cash	31,000	

Liquidation of a Partnership

(4) Record the distribution of cash.

R. Arnet, Capital	22,500	
P. Carey, Capital	22,800	
W. Eaton, Capital		3,700
Cash		49,000

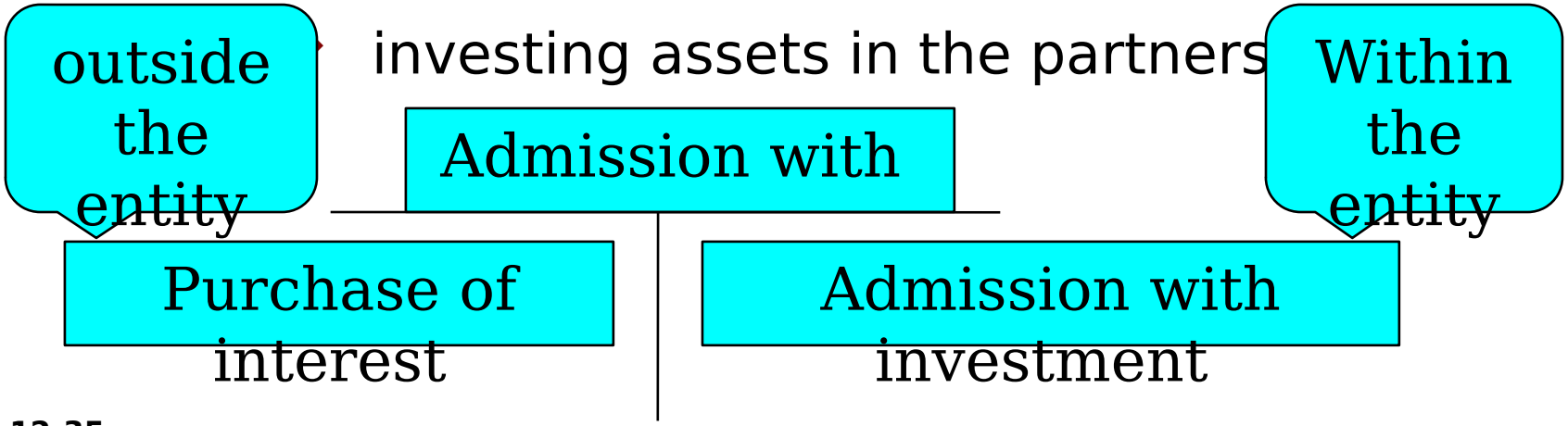
Cash				R. Arnet, Capital			
Bal.	5,000	(3)	31,000		Bal.	15,000	
(1)	75,000				(2)	7,500	
Bal.	**49,000**				**Bal.**	**22,500**	

P. Carey, Capital				W. Eaton, Capital			
	Bal.	17,800			Bal.	1,200	
	(2)	5,000			(2)	2,500	
	Bal.	**22,800**			**Bal.**	**3,700**	

Dissolution of a Partnership

Admission of a Partner

- Results in the **legal dissolution** of the existing partnership and the **beginning** of a new one.
- New partner may be admitted either by
  - purchasing the interest of one or more existing partners or
  - investing assets in the partnership



Purchase of a Partner's Interest

Illustration: L. Carson agrees to pay $10,000 each to C. Ames and D. Barker for 33 1/3% of their interest in the Ames-Barker partnership. At the time of admission of Carson, each partner has a $30,000 capital balance. Both partners, therefore, give up $10,000 of their capital equity. The entry to record the admission of Carson is:

C. Ames, Capital	10,000	
D. Barker, Capital	10,000	
L. Carson, Capital		20,000

Net Assets		C. Ames, Capital		D. Barker, Capital		L. Carson, Capital	
60,000		10,000	30,000	10,000	30,000		20,000
			Bal. 20,000		Bal. 20,000		

Investment of Assets in a Partnership

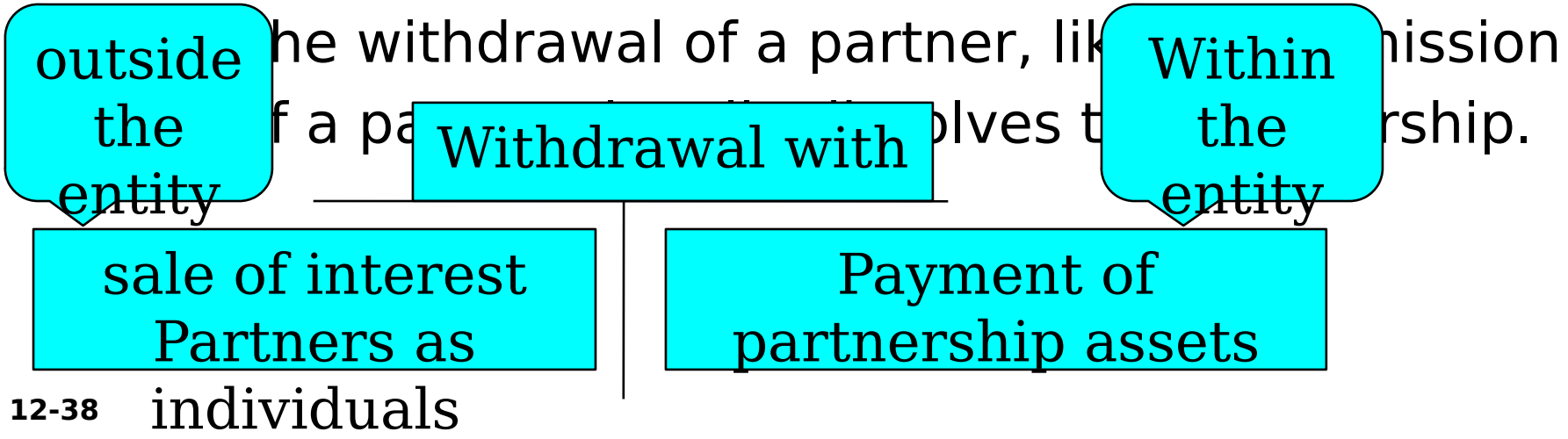
Illustration: Assume that L. Carson agrees to invest $30,000 in cash in the Ames-barker partnership for a 33 1/3% capital interest. At the time of admission of Carson, each partner has a $30,000 capital balance. The entry to record the admission of Carson is:

Cash	30,000	
L. Carson, Capital		30,000

Net Assets		C. Ames, Capital		D. Barker, Capital		L. Carson, Capital	
60,000			30,000		30,000		30,000
30,000							
Bal. 90,000							

Withdrawal of a Partner

- A partner may withdraw from a partnership **voluntarily**, by selling his or her equity in the firm.
- Or, he or she may withdraw **involuntarily**, by reaching mandatory retirement age or by dying.



Payment from Partners' *Personal Assets*

Illustration: Partners Morz, Nead, and Odom have capital balances of $25,000, $15,000, and $10,000, respectively. Morz and Nead agree to buy out Odom's interest. Each of them agrees to pay Odom $8,000 in exchange for one-half of Odom's total interest of $10,000. The entry to record the withdrawal is:

Odom, Capital	10,000	
Morz, Capital		5,000
Nead, Capital		5,000

Note, net assets and total capital remain the same at $50,000. The $16,000 paid to Odom by the remaining partners isn't recorded by the partnership.

Payment from *Partnership Assets*

Illustration: Assume that the following capital balances exist in the RST partnership: Roman $50,000, Sand $30,000, and Terk $20,000. The partners share income in the ratio of 3:2:1, respectively. Terk retires from the partnership and receives a cash payment of $25,000 from the firm.

Note: A bonus is paid to the retiring partner since the cash paid to the retiring partner is more than his/her capital balance ($25,000 – $20,000 = $5,000).

Payment from *Partnership Assets*

Illustration: Assume that the following capital balances exist in the RST partnership: Roman $50,000, Sand $30,000, and Terk $20,000. The partners share income in the ratio of 3:2:1, respectively. Terk retires from the partnership and receives a cash payment of $25,000 from the firm.

Journal entry to record the withdrawal of Terk:

Terk, Capital	20,000	
Roman, Capital	3,000	
Sand, Capital	2,000	
Cash		25,000