CHAPTER FIVE: ACCOUNTING FOR PARTNERSHIPS

5.1 Definition Of Partnership

- **A partnership** is an association of two or more persons who own and manage as co-owners a business for profit.
- A partnership is created by a contract, known as the ***partnership agreement*** or ***articles of partnership***.
- **This agreement** includes:
  - Names and capital contributions of partners.
  - Limits on withdrawals
  - Distributions of income or losses
  - Admission and withdrawal of partners.
  - Rights and duties of partners.

5.2 Characteristics of a partnership

A) Voluntary Association

- A partnership is a voluntary association of individuals rather than a legal entity in itself.

B) Limited life

- A partnership dissolves whenever a partner ceases to be a member of the firm. ***E.g***
  - If a partner withdraws due to bankruptcy
  - Incapacity, or death and
  - Admitting a new partner.

C) Unlimited liability/ No limitation on legal liability/

- Each partner is individually liable to creditors for debts incurred by the partnership.

D) Limited ability to raise capital (funds)

- The ability to raise capital (funds) for the company is limited to what the partners can provide from personal resources or through borrowing.

E) Not taxable

- For federal income tax purposes, a partnership is not taxed.

F) Co-ownership of partnership property

- The property invested in a partnership by a partner becomes the joint property of all the partners.

G) Mutual agency

- Each partner is an agent of the partnership. **For example**, any partner can enter into a contract on behalf of all the members of the partnership.

H) Participation in income - Net income and net loss are distributed among the partners according to their partnership agreement.

- If the partnership agreement **does not provide for distribution of income and losses**, then income and losses are divided equally among the partners.

Advantages and Disadvantages of a Partnership

Advantages	Disadvantages
Combining skills and resources of two or more individuals	Mutual agency
Ease of formation	Limited life
Freedom from governmental regulations and restrictions	Unlimited liability
Ease of decision making	

Dividing Net Income or Net Loss

- If a partnership agreement does not mention the distribution of income and losses, the law requires that they be shared equally by all partners.
- Also, if a partnership agreement specifies only the distribution of income, but is silent as to losses, the law requires that losses be distributed in the same ratio as income.
- Most partnership agreements, however, do specify how income or losses are to be divided.

Common methods of dividing partnership income are based on:

1) Services of the partners
2) Services and investments of the partners

a) <u>Services of Partners</u>

- Dividing income based on the services provided by each partner to the partnership.
- These services are often recognized by partner salary allowances.
- Such allowances reflect differences in
  - Partners' abilities and
  - Time devoted to the partnership.

To illustrate, assume that the partnership agreement of Jennifer Stone and Crystal Mills provides for monthly salary allowances. Stone is to receive a monthly allowance of $5,000 ($60,000 annually), and Mills is to receive $4,000 a month ($48,000 annually). Any net income remaining after the salary allowances is to be divided equally. Assume also that the net income for the year is $150,000.

Net income			$150,000
Division of net income:			
	J. Stone	C. Mills	Total
Annual salary allowance	$60,000	$48,000	$108,000
Remaining income	21,000	21,000	42,000
Net income	$81,000	$69,000	$150,000

The net income division is recorded as a closing entry, even if the partners do not withdraw the amounts of their salary allowances. The entry for closing Income Summary and dividing net income is as follows:

Dec.	31	Income Summary		150,000	
		Jennifer Stone, Capital			81,000
		Crystal Mills, Capital			69,000

- If Stone and Mills had withdrawn their salary allowances monthly, the withdrawals would have been debited to their drawing accounts during the year.
- At the end of the year, the debit balances of $60,000 and $48,000 in their drawing accounts would be transferred as reductions to their capital accounts.

b) Services of Partners and Investments

- Partners may agree that the most equitable plan of dividing income is to provide for
  - **1)** Salary allowances and
  - **2)** Interest on capital investments.
  - **3)** Any remaining net income is then divided as agreed upon.

For example, assume that the partnership agreement for Stone and Mills divides income as follows:

a) Monthly salary allowances of $5,000 for Stone and $4,000 for Mills.
b) Interest of 12% on each partner's capital balance on January 1.
c) Any remaining net income divided equally between the partners.

Stone had a credit balance of $160,000 in her capital account on January 1 of the current fiscal year, and Mills had a credit balance of $120,000 in her capital account. The $150,000 net income for the year is divided per the following schedule:

Net income $150,000

Division of net income:

	J. Stone	C. Mills	Total
Annual salary allowance	$60,000	$48,000	$108,000
Interest allowance	19,200[1]	14,400[2]	33,600
Remaining income	4,200	4,200	8,400
Net income	$83,400	$66,600	$150,000

[1] 12% × $160,000
[2] 12% × $120,000

The entry for closing Income Summary and dividing net income is as follows:

Dec.	31	Income Summary		150,000	
		Jennifer Stone, Capital			83,400
		Crystal Mills, Capital			66,600

C) Allowances Exceed Net Income

- In the preceding example, the net income is $150,000. The total of the salary ($108,000) and interest ($33,600) allowances is $141,600. Thus, the net income exceeds the salary and interest allowances.
- If the net income is less than total allowances, the remaining balance will be a negative amount.
- This amount must be divided among the partners as though it were a net loss.

To illustrate, assume the same salary and interest allowances as in the preceding example, but that the net income is $100,000. In this case, the total of the allowances of $141,600 exceeds the net income by $41,600 ($100,000- $141,600). This amount is divided equally between Stone and Mills. Thus, $20,800 ($41,600/2) is deducted from each partner's share of the allowances. The final division of net income between Stone and Mills is shown as follows:

Net income $100,000

Division of net income:

	J. Stone	C. Mills	Total
Annual salary allowance	$60,000	$48,000	$108,000
Interest allowance	19,200	14,400	33,600
Total	$79,200	$62,400	$141,600
Deduct excess of allowances over income	20,800	20,800	41,600
Net income	$58,400	$41,600	$100,000

The entry for closing Income Summary and dividing net income is as follows:[4]

Dec.	31	Income Summary		100,000	
		Jennifer Stone, Capital			58,400
		Crystal Mills, Capital			41,600

a) Purchasing an Interest from Existing Partners

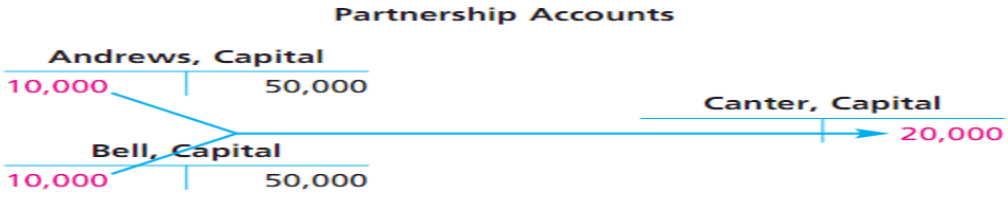
- The purchase and sale of a partnership interest occurs between the new partner and the existing partners acting as individuals.
- The only entry needed is to transfer owner's equity amounts from the capital accounts of the selling partners to the capital account established for the incoming partner.

To illustrate, assume that on June 1, Tom Andrews and Nathan Bell each sell one fifth of their partnership equity of Bring It consulting to Joe Canter for $10,000 in cash. On June 1, the partnership has net assets of $100,000 and both existing partners' have capital balances of $50,000 each. This transaction is between Andrews, Bell, and Canter.

The only entry required by Bring It Consulting is to record the transfer of capital (equity) from Andrews and Bell to Canter, as shown below.

June	1	Tom Andrews, Capital		10,000	
		Nathan Bell, Capital		10,000	
		Joe Canter, Capital			20,000

The effect of the transaction on the partnership accounts is shown in the following diagram:



- After Canter is admitted to Bring It Consulting, the total owners' equity is still$100,000. Canter has a one-fifth (20%) interest and a capital balance of $20,000.
- Andrews and Bell each own two-fifths (40%) interest and have capital balances of $40,000 each.
- Even though Canter has a one-fifth (20%) interest in the partnership:
  - He may not be entitled to a one-fifth share of the partnership net income.
  - The division of the net income or net loss is made according to the new or amended partnership agreement.
- The preceding entry is not affected by the amount paid by Canter for the one-fifth interest. **For example,** if Canter had paid $15,000 to Andrews and Bell instead of $10, 000, the entry would still be the same. This is because the transaction is between Andrews, Bell, and Canter, rather than the partnership.

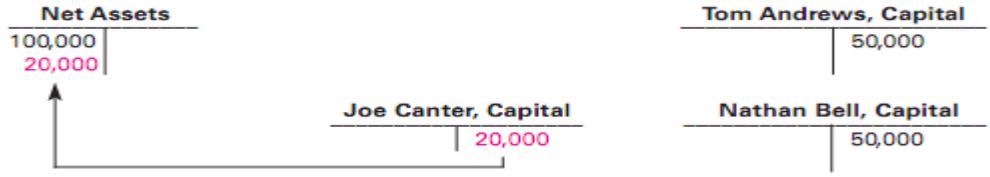
Contributing Assets to a Partnership

- When a new partner is admitted by contributing assets to the partnership, the total assets and the total owners' equity of the partnership are increased. This is because the transaction is between the new partner and the partnership.

To illustrate, assume that instead of purchasing a one-fifth ownership in Bring It Consulting directly from Tom Andrews and Nathan Bell, Joe Canter contributes $20,000 cash to Bring It Consulting for ownership equity of $20,000. The entry to record this transaction is as follows:

June	1	Cash		20,000	
		Joe Canter, Capital			20,000

The effect of the transaction on the partnership accounts is shown in the following diagram:



- After the admission of Canter, the net assets and total owners' equity of Bring It Consulting increase to $120,000, of which Joe Canter has a $20,000 interest.

Revaluation of Assets

- Before a new partner is admitted, the balances of a partnership's asset accounts should be stated at current values. If necessary, the accounts should be adjusted.
- Any net adjustment (increase or decrease) in asset values is divided among the capital accounts of the existing partners similar to the division of income.

To illustrate, assume that in the preceding example the balance of the merchandise inventory account is $14,000 and the current replacement value is $17,000. If Andrews and Bell share net income equally, the revaluation is recorded as follows:

June	1	Merchandise Inventory		3,000	
		Tom Andrews, Capital			1,500
		Nathan Bell, Capital			1,500

Liquidating Partnerships

- When a partnership goes out of business, it sells the assets, pays the creditors, and distributes the remaining cash or other assets to the partners.
- This winding-up process is called the **liquidation** of the partnership.

- Although liquidating refers to the payment of liabilities, it includes the entire winding-up process.
- When the partnership goes out of business and the normal operations are discontinued, the accounts should be adjusted and closed.
- The only accounts remaining open will be the asset, contra asset, liability, and owners' equity accounts.

The steps in the liquidation process are as follows:

- **Step 1**. Sell the partnership assets. This step is called **realization**.
- **Step 2.**Distribute any gains or losses from realization to the partners based on their income-sharing ratio.
- **Step 3**.Pay the claims of creditors using the cash from step 1realization.
- **Step 4.**Distribute the remaining cash to the partners based on the balances in their capital accounts.

To illustrate, assume that Farley, Greene, and Hall share income and losses in a ratio of 5:3:2 (5/10, 3/10, 2/10). On April 9, after discontinuing business operations of the partnership and closing the accounts, the following trial balance in summary form was prepared:

Cash	11,000	
Noncash Assets	64,000	
Liabilities		9,000
Jean Farley, Capital		22,000
Brad Greene, Capital		22,000
Alice Hall, Capital		22,000
Total	75,000	75,000

Based on these facts, we show the accounting for liquidating the partnership by using three different selling prices for the noncash assets.

a) <u>Gain on Realization</u>

- Assume that Farley, Green, and Hall sell all noncash assets for $72,000. Thus, a gain of $8,000 ($72,000 - $64,000) is realized. The partnership is liquidated during April as follows:
- **Step 1.** Sale of assets: $72,000 is realized from sale of all the noncash assets.
- **Step 2.** Division of gain: The gain of $8,000 is distributed to Farley, Green, and Hall in the income-sharing ratio of 5:3:2. Thus, the partner capital accounts are credited as follows:

Farley	$4,000 ($8,000 × 50%)
Green	2,400 ($8,000 × 30%)
Hall	1,600 ($8,000 × 20%)

- Step 3. Payment of liabilities: Creditors are paid $9,000.
- Step 4. Distribution of cash to partners: The remaining cash of $74,000 is distributed to the partners according to their capital balances as follows:

Farley	$26,000
Green	24,400
Hall	23,600

Statement of Partnership Liquidation: Gain on Realization

Farley, Green, and Hall
Statement of Partnership Liquidation
For Period April 10–30, 2010

		Cash	+	Noncash Assets	=	Liabilities	+	Capital: Farley (50%)	+	Capital: Green (30%)	+	Capital: Hall (20%)
	Balances before realization	$ 11,000		$64,000		$9,000		$22,000		$22,000		$22,000
Steps 1–2 →	Sale of assets and division of gain	+72,000		−64,000				+ 4,000		+ 2,400		+ 1,600
	Balances after realization	$83,000		$ 0		$9,000		$26,000		$24,400		$23,600
Step 3 →	Payment of liabilities	− 9,000				−9,000						
	Balances after payment of liabilities	$74,000		$ 0		$ 0		$26,000		$24,400		$23,600
Step 4 →	Cash distributed to partners	−74,000						−26,000		−24,400		−23,600
	Final balances	$ 0		$ 0		$ 0		$ 0		$ 0		$ 0

The entries to record the steps in the liquidating process are as follows:

1) Sale of assets

Cash	72,000	
Noncash Assets		64,000
Gain on Realization		8,000

2) Division of gain:

Gain on Realization	8,000	
Jean Farley, Capital		4,000
Brad Green, Capital		2,400
Alice Hall, Capital		1,600

3) Payment of liabilities

Liabilities	9,000	
Cash		9,000

4) Distribution of cash to partners

Jean Farley, Capital	26,000	
Brad Green, Capital	24,400	
Alice Hall, Capital	23,600	
Cash		74,000

- As shown in above, the cash is distributed to the partners based on the balances of their capital accounts.
- These balances are determined after the gain on realization has been divided among the partners and the liabilities paid.

- The income-sharing ratio should not be used as a basis for distributing the cash to partners.

b) <u>Loss on Realization</u>

- Assume that Farley, Green, and Hall sell all noncash assets for $44,000. Thus, a loss of$20,000 ($64,000 - $44,000) is realized. The liquidation of the partnership is as follows:
- Step 1. Sale of assets: $44,000 is realized from the sale of all the noncash assets.
- Step 2. Division of loss: The loss of $20,000 is distributed to Farley, Green, and Hall in the income-sharing ratio of 5:3:2. Thus, the partner capital accounts are debited as follows:

Farley	$10,000 ($20,000 × 50%)
Green	6,000 ($20,000 × 30%)
Hall	4,000 ($20,000 × 20%)

- Step 3. Payment of liabilities: Creditors are paid $9,000.
- Step 4. Distribution of cash to partners: The remaining cash of $46,000 is distributed to the partners according to their capital balances as follows:

Farley	$12,000
Green	16,000
Hall	18,000

The steps in liquidating the partnership are summarized in the statement of partnership liquidation shown in Exhibit 6.

Statement of Partnership Liquidation: Loss on Realization

Farley, Green, and Hall
Statement of Partnership Liquidation
For Period April 10–30, 2010

		Cash	+ Noncash Assets	= Liabilities	+ Capital: Farley (50%)	+ Green (30%)	+ Hall (20%)
	Balances before realization	$11,000	$64,000	$9,000	$22,000	$22,000	$22,000
Steps 1–2 →	Sale of assets and division of loss	+44,000	−64,000		−10,000	− 6,000	− 4,000
	Balances after realization	$55,000	$ 0	$9,000	$12,000	$16,000	$18,000
Step 3 →	Payment of liabilities	− 9,000		−9,000			
	Balances after payment of liabilities	$46,000	$ 0	$ 0	$12,000	$16,000	$18,000
Step 4 →	Cash distributed to partners	−46,000			−12,000	−16,000	−18,000
	Final balances	$ 0	$ 0	$ 0	$ 0	$ 0	$ 0

The entries to record the steps in the liquidating process are as follows:

2. Sale of assets

Cash		44,000	
Loss on Realization		20,000	
Noncash Assets			64,000

3. Division of gain:

Jean Farley, Capital		10,000	
Brad Green, Capital		6,000	
Alice Hall, Capital		4,000	
Loss on Realization			20,000

4. Payment of liabilities

Liabilities		9,000	
Cash			9,000

5. Distribution of cash to partners

Jean Farley, Capital		12,000	
Brad Green, Capital		16,000	
Alice Hall, Capital		18,000	
Cash			46,000

c) <u>Loss on Realization—Capital Deficiency</u>

- The share of a loss on realization may be greater than the balance in a partner's capital account.
- The resulting debit balance in the capital account is called a **deficiency**. It represents a claim of the partnership against the partner.

To illustrate, assume that Farley, Green, and Hall sell all noncash assets for $10,000.Thus, a loss of $54,000 ($64,000 - $ 10,000) is realized. The liquidation of the partnership is as follows:

- Step 1. Sale of assets: $10,000 is realized from the sale of all the noncash assets.
- Step 2. Division of loss: The loss of $54,000 is distributed to Farley, Green, and Hall in the income-sharing ratio of 5:3:2. The partner capital accounts are debited as follows:

Farley	$27,000 ($54,000 × 50%)
Green	16,200 ($54,000 × 30%)
Hall	10,800 ($54,000 × 20%)

- Step 3. Payment of liabilities: Creditors are paid $9,000.
- Step 4. Distribution of cash to partners: The share of the loss allocated to Farley, $27,000

(50% * $54,000), exceeds the $22,000 balance in her capital account. This $5,000deficiency represents an amount that Farley owes the partnership. Assuming that Farley pays the deficiency, the cash of $17,000 is distributed to the partners according to their capital balances as follows:

Farley	$ 0
Green	5,800
Hall	11,200

Statement of Partnership Liquidation: Loss on Realization—Capital Deficiency

Farley, Green, and Hall
Statement of Partnership Liquidation
For Period April 10–30, 2010

		Cash	+ Noncash Assets	= Liabilities	+ Capital: Farley (50%)	+ Green (30%)	+ Hall (20%)
	Balances before realization	$11,000	$64,000	$9,000	$22,000	$22,000	$22,000
Steps 1–2 →	Sale of assets and division of loss	+10,000	−64,000		−27,000	−16,200	−10,800
	Balances after realization	$21,000	$ 0	$9,000	$ (5,000)	$ 5,800	$11,200
Step 3 →	Payment of liabilities	− 9,000		−9,000			
	Balances after payment of liabilities	$ 12,000	$ 0	$ 0	$ (5,000)	$ 5,800	$11,200
Step 4 →	Receipt of deficiency	+ 5,000			+ 5,000		
	Balances	$ 17,000	$ 0	$ 0	$ 0	$ 5,800	$11,200
	Cash distributed to partners	− 17,000				− 5,800	−11,200
	Final balances	$ 0	$ 0	$ 0	$ 0	$ 0	$ 0

The entries to liquidate the partnership are as follows:

1- Sale of assets

Cash	10,000	
Loss on Realization	54,000	
Noncash Assets		64,000

2- Division of loss

Jean Farley, Capital	27,000	
Brad Green, Capital	16,200	
Alice Hall, Capital	10,800	
Loss on Realization		54,000

3- Payment of liabilities

Liabilities	9,000	
Cash		9,000

4- Receipt of deficiency

Cash	5,000	
Jean Farley, Capital		5,000

5- Distribution of cash to partners

Brad Green, Capital	5,800	
Alice Hall, Capital	11,200	
Cash		17,000

- If the deficient partner does not pay the partnership their deficiency, there will not be sufficient partnership cash to pay the remaining partners in full.
- Any uncollected deficiency becomes a loss to the partnership and is divided among the remaining partners 'capital balances based on their income-sharing ratio.
- The cash balance will then equal the sum of the capital account balances.

- The cash can then be distributed to the remaining partners, based on the balances of their capital accounts.

To illustrate, assume that in the preceding example Farley could not pay her deficiency. The deficiency would be allocated to Green and Hall based on their income sharing ratio of 3:2. The remaining cash of $12,000 would then be distributed to Green ($2,800) and Hall ($9,200) as shown below.

	Capital Balances *Before* (Deficiency)	Allocated (Deficiency)	Capital Balances *After* Deficiency
Farley	$(5,000)	$5,000	$ 0
Green	5,800	(3,000)*	2,800
Hall	11,200	(2,000)**	9,200
Total	$12,000		$12,000

*$3,000 = [$5,000 × (3/5)] or ($5,000 × 60%)
**$2,000 = [$5,000 × (2/5)] or ($5,000 × 40%)

- **The entries to allocate Farley's deficiency and distribute the cash are as follows:**

1. Allocation of deficiency:

		Brad Green, Capital	3,000	
		Alice Hall, Capital	2,000	
		Jean Farley, Capital		5,000

2. Distribution of cash to partners:

		Brad Green, Capital	2,800	
		Alice Hall, Capital	9,200	
		Cash		12,000