Chapter 12

Accounting for Partnerships

STUDY OBJECTIVES

After studying this chapter, you should be able to:

1. Identify the characteristics of the partnership form of business organization.
2. Explain the accounting entries for the formation of a partnership.
3. Identify the bases for dividing net income or net loss.
4. Describe the form and content of partnership financial statements.
5. Explain the effects of the entries to record the liquidation of a partnership.

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- Scan **Study Objectives**
- Read **Feature Story**
- Read **Preview**
- Read text and answer **DO IT!** p. 532 p. 538 p. 541 p. 544
- Work **Comprehensive DO IT!** p. 545
- Review **Summary of Study Objectives**
- Answer **Self-Study Questions**
- Complete **Assignments**

Feature Story

FROM TRIALS TO THE TOP TEN

In 1990 Cliff Chenfield and Craig Balsam gave up the razors, ties, and six-figure salaries they had become accustomed to as New York lawyers. Instead, they set up a partnership, Razor & Tie Music *(www.razorandtie.com)*, in Cliff's living room. Ten years later, it became the only record company in the country that had achieved success in selling music both on television and in stores. Razor & Tie's entertaining and effective TV commercials have yielded unprecedented sales for multi-artist music compilations. At the same time, its hot retail label has been behind some of the most recent original, progressive releases from artists such as Kelly Sweet, All That Remains, EndeverafteR, Angelique Kidjo, Ryan Shaw, Dave Barnes, Twisted Sister, Dar Williams, Danko Jones, and Yerba Buena.

Razor & Tie may be best known for its wildly popular *Kidz Bop* CD series, the top-selling children's audio product in the United States. Advertised on

Nickelodeon, the Cartoon Network, and elsewhere, *Kidz Bop* titles have sold over 7 million copies. Seven of the 11 releases in the series have "gone Gold."

Razor & Tie got its start with its first TV release, *Those Fabulous '70s* (100,000 copies sold), followed by *Disco Fever* (over 300,000 sold).

After restoring the respectability of the oft-maligned music of the 1970s, the partners forged into the musical '80s with the same zeal that elicited success with their first releases. In 1993, Razor & Tie released *Totally '80s*, a collection of Top-10 singles from the 1980s that has sold over 450,000 units. Featuring the tag line, "The greatest hits from the decade when communism died and music videos were born," *Totally '80s* was the best-selling direct-response album in the country in 1993.

In 1995, Razor & Tie broke into the contemporary music world with *Living in the '90s*, the most successful record in the history of the company. Featuring a number of songs that were still hits on the radio at the time the package initially aired, *Living in the '90s* was a blockbuster. It received Gold certification in less than nine months and rewrote the rules on direct-response albums. For the first time, contemporary music was available through an album offered only through direct-response spots. Razor & Tie pursued that same strategy with its 2002 introduction of the *Kidz Bop* titles.

How has Razor & Tie carved out its sizable piece of the market? Through the complementary talents of the two partners. Their imagination and savvy, along with exciting new releases planned for the coming years, ensure Razor & Tie continued growth.

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Inside Chapter 12...

Preview of Chapter 12

It is not surprising that when Cliff Chenfield and Craig Balsam began Razor & Tie, they decided to use the partnership form of organization. Both saw the need for hands-on control of their product and its promotion. In this chapter, we will discuss reasons why businesses select the partnership form of organization. We also will explain the major issues in accounting for partnerships.

The content and organization of Chapter 12 are as follows.

Accounting for Partnerships

Partnership Form of Organization
- Characteristics
- Organizations with partnership characteristics
- Advantages/disadvantages
- Partnership agreement

Basic Partnership Accounting
- Forming a partnership
- Dividing net income/loss
- Financial statements

Liquidation of a Partnership
- No capital deficiency
- Capital deficiency

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PARTNERSHIP FORM OF ORGANIZATION

A **partnership** is an association of two or more persons to carry on as co-owners of a business for profit. Partnerships are sometimes used in small retail, service, or manufacturing companies. Also accountants, lawyers, and doctors find it desirable to form partnerships with other professionals in the field.

Characteristics of Partnerships

STUDY OBJECTIVE 1
Identify the characteristics of the partnership form of business organization.

Partnerships are fairly easy to form. People form partnerships simply by a verbal agreement, or more formally, by written agreement. We explain the principal characteristics of partnerships in the following sections.


Association of Individuals

ASSOCIATION OF INDIVIDUALS

A partnership is a legal entity. A partnership can own property (land, buildings, equipment), and can sue or be sued. **A partnership also is an accounting entity.** Thus, the personal assets, liabilities, and transactions of the partners are excluded from the accounting records of the partnership, just as they are in a proprietorship.

The net income of a partnership is not taxed as a separate entity. But, a partnership must file an information tax return showing partnership net income and each partner's share of that net income. Each partner's share is taxable at **personal tax rates**, regardless of the amount of net income each withdraws from the business during the year.


Mutual Agency

MUTUAL AGENCY

Mutual agency means that each partner acts on behalf of the partnership when engaging in partnership business. The act of any partner is binding on all other partners. This is true even when partners act beyond the scope of their authority, so long as the act appears to be appropriate for the partnership. For example, a partner of a grocery store who purchases a delivery truck creates a binding contract in the name of the partnership, even if the partnership agreement denies this authority. On the other hand, if a partner in a law firm purchased a snowmobile for the partnership, such an act would not be binding on the partnership. The purchase is clearly outside the scope of partnership business.

LIMITED LIFE

Corporations have unlimited life. Partnerships do not. A partnership may be ended voluntarily at any time through the acceptance of a new partner or the withdrawal of a partner. It may be ended involuntarily by the death or incapacity of a partner. **Partnership dissolution** occurs whenever a partner withdraws or a new partner is admitted. Dissolution does not necessarily mean that the business ends. If the continuing partners agree, operations can continue without interruption by forming a new partnership.

Limited Life

UNLIMITED LIABILITY

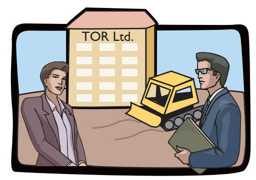
Each partner is **personally and individually liable** for all partnership liabilities. Creditors' claims attach first to partnership assets. If these are insufficient, the claims then attach to the personal resources of any partner, irrespective of that partner's equity in the partnership. Because each partner is responsible for all the debts of the partnership, each partner is said to have **unlimited liability**.


Unlimited Liability

CO-OWNERSHIP OF PROPERTY

Partners jointly own partnership assets. If the partnership is dissolved, each partner has a claim on total assets equal to the balance in his or her respective capital account. This claim does not attach to **specific assets** that an individual partner contributed to the firm. Similarly, if a partner invests a building in the partnership valued at $100,000 and the building is later sold at a gain of $20,000, the partners all share in the gain.

Partnership net income (or net loss) is also co-owned. **If the partnership contract does not specify to the contrary, all net income or net loss is shared equally by the partners.** As you will see later, though, partners may agree to unequal sharing of net income or net loss.



Co-ownership of Property

Organizations with Partnership Characteristics

If you are starting a business with a friend and each of you has little capital and your business is not risky, you probably want to use a partnership. As indicated above, the partnership is easy to establish and its cost is minimal. These types of partnerships are often called **regular partnerships**. However if your business is risky—say, roof repair or providing some type of professional service—you will want to limit your liability and not use a regular partnership. As a result, special forms of business organizations with partnership characteristics are now often used to provide protection from unlimited liability for people who wish to work together in some activity.

The special partnership forms are: limited partnerships, limited liability partnerships, and limited liability companies. These special forms use the same accounting procedures as those described for a regular partnership. In addition, for taxation purposes, all the profits and losses pass through these organizations (similar to the regular partnership) to the owners, who report their share of partnership net income or losses on their personal tax returns.

LIMITED PARTNERSHIPS

In a **limited partnership**, one or more partners have **unlimited liability** and one or more partners have **limited liability** for the debts of the firm. Those with unlimited

INTERNATIONAL NOTE
Much of the funding for successful new U.S. businesses comes from "venture capital" firms, which are organized as limited partnerships. To develop its own venture capital industry, China believes that it needs the limited liability form. Therefore, China has taken steps to model its partnership laws to allow for limited partnerships like those in the U.S.

liability are **general partners**. Those with limited liability are **limited partners**. Limited partners are responsible for the debts of the partnership up to the limit of their investment in the firm.

The words "Limited Partnership," or "Ltd.," or "LP" identify this type of organization. For the privilege of limited liability, the limited partner usually accepts less compensation than a general partner and exercises less influence in the affairs of the firm. If the limited partners get involved in management, they risk their liability protection.

LIMITED LIABILITY PARTNERSHIP

Most states allow professionals such as lawyers, doctors, and accountants to form a **limited liability partnership** or "LLP." The LLP is designed to protect innocent partners from malpractice or negligence claims resulting from the acts of another partner. LLPs generally carry large insurance policies as protection against malpractice suits. These professional partnerships vary in size from a medical partnership of three to five doctors, to 150 to 200 partners in a large law firm, to more than 2,000 partners in an international accounting firm.

HELPFUL HINT
In an LLP, *all* partners have limited liability. There are no general partners.

LIMITED LIABILITY COMPANIES

A hybrid form of business organization with certain features like a corporation and others like a limited partnership is the **limited liability company**, or "LLC." An LLC usually has a limited life. The owners, called **members**, have limited liability like owners of a corporation. Whereas limited partners do not actively participate in the management of a limited partnership (LP), the members of a limited liability company (LLC) can assume an active management role. For income tax purposes, the IRS usually classifies an LLC as a partnership.

ACCOUNTING ACROSS THE ORGANIZATION

Limited Liability Companies Gain in Popularity

The proprietorship form of business organization is still the most popular, followed by the corporate form. But whenever a group of individuals wants to form a partnership, the limited liability company is usually the popular choice.

One other form of business organization is a *subchapter S corporation*. A subchapter S corporation has many of the characteristics of a partnership—especially, taxation as a partnership—but it is losing its popularity. The reason: It involves more paperwork and expense than a limited liability company, which in most cases offers similar advantages.

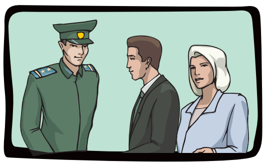
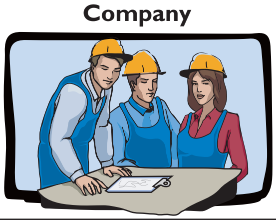
? Why do you think that the use of the limited liability company is gaining in popularity?

Illustration 12-1 (next page) summarizes different forms of organizations that have partnership characteristics.

Advantages and Disadvantages of Partnerships

Why do people choose partnerships? One major advantage of a partnership is to combine the skills and resources of two or more individuals. In addition, partnerships are easily formed and are relatively free from government regulations and restrictions. A partnership does not have to contend with the "red tape" that a

Illustration 12-1
Different forms of organizations with partnership characteristics

	Major Advantages	Major Disadvantages
Regular Partnership  General Partners	Simple and inexpensive to create and operate.	Owners (partners) personally liable for business debts.
Limited Partnership  General Partners / Limited Partners	Limited partners have limited personal liability for business debts as long as they do not participate in management. General partners can raise cash without involving outside investors in management of business.	General partners personally liable for business debts. More expensive to create than regular partnership. Suitable mainly for companies that invest in real estate.
Limited Liability Partnership 	Mostly of interest to partners in old-line professions such as law, medicine, and accounting. Owners (partners) are not personally liable for the malpractice of other partners.	Unlike a limited liability company, owners (partners) remain personally liable for many types of obligations owed to business creditors, lenders, and landlords. Often limited to a short list of professions.
Limited Liability Company 	Owners have limited personal liability for business debts even if they participate in management.	More expensive to create than regular partnership.

Source: *www.nolo.com* (accessed June 2006).

corporation must face. Also, partners generally can make decisions quickly on substantive business matters without having to consult a board of directors.

On the other hand, partnerships also have some major disadvantages. **Unlimited liability** is particularly troublesome. Many individuals fear they may lose not only their initial investment but also their personal assets, if those assets are needed to pay partnership creditors.

Illustration 12-2 summarizes the advantages and disadvantages of the regular partnership form of business organization. As indicated in the previous section,

Illustration 12-2
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	

different types of partnership forms have evolved to reduce some of the disadvantages.

DO IT!

PARTNERSHIP ORGANIZATION

Indicate whether each of the following statements is true or false.

______ **1.** Partnerships have unlimited life. Corporations do not.

______ **2.** Partners jointly own partnership assets. A partner's claim on partnership assets does not attach to specific assets.

______ **3.** In a limited partnership, the general partners have unlimited liability.

______ **4.** The members of a limited liability company have limited liability, like shareholders of a corporation, and they are taxed like corporate shareholders.

______ **5.** Because of mutual agency, the act of any partner is binding on all other partners.

action plan

✔ When forming a business, carefully consider what type of organization would best suit the needs of the business.

✔ Keep in mind the new, "hybrid" organizational forms that have many of the best characteristics of partnerships and corporations.

Solution

1. False. Corporations have unlimited life. Partnerships do not.
2. True.
3. True.
4. False. The members of a limited liability company are taxed like partners in a partnership.
5. True.

Related exercise material: **E12-1** and **DO IT! 12-1.**

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The Partnership Agreement

ETHICS NOTE

A well-developed partnership agreement reduces ethical conflict among partners. It specifies in clear and concise language the process by which the partners will resolve ethical and legal problems. This issue is especially significant when the partnership experiences financial distress.

Ideally, the agreement of two or more individuals to form a partnership should be expressed in a written contract, called the **partnership agreement** or **articles of co-partnership**. The partnership agreement contains such basic information as the name and principal location of the firm, the purpose of the business, and date of inception. In addition, it should specify relationships among the partners, such as:

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.

We cannot overemphasize the importance of a written contract. The agreement should attempt to anticipate all possible situations, contingencies, and disagreements. The help of a lawyer is highly desirable in preparing the agreement.

ACCOUNTING ACROSS THE ORGANIZATION

How to Part Ways Nicely

What should you do when you and your business partner do not agree on things, to the point where you are no longer on speaking terms? Given how heated business situations can get, this is not an unusual occurrence. Unfortunately, in many instances the partners do everything they can to undermine the other partner, eventually destroying the business. In some instances people even steal from the partnership because they either feel that they "deserve it" or they assume that the other partners are stealing from them.

It would be much better to follow the example of Jennifer Appel and her partner. They found that after opening a successful bakery and writing a cookbook, they couldn't agree on how the business should be run. The other partner bought out Ms. Appel's share of the business, and Ms. Appel went on to start her own style of bakery, which she ultimately franchised.

Source: Paulette Thomas, "As Partnership Sours, Parting Is Sweet," *Wall Street Journal*, July 6, 2004, p. A20.

? How can partnership conflicts be minimized and more easily resolved?

BASIC PARTNERSHIP ACCOUNTING

We now turn to the basic accounting for partnerships. The major accounting issues relate to forming the partnership, dividing income or loss, and preparing financial statements.

Forming a Partnership

STUDY OBJECTIVE 2
Explain the accounting entries for the formation of a partnership.

Each partner's initial investment in a partnership is entered in the partnership records. The partnership should record these investments at the **fair market value of the assets at the date of their transfer to the partnership**. All partners must agree to the values assigned.

To illustrate, assume that A. Rolfe and T. Shea combine their proprietorships to start a partnership named U.S. Software. The firm will specialize in developing financial modeling software packages. Rolfe and Shea have the following assets prior to the formation of the partnership.

	Book Value		Market Value	
	A. Rolfe	**T. Shea**	**A. Rolfe**	**T. Shea**
Cash	$ 8,000	$ 9,000	**$ 8,000**	**$ 9,000**
Office equipment	5,000		**4,000**	
Accumulated depreciation	(2,000)			
Accounts receivable		4,000		**4,000**
Allowance for doubtful accounts		(700)		**(1,000)**
	$11,000	$12,300	**$12,000**	**$12,000**

Illustration 12-3
Book and market values of assets invested

*Items under **owners' equity (OE)** in the accounting equation analyses (in margins) are not labeled in this partnership chapter. Nearly all affect partners' **capital** accounts.*

The partnership records the investments as follows.

Investment of A. Rolfe

Cash	8,000	
Office Equipment	4,000	
A. Rolfe, Capital		12,000
(To record investment of Rolfe)		

A	=	L	+	OE
+8,000				
+4,000				
				+12,000

Cash Flows
+8,000

A	=	L	+	OE
+9,000				
+4,000				
−1,000				
				+12,000

Cash Flows
+9,000

Investment of T. Shea

	Debit	Credit
Cash	9,000	
Accounts Receivable	4,000	
Allowance for Doubtful Accounts		1,000
T. Shea, Capital		12,000
(To record investment of Shea)		

Note that the partnership records neither the original cost of the office equipment ($5,000) nor its book value ($5,000 − $2,000). It records the equipment at its fair market value, $4,000. The partnership does not carry forward any accumulated depreciation from the books of previous entities (in this case, the two proprietorships).

In contrast, the gross claims on customers ($4,000) are carried forward to the partnership. The partnership adjusts the allowance for doubtful accounts to $1,000, to arrive at a cash (net) realizable value of $3,000. A partnership may start with an allowance for doubtful accounts because it will continue to collect existing accounts receivable, some of which are expected to be uncollectible. In addition, this procedure maintains the control and subsidiary relationship between Accounts Receivable and the accounts receivable subsidiary ledger.

After formation of the partnership, the accounting for transactions is similar to any other type of business organization. For example, the partners record all transactions with outside parties, such as the purchase or sale of merchandise inventory and the payment or receipt of cash, the same as would a sole proprietor.

The steps in the accounting cycle described in Chapter 4 for a proprietorship also apply to a partnership. For example, the partnership prepares a trial balance and journalizes and posts adjusting entries. A worksheet may be used. There are minor differences in journalizing and posting closing entries and in preparing financial statements, as we explain in the following sections. The differences occur because there is more than one owner.

Dividing Net Income or Net Loss

Partners equally share partnership net income or net loss unless the partnership contract indicates otherwise. The same basis of division usually applies to both net income and net loss. It is customary to refer to this basis as the **income ratio**, the **income and loss ratio**, or the **profit and loss (P&L) ratio**. Because of its wide acceptance, we will use the term **income ratio** to identify the basis for dividing net income and net loss. The partnership recognizes a partner's share of net income or net loss in the accounts through closing entries.

CLOSING ENTRIES

As in the case of a proprietorship, a partnership must make four entries in preparing closing entries. The entries are:

1. Debit each revenue account for its balance, and credit Income Summary for total revenues.
2. Debit Income Summary for total expenses, and credit each expense account for its balance.
3. Debit Income Summary for its balance, and credit each partner's capital account for his or her share of net income. Or, credit Income Summary, and debit each partner's capital account for his or her share of net loss.
4. Debit each partner's capital account for the balance in that partner's drawing account, and credit each partner's drawing account for the same amount.

The first two entries are the same as in a proprietorship. The last two entries are different because (1) there are two or more owners' capital and drawing accounts, and (2) it is necessary to divide net income (or net loss) among the partners.

To illustrate the last two closing entries, assume that AB Company has net income of $32,000 for 2010. The partners, L. Arbor and D. Barnett, share net income and net loss equally. Drawings for the year were Arbor $8,000 and Barnett $6,000. The last two closing entries are:

Dec. 31	Income Summary	32,000	
	L. Arbor, Capital ($32,000 × 50%)		16,000
	D. Barnett, Capital ($32,000 × 50%)		16,000
	(To transfer net income to partners' capital accounts)		
Dec. 31	L. Arbor, Capital	8,000	
	D. Barnett, Capital	6,000	
	L. Arbor, Drawing		8,000
	D. Barnett, Drawing		6,000
	(To close drawing accounts to capital accounts)		

A	=	L	+	OE
				−32,000
				+16,000
				+16,000

Cash Flows
no effect

A	=	L	+	OE
				−8,000
				−6,000
				+8,000
				+6,000

Cash Flows
no effect

Assume that the beginning capital balance is $47,000 for Arbor and $36,000 for Barnett. After posting the closing entries, the capital and drawing accounts will appear as shown in Illustration 12-4.

Illustration 12-4
Partners' capital and drawing accounts after closing

L. Arbor, Capital

Debit		Credit	
12/31 Clos.	**8,000**	1/1 Bal.	47,000
		12/31 Clos.	**16,000**
		12/31 Bal.	55,000

D. Barnett, Capital

Debit		Credit	
12/31 Clos.	**6,000**	1/1 Bal.	36,000
		12/31 Clos.	**16,000**
		12/31 Bal.	46,000

L. Arbor, Drawing

Debit		Credit	
12/31 Bal.	8,000	12/31 Clos.	**8,000**

D. Barnett, Drawing

Debit		Credit	
12/31 Bal.	6,000	12/31 Clos.	**6,000**

As in a proprietorship, the partners' capital accounts are permanent accounts; their drawing accounts are temporary accounts. Normally, the capital accounts will have credit balances, and the drawing accounts will have debit balances. Drawing accounts are debited when partners withdraw cash or other assets from the partnership for personal use.

INCOME RATIOS

STUDY OBJECTIVE 3
Identify the bases for dividing net income or net loss.

As noted earlier, the partnership agreement should specify the basis for sharing net income or net loss. The following are typical income ratios.

1. A fixed ratio, expressed as a proportion (6:4), a percentage (70% and 30%), or a fraction (2/3 and 1/3).
2. A ratio based either on capital balances at the beginning of the year or on average capital balances during the year.
3. Salaries to partners and the remainder on a fixed ratio.
4. Interest on partners' capital balances and the remainder on a fixed ratio.
5. Salaries to partners, interest on partners' capital, and the remainder on a fixed ratio.

The objective is to settle on a basis that will equitably reflect the partners' capital investment and service to the partnership.

A **fixed ratio** is easy to apply, and it may be an equitable basis in some circumstances. Assume, for example, that Hughes and Lane are partners. Each contributes the same amount of capital, but Hughes expects to work full-time in the partnership and Lane expects to work only half-time. Accordingly, the partners agree to a fixed ratio of 2/3 to Hughes and 1/3 to Lane.

A **ratio based on capital balances** may be appropriate when the funds invested in the partnership are considered the critical factor. Capital ratios may also be equitable when the partners hire a manager to run the business and do not plan to take an active role in daily operations.

The three remaining ratios (items 3, 4, and 5) give specific recognition to differences among partners. These ratios provide salary allowances for time worked and interest allowances for capital invested. Then, the partnership allocates any remaining net income or net loss on a fixed ratio.

Salaries to partners and interest on partners' capital are not expenses of the partnership. Therefore, these items do not enter into the matching of expenses with revenues and the determination of net income or net loss. For a partnership, as for other entities, salaries expense pertains to the cost of services performed by employees. Likewise, interest expense relates to the cost of borrowing from creditors. But partners, as owners, are not considered either **employees** or **creditors**. When the partnership agreement permits the partners to make monthly withdrawals of cash based on their "salary," the partnership debits these withdrawals to the partner's drawing account.

SALARIES, INTEREST, AND REMAINDER ON A FIXED RATIO

Under income ratio (5) in the list above, the partnership must apply salaries and interest **before** it allocates the remainder on the specified fixed ratio. **This is true even if the provisions exceed net income. It is also true even if the partnership has suffered a net loss for the year.** The partnership's income statement should show, below net income, detailed information concerning the division of net income or net loss.

To illustrate, assume that 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 2010, partnership net income is $22,000. The division of net income is as follows.

Illustration 12-5
Income statement with division of net income

KINGSLEE COMPANY
Income Statement (partial)
For the Year Ended December 31, 2010

Sales	$200,000
Net income	$ 22,000

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**

Kingslee records the division of net income as follows.

Dec. 31	Income Summary	22,000	
	Sara King, Capital		12,400
	Ray Lee, Capital		9,600
	(To close net income to partners' capital)		

A	=	L	+	OE
				−22,000
				+12,000
				+9,600

Cash Flows
no effect

Now let's look at a situation in which the salary and interest allowances *exceed* net income. Assume that Kingslee Company's net income is only $18,000. In this case, the salary and interest allowances will create a deficiency of $1,600 ($19,600 − $18,000). The computations of the allowances are the same as those in the preceding example. Beginning with total salaries and interest, we complete the division of net income as shown in Illustration 12-6.

Illustration 12-6
Division of net income—income deficiency

	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

STUDY OBJECTIVE 4
Describe the form and content of partnership financial statements.

The financial statements of a partnership are similar to those of a proprietorship. The differences are due to the number of owners involved. The income statement for a partnership is identical to the income statement for a proprietorship except for the division of net income, as shown earlier.

The owners' equity statement for a partnership is called the **partners' capital statement**. It explains the changes in each partner's capital account and in total partnership capital during the year. Illustration 12-7 shows the partners' capital statement for Kingslee Company. It is based on the division of $22,000 of net income in Illustration 12-5. The statement includes assumed data for the additional investment and drawings. The partnership prepares the partners' capital statement from the income statement and the partners' capital and drawing accounts.

Illustration 12-7
Partners' capital statement

KINGSLEE COMPANY
Partners' Capital Statement
For the Year Ended December 31, 2010

	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**

HELPFUL HINT
As in a proprietorship, partners' capital may change due to (1) additional investment, (2) drawings, and (3) net income or net loss.

The balance sheet for a partnership is the same as for a proprietorship except for the owner's equity section. For a partnership, the balance sheet shows the capital balances of each partner. The owners' equity section for Kingslee Company would show the following.

Illustration 12-8
Owners' equity section of a partnership balance sheet

KINGSLEE COMPANY
Balance Sheet (partial)
December 31, 2010

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

DO IT!

DIVISION OF NET INCOME

LeeMay Company reports net income of $57,000. The partnership agreement provides for salaries of $15,000 to L. Lee and $12,000 to R. May. They will share the remainder on a 60:40 basis (60% to Lee). L. Lee asks your help to divide the net income between the partners and to prepare the closing entry.

action plan

- ✔ Compute net income exclusive of any salaries to partners and interest on partners' capital.
- ✔ Deduct salaries to partners from net income.
- ✔ Apply the partners' income ratios to the remaining net income.
- ✔ Prepare the closing entry distributing net income or net loss among the partners' capital accounts.

Solution

The division of net income is as follows.

	L. Lee	R. May	Total
Salary allowance	$15,000	$12,000	$27,000
Remaining income $30,000 ($57,000 − $27,000)			
L. Lee (60% × $30,000)	18,000		
R. May (40% × $30,000)		12,000	
Total remaining income			30,000
Total division of net income	$33,000	$24,000	$57,000

The closing entry for net income therefore is:

Income Summary	57,000	
L. Lee, Capital		33,000
R. May, Capital		24,000
(To close net income to partners' capital accounts)		

Related exercise material: **BE12-3, BE12-4, BE12-5, E12-4, E12-5,** and **DO IT! 12-2.**

✔ The Navigator

LIQUIDATION OF A PARTNERSHIP

STUDY OBJECTIVE 5
Explain the effects of the entries to record the liquidation of a partnership.

Liquidation of a business involves selling the assets of the firm, paying liabilities, and distributing any remaining assets. Liquidation may result from the sale of the business by mutual agreement of the partners, from the death of a partner, or from bankruptcy. **Partnership liquidation** ends both the legal and economic life of the entity.

From an accounting standpoint, the partnership should complete the accounting cycle for the final operating period prior to liquidation. This includes preparing adjusting entries and financial statements. It also involves preparing closing entries and a post-closing trial balance. Thus, only balance sheet accounts should be open as the liquidation process begins.

In liquidation, the sale of noncash assets for cash is called **realization**. Any difference between book value and the cash proceeds is called the **gain or loss on realization**. To liquidate a partnership, 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**.

ETHICS NOTE

The process of selling noncash assets and then distributing the cash reduces the likelihood of partner disputes. If, instead, the partnership distributes noncash assets to partners to liquidate the firm, the partners would need to agree on the value of the noncash assets, which can be very difficult to determine.

Each of the steps must be performed in sequence. The partnership must pay creditors **before** partners receive any cash distributions. Also, an accounting entry must record each step.

When a partnership is liquidated, all partners may have credit balances in their capital accounts. This situation is called **no capital deficiency**. Or, one or more partners may have a debit balance in the capital account. This situation is termed a **capital deficiency**. To illustrate each of these conditions, assume that Ace Company is liquidated when its ledger shows the following assets, liabilities, and owners' equity accounts.

Illustration 12-9
Account balances prior to liquidation

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

No Capital Deficiency

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. The steps in the liquidation process are as follows.

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). Thus Ace realizes a gain of $15,000 on the sale. The entry is:

(1)

Cash	75,000	
Accumulated Depreciation–Equipment	8,000	
Accounts Receivable		15,000
Inventory		18,000
Equipment		35,000
Gain on Realization		15,000
(To record realization of noncash assets)		

A	= L	+ OE
+75,000		
+8,000		
−15,000		
−18,000		
−35,000		
		+15,000

Cash Flows
+75,000

2. Ace allocates the $15,000 gain on realization to the partners based on their income ratios, which are 3:2:1. The entry is:

A	=	L	+	OE
				−15,000
				+7,500
				+5,000
				+2,500

Cash Flows
no effect

(2)

Gain on Realization	15,000	
R. Arnet, Capital ($15,000 × 3/6)		7,500
P. Carey, Capital ($15,000 × 2/6)		5,000
W. Eaton, Capital ($15,000 × 1/6)		2,500
(To allocate gain to partners' capital accounts)		

3. Partnership liabilities consist of Notes Payable $15,000 and Accounts Payable $16,000. Ace pays creditors in full by a cash payment of $31,000. The entry is:

A	=	L	+	OE
		−15,000		
		−16,000		
−31,000				

Cash Flows
−31,000

(3)

Notes Payable	15,000	
Accounts Payable	16,000	
Cash		31,000
(To record payment of partnership liabilities)		

4. Ace distributes the remaining cash to the partners on the basis of **their capital balances**. After posting the entries in the first three steps, all partnership accounts, including Gain on Realization, will have zero balances except for four accounts: Cash $49,000; R. Arnet, Capital $22,500; P. Carey, Capital $22,800; and W. Eaton, Capital $3,700, as shown below.

Cash				R. Arnet, Capital				P. Carey, Capital				W. Eaton, Capital			
Bal.	5,000	(3)	31,000			Bal.	15,000			Bal.	17,800			Bal.	1,200
(1)	75,000					(2)	7,500			(2)	5,000			(2)	2,500
Bal.	**49,000**					**Bal.**	**22,500**			**Bal.**	**22,800**			**Bal.**	**3,700**

Illustration 12-10
Ledger balances before distribution of cash

Ace records the distribution of cash as follows.

A	=	L	+	OE
				−22,500
				−22,800
				−3,700
−49,000				

Cash Flows
−49,000

(4)

R. Arnet, Capital	22,500	
P. Carey, Capital	22,800	
W. Eaton, Capital	3,700	
Cash		49,000
(To record distribution of cash to partners)		

After posting this entry, all partnership accounts will have zero balances.

A word of caution: **Partnerships should not distribute remaining cash to partners on the basis of their income-sharing ratios.** On this basis, Arnet would receive three-sixths, or $24,500, which would produce an erroneous debit balance of $2,000. The income ratio is the proper basis for allocating net income or loss. **It is not a proper basis for making the final distribution of cash to the partners.**

ALTERNATIVE TERMINOLOGY

The schedule of cash payments is sometimes called a *safe cash payments schedule.*

SCHEDULE OF CASH PAYMENTS

The **schedule of cash payments** shows the distribution of cash to the partners in a partnership liquidation. A cash payments schedule is sometimes prepared to determine the distribution of cash to the partners in the liquidation of a partnership.

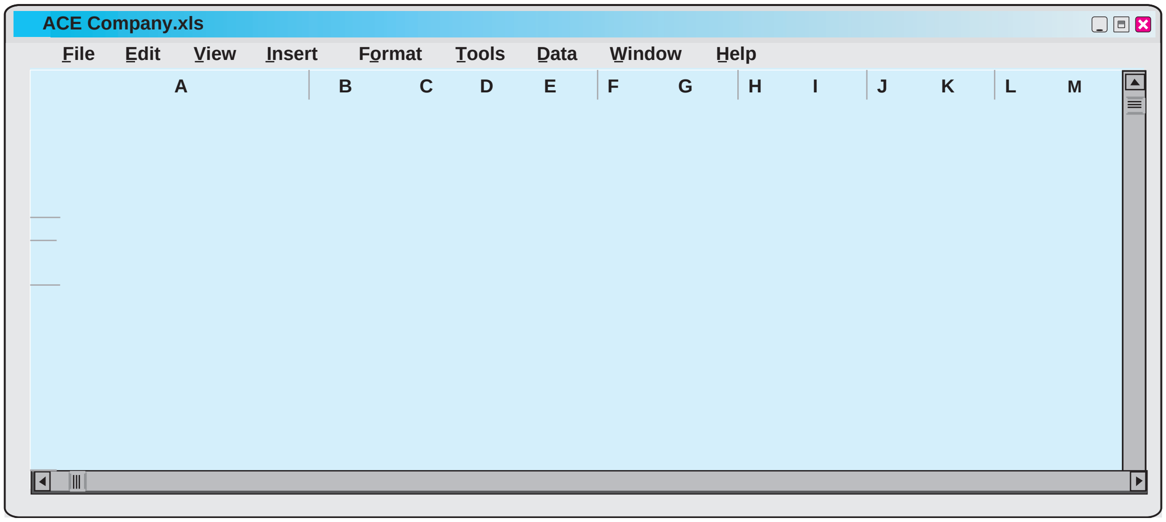
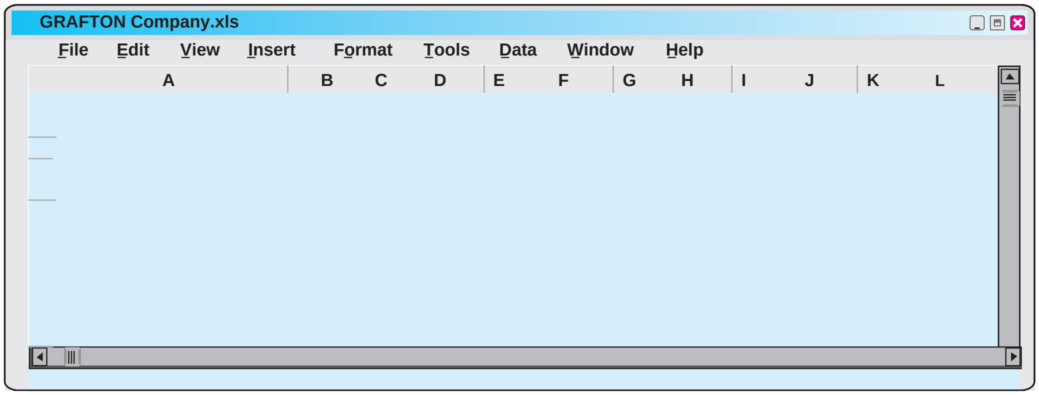


Illustration 12-11
Schedule of cash payments, no capital deficiency

Solution



[a]30,000 × 2/8
[b]30,000 × 3/8

3. Ace pays the partnership liabilities. This entry is the same as the previous one.

(3)

Notes Payable	15,000	
Accounts Payable	16,000	
Cash		31,000
(To record payment of partnership liabilities)		

A	=	L	+	OE
				−15,000
				−16,000
−31,000				

Cash Flows
−31,000

4. After posting the three entries, two accounts will have debit balances—Cash $16,000, and W. Eaton, Capital $1,800. Two accounts will have credit balances—R. Arnet, Capital $6,000, and P. Carey, Capital $11,800. All four accounts are shown below.

Cash				R. Arnet, Capital				P. Carey, Capital				W. Eaton, Capital			
Bal.	5,000	(3)	31,000	(2)	9,000	Bal.	15,000	(2)	6,000	Bal.	17,800	(2)	3,000	Bal.	1,200
(1)	42,000														
Bal.	**16,000**					**Bal.**	**6,000**			**Bal.**	**11,800**	**Bal.**	**1,800**		

Illustration 12-12
Ledger balances before distribution of cash

Eaton has a capital deficiency of $1,800, and so owes the partnership $1,800. Arnet and Carey have a legally enforceable claim for that amount against Eaton's personal assets. Note that the distribution of cash is still made on the basis of capital balances. But the amount will vary depending on how Eaton settles the deficiency. Two alternatives are presented in the following sections.

PAYMENT OF DEFICIENCY

If the partner with the capital deficiency pays the amount owed the partnership, the deficiency is eliminated. To illustrate, assume that Eaton pays $1,800 to the partnership. The entry is:

(a)

Cash	1,800	
W. Eaton, Capital		1,800
(To record payment of capital deficiency by Eaton)		

A	=	L	+	OE
+1,800				
				+1,800

Cash Flows
+1,800

After posting this entry, account balances are as follows.

Cash				R. Arnet, Capital				P. Carey, Capital				W. Eaton, Capital			
Bal.	5,000	(3)	31,000	(2)	9,000	Bal.	15,000	(2)	6,000	Bal.	17,800	(2)	3,000	Bal.	1,200
(1)	42,000													(a)	1,800
(a)	1,800					**Bal.**	**6,000**			**Bal.**	**11,800**			**Bal.**	**–0–**
Bal.	**17,800**														

Illustration 12-13
Ledger balances after paying capital deficiency

The cash balance of $17,800 is now equal to the credit balances in the capital accounts (Arnet $6,000 + Carey $11,800). Ace now distributes cash on the basis of these balances. The entry is:

R. Arnet, Capital	6,000	
P. Carey, Capital	11,800	
Cash		17,800
(To record distribution of cash to the partners)		

A	=	L	+	OE
				−6,000
				−11,800
−17,800				

Cash Flows
−17,800

After posting this entry, all accounts will have zero balances.

NONPAYMENT OF DEFICIENCY

If a partner with a capital deficiency is unable to pay the amount owed to the partnership, the partners with credit balances must absorb the loss. The partnership allocates the loss on the basis of the income ratios that exist between the partners with credit balances.

The income ratios of Arnet and Carey are 3 : 2, or 3/5 and 2/5, respectively. Thus, Ace would make the following entry to remove Eaton's capital deficiency.

A	=	L	+	OE
				−1,080
				−720
				+1,800

Cash Flows
no effect

(a)

	Debit	Credit
R. Arnet, Capital ($1,800 × 3/5)	1,080	
P. Carey, Capital ($1,800 × 2/5)	720	
W. Eaton, Capital		1,800
(To record write-off of capital deficiency)		

After posting this entry, the cash and capital accounts will have the following balances.

Cash				R. Arnet, Capital				P. Carey, Capital				W. Eaton, Capital			
Bal.	5,000	(3)	31,000	(2)	9,000	Bal.	15,000	(2)	6,000	Bal.	17,800	(2)	3,000	Bal.	1,200
(1)	42,000			(a)	1,080			(a)	720					(a)	1,800
Bal.	**16,000**					**Bal.**	**4,920**			**Bal.**	**11,080**			**Bal.**	**–0–**

Illustration 12-14
Ledger balances after non-payment of capital deficiency

The cash balance ($16,000) now equals the sum of the credit balances in the capital accounts (Arnet $4,920 + Carey $11,080). Ace records the distribution of cash as:

A	=	L	+	OE
				−4,920
				−11,080
−16,000				

Cash Flows
−16,000

	Debit	Credit
R. Arnet, Capital	4,920	
P. Carey, Capital	11,080	
Cash		16,000
(To record distribution of cash to the partners)		

After posting this entry, all accounts will have zero balances.

DO IT!

PARTNERSHIP LIQUIDATION

Kessington Company wishes to liquidate the firm by distributing the company's cash to the three partners. Prior to the distribution of cash, the company's balances are: Cash $45,000; Rollings, Capital (Cr.) $28,000; Havens, Capital (Dr.) $12,000; and Ostergard, Capital (Cr.) $29,000. The income ratios of the three partners are 4:4:2, respectively. Prepare the entry to record the absorption of Havens' capital deficiency by the other partners and the distribution of cash to the partners with credit balances.

action plan

- ✔ Allocate any unpaid capital deficiency to the partners with credit balances, based on their income ratios.
- ✔ After distribution of the deficiency, distribute cash to the remaining partners, based on their capital balances.

Solution

	Debit	Credit
Rollings, Capital ($12,000 × 4/6)	8,000	
Ostergard, Capital ($12,000 × 2/6)	4,000	
Havens, Capital		12,000
(To record write-off of capital deficiency)		
Rollings, Capital ($28,000 − $8,000)	20,000	
Ostergard, Capital ($29,000 − $4,000)	25,000	
Cash		45,000
(To record distribution of cash to partners)		

Related exercise material: **E12-10** and **DO IT! 12-4.**

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Comprehensive DO IT!

On January 1, 2010, the capital balances in Hollingsworth Company are Lois Holly $26,000, and Jim Worth $24,000. In 2010 the partnership reports net income of $30,000. The income ratio provides for salary allowances of $12,000 for Holly and $10,000 to Worth and the remainder equally. Neither partner had any drawings in 2010.

Instructions

(a) Prepare a schedule showing the distribution of net income in 2010.
(b) Journalize the division of 2010 net income to the partners.

action plan

- ✔ Compute the net income of the partnership.
- ✔ Allocate the partners' salaries.
- ✔ Divide the remaining net income among the partners, applying the income/loss ratio.
- ✔ Journalize the division of net income in a closing entry.

Solution to Comprehensive DO IT!

(a) Net income 30,000

Division of Net Income

	Lois Holly	Jim Worth	Total
Salary allowance	$12,000	$10,000	$22,000
Remaining income $8,000 ($30,000 − $22,000)			
Lois Holly ($8,000 × 50%)	4,000		
Jim Worth ($8,000 × 50%)		4,000	
Total remainder			8,000
Total division of net income	$16,000	$14,000	$30,000

(b)

12/31/10	Income Summary	30,000	
	Lois Holly, Capital		16,000
	Jim Worth, Capital		14,000
	(To close net income to partners' capital)		

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SUMMARY OF STUDY OBJECTIVES

1 **Identify the characteristics of the partnership form of business organization.** The principal characteristics of a partnership are: (a) association of individuals, (b) mutual agency, (c) limited life, (d) unlimited liability, and (e) co-ownership of property.

2 **Explain the accounting entries for the formation of a partnership.** When formed, a partnership records each partner's initial investment at the fair market value of the assets at the date of their transfer to the partnership.

3 **Identify the bases for dividing net income or net loss.** Partnerships divide net income or net loss on the basis of the income ratio, which may be (a) a fixed ratio, (b) a ratio based on beginning or average capital balances, (c) salaries to partners and the remainder on a fixed ratio, (d) interest on partners' capital and the remainder on a fixed ratio, and (e) salaries to partners, interest on partners' capital, and the remainder on a fixed ratio.

4 **Describe the form and content of partnership financial statements.** The financial statements of a partnership are similar to those of a proprietorship. The principal differences are: (a) The partnership shows the division of net income on the income statement. (b) The owners' equity statement is called a partners' capital statement. (c) The partnership reports each partner's capital on the balance sheet.

5 **Explain the effects of the entries to record the liquidation of a partnership.** When a partnership is liquidated, it is necessary to record the (a) sale of noncash assets, (b) allocation of the gain or loss on realization, (c) payment of partnership liabilities, and (d) distribution of cash to the partners on the basis of their capital balances.

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GLOSSARY

Capital deficiency A debit balance in a partner's capital account after allocation of gain or loss. (p. 539).

General partner A partner who has unlimited liability for the debts of the firm. (p. 530).

Income ratio The basis for dividing net income and net loss in a partnership. (p. 534).

Limited liability company A form of business organization, usually classified as a partnership for tax purposes and usually with limited life, in which partners, who are called *members*, have limited liability. (p. 530).

Limited liability partnership A partnership of professionals in which partners are given limited liability and the public is protected from malpractice by insurance carried by the partnership. (p. 530).

Limited partner A partner whose liability for the debts of the firm is limited to that partner's investment in the firm. (p. 532).

Limited partnership A partnership in which one or more general partners have unlimited liability and one or more partners have limited liability for the obligations of the firm. (p. 529).

No capital deficiency All partners have credit balances after allocation of gain or loss. (p. 539).

Partners' capital statement The owners' equity statement for a partnership which shows the changes in each partner's capital account and in total partnership capital during the year. (p. 537).

Partnership An association of two or more persons to carry on as co-owners of a business for profit. (p. 528).

Partnership agreement A written contract expressing the voluntary agreement of two or more individuals in a partnership. (p. 532).

Partnership dissolution A change in partners due to withdrawal or admission, which does not necessarily terminate the business. (p. 529).

Partnership liquidation An event that ends both the legal and economic life of a partnership. (p. 538).

Schedule of cash payments A schedule showing the distribution of cash to the partners in a partnership liquidation. (p. 540).

APPENDIX Admission and Withdrawal of Partners

The chapter explained how the basic accounting for a partnership works. We now look at how to account for a common occurrence in partnerships—the addition or withdrawal of a partner.

Admission of a Partner

STUDY OBJECTIVE 6

Explain the effects of the entries when a new partner is admitted.

The admission of a new partner results in the **legal dissolution** of the existing partnership and the beginning of a new one. From an economic standpoint, however, the admission of a new partner (or partners) may be of minor significance in the continuity of the business. For example, in large public accounting or law firms, partners are admitted annually without any change in operating policies. **To recognize the economic effects, it is necessary only to open a capital account for each new partner.** In the entries illustrated in this appendix, we assume that the accounting records of the predecessor firm will continue to be used by the new partnership.

A new partner may be admitted either by (1) purchasing the interest of one or more existing partners or (2) investing assets in the partnership. The former affects only the capital accounts of the partners who are parties to the transaction. The latter increases both net assets and total capital of the partnership.

HELPFUL HINT

In a purchase of an interest, the partnership is not a participant in the transaction. In this transaction, the new partner contributes *no* cash to the partnership.

PURCHASE OF A PARTNER'S INTEREST

The **admission** of a partner **by purchase of an interest** is a personal transaction between one or more existing partners and the new partner. Each party acts as an individual separate from the partnership entity. The individuals involved negotiate the price paid. It may be equal to or different from the capital equity acquired. The purchase price passes directly from the new partner to the partners who are giving up part or all of their ownership claims.

Any money or other consideration exchanged is the personal property of the participants and **not** the property of the partnership. Upon purchase of an interest, the new partner acquires each selling partner's capital interest and income ratio.

Accounting for the purchase of an interest is straightforward. The partnership records record only the changes in partners' capital. **Partners' capital accounts are debited for any ownership claims sold.** At the same time, the new partner's capital account is credited for the capital equity purchased. Total assets, total liabilities, and total capital remain unchanged, as do all individual asset and liability accounts.

To illustrate, assume that L. Carson agrees to pay $10,000 each to C. Ames and D. Barker for 33⅓% (one-third) of their interest in the Ames–Barker partnership. At the time of the 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
(To record admission of Carson by purchase)		

The effect of this transaction on net assets and partners' capital is shown below.

Illustration 12A-1
Ledger balances after purchase of a partner's interest

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		

Note that net assets remain unchanged at $60,000, and each partner has a $20,000 capital balance. Ames and Barker continue as partners in the firm, but the capital interest of each has changed. The cash paid by Carson goes directly to the individual partners and not to the partnership.

Regardless of the amount paid by Carson for the one-third interest, the entry is exactly the same. If Carson pays $12,000 each to Ames and Barker for one-third of the partnership, the partnership still makes the entry shown above.

INVESTMENT OF ASSETS IN A PARTNERSHIP

The admission of a partner by an investment of assets is a transaction between the new partner and the partnership. Often referred to simply as **admission by investment**, the transaction **increases both the net assets and total capital of the partnership**.

Assume, for example, that instead of purchasing an interest, Carson invests $30,000 in cash in the Ames–Barker partnership for a 33⅓% capital interest. In such a case, the entry is:

Cash	30,000	
L. Carson, Capital		30,000
(To record admission of Carson by investment)		

The effects of this transaction on the partnership accounts would be:

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

Illustration 12A-2
Ledger balances after investment of assets

Note that both net assets and total capital have increased by $30,000.

Remember that Carson's one-third capital interest might not result in a one-third income ratio. The new partnership agreement should specify Carson's income ratio, and it may or may not be equal to the one-third capital interest.

The comparison of the net assets and capital balances in Illustration 12A-3 shows the different effects of the purchase of an interest and admission by investment.

Illustration 12A-3
Comparison of purchase of an interest and admission by investment

Purchase of an Interest		Admission by Investment	
Net assets	**$60,000**	**Net assets**	**$90,000**
Capital		Capital	
C. Ames	$20,000	C. Ames	$30,000
D. Barker	20,000	D. Barker	30,000
L. Carson	20,000	L. Carson	30,000
Total capital	**$60,000**	**Total capital**	**$90,000**

When a new partner purchases an interest, the total net assets and total capital of the partnership *do not change*. When a partner is admitted by investment, both the total net assets and the total capital *change*.

In the case of admission by investment, further complications occur when the new partner's investment differs from the capital equity acquired. When those amounts are not the same, the difference is considered a **bonus** either to (1) the existing (old) partners or (2) the new partner.

Bonus to Old Partners. For both personal and business reasons, the existing partners may be unwilling to admit a new partner without receiving a bonus. In an established firm, existing partners may insist on a bonus as compensation for the work they have put into the company over the years. Two accounting factors underlie the business reason: First, total partners' capital equals the **book value** of the recorded net assets of the partnership. When the new partner is admitted, the fair market values of assets such as land and buildings may be higher than their book values. The bonus will help make up the difference between fair market value and book value. Second, when the partnership has been profitable, goodwill may exist. But, the partnership balance sheet does not report goodwill. The new partner is usually willing to pay the bonus to become a partner.

A bonus to old partners results when the new partner's investment in the firm is greater than the capital credit on the date of admittance. The bonus results in **an increase in the capital balances of the old partners**. **The partnership allocates the bonus to them on the basis of their income ratios before the admission of the new partner.** To illustrate, assume that the Bart–Cohen partnership, owned by Sam Bart and Tom Cohen, has total capital of $120,000. Lea Eden acquires a 25% ownership (capital) interest in the partnership by making a cash investment of $80,000. The procedure for determining Eden's capital credit and the bonus to the old partners is as follows.

1. **Determine the total capital of the new partnership:** Add the new partner's investment to the total capital of the old partnership. In this case the total capital of the new firm is $200,000, computed as follows.

Total capital of existing partnership	$120,000
Investment by new partner, Eden	80,000
Total capital of new partnership	$200,000

2. **Determine the new partner's capital credit:** Multiply the total capital of the new partnership by the new partner's ownership interest. Eden's capital credit is $50,000 ($200,000 × 25%).
3. **Determine the amount of bonus:** Subtract the new partner's capital credit from the new partner's investment. The bonus in this case is $30,000 ($80,000 − $50,000).
4. **Allocate the bonus to the old partners on the basis of their income ratios:** Assuming the ratios are Bart 60%, and Cohen 40%, the allocation is: Bart $18,000 ($30,000 × 60%) and Cohen $12,000 ($30,000 × 40%).

The entry to record the admission of Eden is:

Cash	80,000	
Sam Bart, Capital		18,000
Tom Cohen, Capital		12,000
Lea Eden, Capital		50,000
(To record admission of Eden and bonus to old partners)		

A	=	L	+	OE
+80,000				
				+18,000
				+12,000
				+50,000

Cash Flows
+80,000

Bonus to New Partner. A bonus to a new partner results when the new partner's investment in the firm is less than his or her capital credit. This may occur when the new partner possesses special attributes that the partnership wants. For example, the new partner may be able to supply cash that the firm needs for expansion or to meet maturing debts. Or the new partner may be a recognized expert in a relevant field. Thus, an engineering firm may be willing to give a renowned engineer a bonus to join the firm. The partners of a restaurant may offer a bonus to a sports celebrity in order to add the athlete's name to the partnership. A bonus to a new partner may also result when recorded book values on the partnership books are higher than their market values.

A bonus to a new partner results in a **decrease in the capital balances of the old partners**. **The amount of the decrease for each partner is based on the income ratios before the admission of the new partner.** To illustrate, assume that Lea Eden invests $20,000 in cash for a 25% ownership interest in the Bart–Cohen partnership. The computations for Eden's capital credit and the bonus are as follows, using the four procedures described in the preceding section.

1. Total capital of Bart–Cohen partnership		$120,000
Investment by new partner, Eden		20,000
Total capital of new partnership		$140,000
2. **Eden's capital credit** (25% × $140,000)		**$ 35,000**
3. **Bonus to Eden** ($35,000 − $20,000)		**$ 15,000**
4. Allocation of bonus to old partners:		
Bart ($15,000 × 60%)	$9,000	
Cohen ($15,000 × 40%)	6,000	$ 15,000

Illustration 12A-4
Computation of capital credit and bonus to new partner

A	= L	+ OE
+20,000		
		−9,000
		−6,000
		+35,000

Cash Flows
+20,000

The partnership records the admission of Eden as follows:

Cash	20,000	
Sam Bart, Capital	9,000	
Tom Cohen, Capital	6,000	
Lea Eden, Capital		35,000
(To record Eden's admission and bonus)		

Withdrawal of a Partner

STUDY OBJECTIVE 7

Describe the effects of the entries when a partner withdraws from the firm.

Now let's look at the opposite situation—the 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. The withdrawal of a partner, like the admission of a partner, legally dissolves the partnership. The legal effects may be recognized by dissolving the firm. However, it is customary to record only the economic effects of the partner's withdrawal, while the firm continues to operate and reorganizes itself legally.

As indicated earlier, the partnership agreement should specify the terms of withdrawal. The withdrawal of a partner may be accomplished by (1) payment from partners' personal assets or (2) payment from partnership assets. The former affects only the partners' capital accounts. The latter decreases total net assets and total capital of the partnership.

PAYMENT FROM PARTNERS' PERSONAL ASSETS

Withdrawal by payment from partners' personal assets is a personal transaction between the partners. **It is the direct opposite of admitting a new partner who purchases a partner's interest.** The remaining partners pay the retiring partner directly from their personal assets. **Partnership assets are not involved in any way, and total capital does not change.** The effect on the partnership is limited to changes in the partners' capital balances.

To illustrate, assume that 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:

A	= L	+ OE
		−10,000
		+5,000
		+5,000

Cash Flows
no effect

J. Odom, Capital	10,000	
A. Morz, Capital		5,000
M. Nead, Capital		5,000
(To record purchase of Odom's interest)		

The effect of this entry on the partnership accounts is shown below.

Net Assets		A. Morz, Capital		M. Nead, Capital		J. Odom, Capital	
50, 000			25,000		15,000	**10,000**	10,000
			5,000		**5,000**		Bal. –0–
			Bal. 30,000		Bal. 20,000		

Illustration 12A-5
Ledger balances after payment from partners' personal assets

Note that net assets and total capital remain the same at $50,000.

What about the $16,000 paid to Odom? You've probably noted that it is not recorded. The entry debited Odom's capital only for $10,000, not for the $16,000 that she received. Similarly, both Morz and Nead credit their capital accounts for only $5,000, not for the $8,000 they each paid.

After Odom's withdrawal, Morz and Nead will share net income or net loss equally unless they indicate another income ratio in the partnership agreement.

PAYMENT FROM PARTNERSHIP ASSETS

Withdrawal by payment from partnership assets is a transaction that involves the partnership. **Both partnership net assets and total capital decrease as a result.** Using partnership assets to pay for a withdrawing partner's interest is the **reverse** of admitting a partner through the investment of assets in the partnership.

Many partnership agreements provide that the amount paid should be based on the fair market value of the assets at the time of the partner's withdrawal. When this basis is required, some maintain that any differences between recorded asset balances and their fair market values should be (1) recorded by an adjusting entry, and (2) allocated to all partners on the basis of their income ratios. This position has serious flaws. Recording the revaluations violates the cost principle, which requires that assets be stated at original cost. It also violates the going-concern assumption, which assumes the entity will continue indefinitely. The terms of the partnership contract should not dictate the accounting for this event.

In accounting for a withdrawal by payment from partnership assets, the partnership should not record asset revaluations. Instead, it should consider any difference between the amount paid and the withdrawing partner's capital balance as **a bonus** to the retiring partner or to the remaining partners.

Bonus to Retiring Partner. A partnership may pay a bonus to a retiring partner when:

1. The fair market value of partnership assets is more than their book value,
2. There is unrecorded goodwill resulting from the partnership's superior earnings record, or
3. The remaining partners are eager to remove the partner from the firm.

The partnership deducts the bonus from the remaining partners' capital balances on the basis of their income ratios at the time of the withdrawal.

To illustrate, 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. The procedure for determining the bonus to the retiring partner and the allocation of the bonus to the remaining partners is as follows.

1. **Determine the amount of the bonus:** Subtract the retiring partner's capital balance from the cash paid by the partnership. The bonus in this case is $5,000 ($25,000 − $20,000).
2. **Allocate the bonus to the remaining partners on the basis of their income ratios:** The ratios of Roman and Sand are 3 : 2. Thus, the allocation of the $5,000 bonus is: Roman $3,000 ($5,000 × 3/5) and Sand $2,000 ($5,000 × 2/5).

HELPFUL HINT
Compare this entry to the one on page 552.

The partnership records the withdrawal of Terk as follows.

B. Terk, Capital	20,000	
F. Roman, Capital	3,000	
D. Sand, Capital	2,000	
Cash		25,000
(To record withdrawal of and bonus to Terk)		

A	=	L	+	OE
				−20,000
				−3,000
				−2,000
−25,000				

Cash Flows
−25,000

The remaining partners, Roman and Sand, will recover the bonus given to Terk as the partnership sells or uses the undervalued assets.

Bonus to Remaining Partners. The retiring partner may give a bonus to the remaining partners when:

1. Recorded assets are overvalued,
2. The partnership has a poor earnings record, or
3. The partner is eager to leave the partnership.

In such cases, the cash paid to the retiring partner will be less than the retiring partner's capital balance. **The partnership allocates (credits) the bonus to the capital accounts of the remaining partners on the basis of their income ratios.**

To illustrate, assume instead that the partnership pays Terk only $16,000 for her $20,000 equity when she withdraws from the partnership. In that case:

HELPFUL HINT
Compare this entry to the one on page 551.

1. The bonus to remaining partners is $4,000 ($20,000 − $16,000).
2. The allocation of the $4,000 bonus is: Roman $2,400 ($4,000 × 3/5) and Sand $1,600 ($4,000 × 2/5).

Under these circumstances, the entry to record the withdrawal is:

A	=	L	+	OE
				−20,000
				+2,400
				+1,600
−16,000				

Cash Flows
−16,000

B. Terk, Capital	20,000	
F. Roman, Capital		2,400
D. Sand, Capital		1,600
Cash		16,000
(To record withdrawal of Terk and bonus to remaining partners)		

Note that if Sand had withdrawn from the partnership, Roman and Terk would divide any bonus on the basis of their income ratio, which is 3 : 1 or 75% and 25%.

DEATH OF A PARTNER

The death of a partner dissolves the partnership. But partnership agreements usually contain a provision for the surviving partners to continue operations. When a partner dies, it usually is necessary to determine the partner's equity at the date of death. This is done by (1) determining the net income or loss for the year to date, (2) closing the books, and (3) preparing financial statements. The partnership agreement may also require an independent audit and a revaluation of assets.

The surviving partners may agree to purchase the deceased partner's equity from their personal assets. Or they may use partnership assets to settle with the deceased partner's estate. In both instances, the entries to record the withdrawal of the partner are similar to those presented earlier.

To facilitate payment from partnership assets, some partnerships obtain life insurance policies on each partner, with the partnership named as the beneficiary. The partnership then uses the proceeds from the insurance policy on the deceased partner to settle with the estate.

SUMMARY OF STUDY OBJECTIVES FOR APPENDIX

6 **Explain the effects of the entries when a new partner is admitted.** The entry to record the admittance of a new partner by purchase of a partner's interest affects only partners' capital accounts. The entries to record the admittance by investment of assets in the partnership (a) increase both net assets and total capital and (b) may result in recognition of a bonus to either the old partners or the new partner.

7 **Describe the effects of the entries when a partner withdraws from the firm.** The entry to record a withdrawal from the firm when the partners pay from their personal assets affects only partners' capital accounts. The entry to record a withdrawal when payment is made from partnership assets (a) decreases net assets and total capital and (b) may result in recognizing a bonus either to the retiring partner or the remaining partners.

GLOSSARY FOR APPENDIX

Admission by investment Admission of a partner by investing assets in the partnership, causing both partnership net assets and total capital to increase. (p. 547).

Admission by purchase of an interest Admission of a partner in a personal transaction between one or more existing partners and the new partner; does not change total partnership assets or total capital. (p. 546).

Withdrawal by payment from partners' personal assets Withdrawal of a partner in a personal transaction between partners; does not change total partnership assets or total capital. (p. 550).

Withdrawal by payment from partnership assets Withdrawal of a partner in a transaction involving the partnership, causing both partnership net assets and total capital to decrease. (p. 551).

***Note:** All **asterisked** Questions, Exercises, and Problems relate to material in the appendix to the chapter.

SELF-STUDY QUESTIONS

Answers are at the end of the chapter.

(SO 1) **1.** Which of the following is *not* a characteristic of a partnership?
- **a.** Taxable entity
- **b.** Co-ownership of property
- **c.** Mutual agency
- **d.** Limited life

(SO 1) **2.** A partnership agreement should include each of the following except:
- **a.** names and capital contributions of partners.
- **b.** rights and duties of partners as well as basis for sharing net income or loss.
- **c.** basis for splitting partnership income taxes.
- **d.** provision for withdrawal of assets.

(SO 1) **3.** The advantages of a partnership do *not* include:
- **a.** ease of formation.
- **b.** unlimited liability.
- **c.** freedom from government regulation.
- **d.** ease of decision making.

(SO 2) **4.** Upon formation of a partnership, each partner's initial investment of assets should be recorded at their:
- **a.** book values.
- **b.** cost.
- **c.** market values.
- **d.** appraised values.

(SO 2) **5.** Ben and Sam Jenkins formed a partnership. Ben contributed $8,000 cash and a used truck that originally cost $35,000 and had accumulated depreciation of $15,000. The truck's market value was $16,000. Sam, a builder, contributed a new storage garage. His cost of construction was $40,000. The garage has a market value of $55,000. What is the combined total capital that would be recorded on the partnership books for the two partners?
- **a.** $79,000.
- **b.** $60,000.
- **c.** $75,000.
- **d.** $90,000.

(SO 3) **6.** The NBC Company reports net income of $60,000. If partners N, B, and C have an income ratio of 50%, 30%, and 20%, respectively, C's share of the net income is:
- **a.** $30,000.
- **b.** $12,000.
- **c.** $18,000.
- **d.** No correct answer is given.

7. Using the data in (4) above, what is B's share of net income if the percentages are applicable after each partner receives a $10,000 salary allowance? (SO 3)
- **a.** $12,000
- **b.** $20,000
- **c.** $19,000
- **d.** $21,000

8. To close a partner's drawing account, an entry must be made that: (SO 3)
- **a.** debits that partner's drawing account and credits Income Summary.
- **b.** debits that partner's drawing account and credits that partner's capital account.
- **c.** credits that partner's drawing account and debits that partner's capital account.
- **d.** credits that partner's drawing account and debits the firm's dividend account.

9. Which of the following statements about partnership financial statements is true? (SO 4)
- **a.** Details of the distribution of net income are shown in the owners' equity statement.
- **b.** The distribution of net income is shown on the balance sheet.
- **c.** Only the total of all partner capital balances is shown in the balance sheet.
- **d.** The owners' equity statement is called the partners' capital statement.

10. In the liquidation of a partnership it is necessary to (1) distribute cash to the partners, (2) sell noncash assets, (3) allocate any gain or loss on realization to the partners, and (4) pay liabilities. These steps should be performed in the following order: (SO 5)
- **a.** (2), (3), (4), (1).
- **b.** (2), (3), (1), (4).
- **c.** (3), (2), (1), (4).
- **d.** (3), (2), (4), (1).

Use the following account balance information for Creekville Partnership to answer questions 11 and 12. Income ratios are 2:4:4 for Harriet, Mike, and Elly, respectively.

Assets		Liabilities and Owners' Equity	
Cash	$ 9,000	Accounts payable	$ 21,000
Accounts receivable	22,000	Harriet, Capital	23,000
Inventory	73,000	Mike, Capital	8,000
		Elly, Capital	52,000
	$104,000		$104,000

(SO 5) **11.** Assume that, as part of liquidation proceedings, Creekville sells its noncash assets for $85,000. The amount of cash that would ultimately be distributed to Elly would be:
a. $52,000.
b. $48,000.
c. $34,000.
d. $86,000.

(SO 5) **12.** Assume that, as part of liquidation proceedings, Creekville sells its noncash assets for $60,000. As a result, one of the partners has a capital deficiency which that partner decides not to repay. The amount of cash that would ultimately be distributed to Elly would be:
a. $52,000.
b. $38,000.
c. $24,000.
d. $34,000.

(SO 6) ***13.** Louisa Santiago purchases 50% of Leo Lemon's capital interest in the K & L partnership for $22,000. If the capital balance of Kate Kildare and Leo Lemon are $40,000 and $30,000, respectively, Santiago's capital balance following the purchase is:
a. $22,000.
b. $35,000.
c. $20,000.
d. $15,000.

***14.** Capital balances in the MEM partnership are Mary, Capital $60,000, Ellen, Capital $50,000, and Mills, Capital $40,000, and income ratios are 5 : 3 : 2, respectively. The MEMO partnership is formed by admitting Oleg to the firm with a cash investment of $60,000 for a 25% capital interest. The bonus to be credited to Mills, Capital in admitting Oleg is: (SO 6)
a. $10,000.
b. $7,500.
c. $3,750.
d. $1,500.

***15.** Capital balances in the MURF partnership are Molly, Capital $50,000, Ursula, Capital $40,000, Ray, Capital $30,000, and Fred, Capital $20,000, and income ratios are 4 : 3 : 2 : 1, respectively. Fred withdraws from the firm following payment of $29,000 in cash from the partnership. Ursula's capital balance after recording the withdrawal of Fred is: (SO 7)
a. $36,000.
b. $37,000.
c. $38,000.
d. $40,000.

Go to the book's companion website, **www.wiley.com/college/weygandt**, for Additional Self-Study questions.

The Navigator

QUESTIONS

1. The characteristics of a partnership include the following: (a) association of individuals, (b) limited life, and (c) co-ownership of property. Explain each of these terms.
2. Jerry Kerwin is confused about the partnership characteristics of (a) mutual agency and (b) unlimited liability. Explain these two characteristics for Jerry.
3. Brent Houghton and Dick Kreibach are considering a business venture. They ask you to explain the advantages and disadvantages of the partnership form of organization.
4. Why might a company choose to use a limited partnership?
5. Sampson and Stevens form a partnership. Sampson contributes land with a book value of $50,000 and a fair market value of $65,000. Sampson also contributes equipment with a book value of $52,000 and a fair market value of $57,000. The partnership assumes a $20,000 mortgage on the land. What should be the balance in Sampson's capital account upon formation of the partnership?
6. W. Mantle, N. Cash, and W. DiMaggio have a partnership called Outlaws. A dispute has arisen among the partners. Mantle has invested twice as much in assets as the other two partners, and he believes net income and net losses should be shared in accordance with the capital ratios. The partnership agreement does not specify the division of profits and losses. How will net income and net loss be divided?
7. Blue and Grey are discussing how income and losses should be divided in a partnership they plan to form. What factors should be considered in determining the division of net income or net loss?
8. M. Carson and R. Leno have partnership capital balances of $40,000 and $80,000, respectively. The partnership agreement indicates that net income or net loss should be shared equally. If net income for the partnership is $36,000, how should the net income be divided?
9. S. McMurray and F. Kohl share net income and net loss equally. (a) Which account(s) is (are) debited and credited to record the division of net income between the partners? (b) If S. McMurray withdraws $30,000 in cash for personal use in lieu of salary, which account is debited and which is credited?
10. Partners T. Evans and R. Meloy are provided salary allowances of $30,000 and $25,000, respectively. They divide the remainder of the partnership income in a ratio of 3 : 2. If partnership net income is $45,000, how much is allocated to Evans and Meloy?
11. Are the financial statements of a partnership similar to those of a proprietorship? Discuss.
12. How does the liquidation of a partnership differ from the dissolution of a partnership?
13. Bobby Donal and Bill Spader are discussing the liquidation of a partnership. Bobby maintains that all cash should be distributed to partners on the basis of their income ratios. Is he correct? Explain.

14. In continuing their discussion from Question 13, Bill says that even in the case of a capital deficiency, all cash should still be distributed on the basis of capital balances. Is Bill correct? Explain.
15. Lowery, Keegan, and Feeney have income ratios of 5 : 3 : 2 and capital balances of $34,000, $31,000, and $28,000, respectively. Noncash assets are sold at a gain. After creditors are paid, $109,000 of cash is available for distribution to the partners. How much cash should be paid to Keegan?
16. Before the final distribution of cash, account balances are: Cash $23,000; S. Penn, Capital $19,000 (Cr.); L. Pattison, Capital $12,000 (Cr.); and M. Jeter, Capital $8,000 (Dr.). Jeter is unable to pay any of the capital deficiency. If the income-sharing ratios are 5 : 3 : 2, respectively, how much cash should be paid to L. Pattison?
*17. Linda Ratzlaff decides to purchase from an existing partner for $50,000 a one-third interest in a partnership. What effect does this transaction have on partnership net assets?
*18. Steve Renn decides to invest $25,000 in a partnership for a one-sixth capital interest. How much do the partnership's net assets increase? Does Renn also acquire a one-sixth income ratio through this investment?
*19. Kate Robidou purchases for $72,000 Grant's interest in the Sharon-Grant partnership. Assuming that Grant has a $66,000 capital balance in the partnership, what journal entry is made by the partnership to record this transaction?
*20. Tracy Harper has a $39,000 capital balance in a partnership. She sells her interest to Kim Remington for $45,000 cash. What entry is made by the partnership for this transaction?
*21. Debbie Perry retires from the partnership of Garland, Newlin, and Perry. She receives $85,000 of partnership assets in settlement of her capital balance of $77,000. Assuming that the income-sharing ratios are 5 : 3 : 2, respectively, how much of Perry's bonus is debited to Newlin's capital account?
*22. Your roommate argues that partnership assets should be revalued in situations like those in question 21. Why is this generally not done?
*23. How is a deceased partner's equity determined?
24. PEPSICO Why is PepsiCo not a partnership?

BRIEF EXERCISES

BE12-1 Jennifer DeVine and Stanley Farrin decide to organize the ALL-Star partnership. DeVine invests $15,000 cash, and Farrin contributes $10,000 cash and equipment having a book value of $3,500. Prepare the entry to record Farrin's investment in the partnership, assuming the equipment has a fair market value of $5,000.

Journalize entries in forming a partnership.
(SO 2)

BE12-2 Beck and Cey decide to merge their proprietorships into a partnership called Fresh Start Company. The balance sheet of Cey Co. shows:

Prepare portion of opening balance sheet for partnership.
(SO 2)

Accounts receivable	$16,000	
Less: Allowance for doubtful accounts	1,200	$14,800
Equipment	20,000	
Less: Accumulated depreciation	7,000	13,000

The partners agree that the net realizable value of the receivables is $13,500 and that the fair market value of the equipment is $11,000. Indicate how the four accounts should appear in the opening balance sheet of the partnership.

BE12-3 Held Bond Co. reports net income of $70,000. The income ratios are Held 60% and Bond 40%. Indicate the division of net income to each partner, and prepare the entry to distribute the net income.

Journalize the division of net income using fixed income ratios.
(SO 3)

BE12-4 ESU Co. reports net income of $55,000. Partner salary allowances are Espino $15,000, Sears $5,000, and Utech $5,000. Indicate the division of net income to each partner, assuming the income ratio is 50 : 30 : 20, respectively.

Compute division of net income with a salary allowance and fixed ratios.
(SO 3)

BE12-5 Joe & Sam Co. reports net income of $28,000. Interest allowances are Joe $7,000 and Sam $5,000; salary allowances are Joe $15,000 and Sam $10,000; the remainder is shared equally. Show the distribution of income on the income statement.

Show division of net income when allowances exceed net income.
(SO 3)

BE12-6 After liquidating noncash assets and paying creditors, account balances in the Heartley Co. are Cash $19,000, A Capital (Cr.) $8,000, L Capital (Cr.) $7,000, and F Capital (Cr.) $4,000. The partners share income equally. Journalize the final distribution of cash to the partners.

Journalize final cash distribution in liquidation.
(SO 5)

***BE12-7** Alpha Co. capital balances are: Ace $30,000, Bly $25,000, and Cox $20,000. The partners share income equally. Day is admitted to the firm by purchasing one-half of Cox's interest for $13,000. Journalize the admission of Day to the partnership.

Journalize admission by purchase of an interest.
(SO 6)

Journalize admission by investment.
(SO 6)

***BE12-8** In Decker Co., capital balances are Menke $40,000 and Hibbett $50,000. The partners share income equally. Kosko is admitted to the firm with a 45% interest by an investment of cash of $52,000. Journalize the admission of Kosko.

Journalize withdrawal paid by personal assets.
(SO 7)

***BE12-9** Capital balances in Midway Co. are Messer $40,000, Isch $30,000, and Denny $18,000. Messer and Isch each agree to pay Denny $12,000 from their personal assets. Messer and Isch each receive 50% of Denny's equity. The partners share income equally. Journalize the withdrawal of Denny.

Journalize withdrawal paid by partnership assets.
(SO 7)

***BE12-10** Data pertaining to Midway Co. are presented in BE12-9. Instead of payment from personal assets, assume that Denny receives $24,000 from partnership assets in withdrawing from the firm. Journalize the withdrawal of Denny.

DO IT! REVIEW

Analyze statements about partnership organization.
(SO 1)

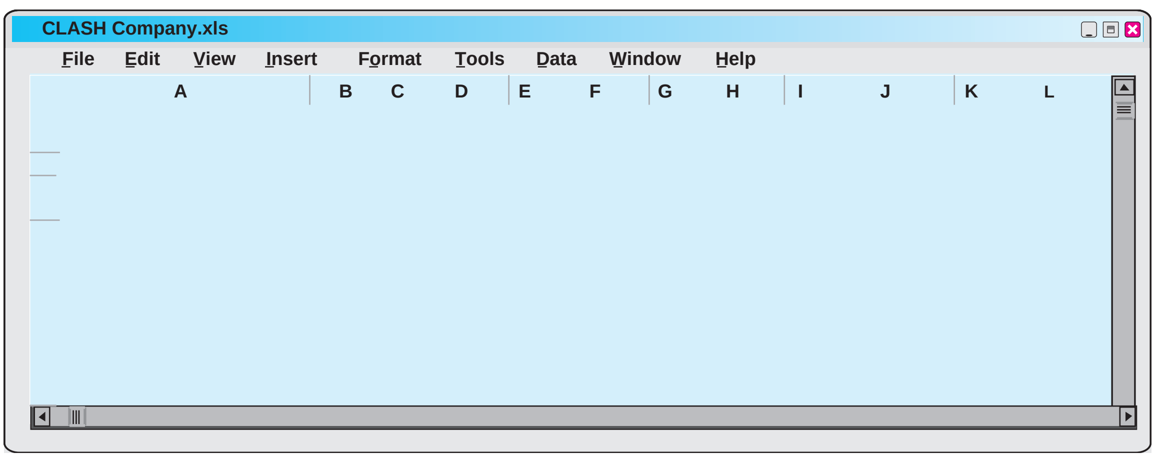
DO IT! 12-1 Indicate whether each of the following statements is true or false.

_____ **1.** Each partner is personally and individually liable for all partnership liabilities.
_____ **2.** If a partnership dissolves, each partner has a claim to the specific assets he/she contributed to the firm.
_____ **3.** In a limited partnership, all partners have limited liability.
_____ **4.** A major advantage of regular partnership is that it is simple and inexpensive to create and operate.
_____ **5.** Members of a limited liability company can take an active management role.

Divide net income and prepare closing entry.
(SO 3)

12-2 Villa America Company reported net income of $85,000. The partnership agreement provides for salaries of $25,000 to S. Wiborg and $18,000 to G. Murphy. They divide the remainder 40% to Wiborg and 60% to Murphy. S. Wiborg asks your help to divide the net income between the partners and to prepare the closing entry.

12-3 The partners of Clash Company have decided to liquidate their business. Noncash assets were sold for $125,000. The income ratios of the partners M. Jones, J. Strummer, and P. Simonon are 3:2:3, respectively. Complete the following schedule of cash payments for Clash Company



EXERCISES

E12-1 Shani Davis has prepared the following list of statements about partnerships.

Identify characteristics of partnership.
(SO 1)

1. A partnership is an association of three or more persons to carry on as co-owners of a business for profit.
2. The legal requirements for forming a partnership can be quite burdensome.
3. A partnership is not an entity for financial reporting purposes.
4. The net income of a partnership is taxed as a separate entity.
5. The act of any partner is binding on all other partners, even when partners perform business acts beyond the scope of their authority.
6. Each partner is personally and individually liable for all partnership liabilities.
7. When a partnership is dissolved, the assets legally revert to the original contributor.
8. In a limited partnership, one or more partners have unlimited liability and one or more partners have limited liability for the debts of the firm.
9. Mutual agency is a major advantage of the partnership form of business.

Instructions
Identify each statement as true or false. If false, indicate how to correct the statement.

E12-2 K. Meissner, S. Cohen, and E. Hughes are forming a partnership. Meissner is transferring $50,000 of personal cash to the partnership. Cohen owns land worth $15,000 and a small building worth $80,000, which she transfers to the partnership. Hughes transfers to the partnership cash of $9,000, accounts receivable of $32,000 and equipment worth $19,000. The partnership expects to collect $29,000 of the accounts receivable.

Journalize entry for formation of a partnership.
(SO 2)

Instructions
(a) Prepare the journal entries to record each of the partners' investments.
(b) What amount would be reported as total owners' equity immediately after the investments?

E12-3 Jack Herington has owned and operated a proprietorship for several years. On January 1, he decides to terminate this business and become a partner in the firm of Herington and Kaspar. Herington's investment in the partnership consists of $12,000 in cash, and the following assets of the proprietorship: accounts receivable $14,000 less allowance for doubtful accounts of $2,000, and equipment $20,000 less accumulated depreciation of $4,000. It is agreed that the allowance for doubtful accounts should be $3,000 for the partnership. The fair market value of the equipment is $13,500.

Journalize entry for formation of a partnership.
(SO 2)

Instructions
Journalize Herington's admission to the firm of Kaspar and Herington.

E12-4 F. Calvert and G. Powers have capital balances on January 1 of $50,000 and $40,000, respectively. The partnership income-sharing agreement provides for (1) annual salaries of $20,000 for Calvert and $12,000 for Powers, (2) interest at 10% on beginning capital balances, and (3) remaining income or loss to be shared 60% by Calvert and 40% by Powers.

Prepare schedule showing distribution of net income and closing entry.
(SO 3)

Instructions
(a) Prepare a schedule showing the distribution of net income, assuming net income is (1) $50,000 and (2) $36,000.
(b) Journalize the allocation of net income in each of the situations above.

E12-5 O. Guillen (beginning capital, $60,000) and K. Williams (beginning capital $90,000) are partners. During 2010, the partnership earned net income of $70,000, and Guillen made drawings of $18,000 while Williams made drawings of $24,000.

Prepare journal entries to record allocation of net income.
(SO 3)

Instructions
(a) Assume the partnership income-sharing agreement calls for income to be divided 45% to Guillen and 55% to Williams. Prepare the journal entry to record the allocation of net income.

(b) Assume the partnership income-sharing agreement calls for income to be divided with a salary of $30,000 to Guillen and $25,000 to Williams, with the remainder divided 45% to Guillen and 55% to Williams. Prepare the journal entry to record the allocation of net income.
(c) Assume the partnership income-sharing agreement calls for income to be divided with a salary of $40,000 to Guillen and $35,000 to Williams, interest of 10% on beginning capital, and the remainder divided 50%–50%. Prepare the journal entry to record the allocation of net income.
(d) Compute the partners' ending capital balances under the assumption in part (c).

Prepare partners' capital statement and partial balance sheet.
(SO 4)

E12-6 For Starrite Co., beginning capital balances on January 1, 2010, are Gary Stark $20,000 and Jim Nyland $18,000. During the year, drawings were Stark $8,000 and Nyland $5,000. Net income was $30,000, and the partners share income equally.

Instructions
(a) Prepare the partners' capital statement for the year.
(b) Prepare the owners' equity section of the balance sheet at December 31, 2010.

Prepare a classified balance sheet of a partnership.
(SO 4)

E12-7 Moe, Larry, and Curly are forming The Stooges Partnership. Moe is transferring $30,000 of personal cash and equipment worth $25,000 to the partnership. Larry owns land worth $18,000 and a small building worth $75,000, which he transfers to the partnership. There is a long-term mortgage of $20,000 on the land and building, which the partnership assumes. Curly transfers cash of $7,000, accounts receivable of $36,000, supplies worth $3,000, and equipment worth $22,000 to the partnership. The partnership expects to collect $32,000 of the accounts receivable.

Instructions
Prepare a classified balance sheet for the partnership after the partners' investments on December 31, 2010.

Prepare cash payments schedule.
(SO 5)

E12-8 The Best Company at December 31 has cash $20,000, noncash assets $100,000, liabilities $55,000, and the following capital balances: Rodriguez $45,000 and Escobedo $20,000. The firm is liquidated, and $110,000 in cash is received for the noncash assets. Rodriguez and Escobedo income ratios are 60% and 40%, respectively.

Instructions
Prepare a schedule of cash payments.

Journalize transactions in a liquidation.
(SO 5)

E12-9 Data for The Best Company are presented in E12-8.

Instructions
Prepare the entries to record:
(a) The sale of noncash assets.
(b) The allocation of the gain or loss on realization to the partners.
(c) Payment of creditors.
(d) Distribution of cash to the partners.

Journalize transactions with a capital deficiency.
(SO 5)

E12-10 Prior to the distribution of cash to the partners, the accounts in the NJF Company are: Cash $28,000, Newell Capital (Cr.) $17,000, Jennings Capital (Cr.) $15,000, and Farley Capital (Dr.) $4,000. The income ratios are 5 : 3 : 2, respectively.

Instructions
(a) Prepare the entry to record (1) Farley's payment of $4,000 in cash to the partnership and (2) the distribution of cash to the partners with credit balances.
(b) Prepare the entry to record (1) the absorption of Farley's capital deficiency by the other partners and (2) the distribution of cash to the partners with credit balances.

Journalize admission of a new partner by purchase of an interest.
(SO 6)

***E12-11** J. Lynn, M. Oller, and F. Tate share income on a 5 : 3 : 2 basis. They have capital balances of $30,000, $26,000, and $18,000, respectively, when Doc Duran is admitted to the partnership.

Instructions
Prepare the journal entry to record the admission of Doc Duran under each of the following assumptions.

(a) Purchase of 50% of Lynn's equity for $19,000.
(b) Purchase of 50% of Oller's equity for $12,000.
(c) Purchase of 33⅓% of Tate's equity for $9,000.

***E12-12** G. Olde and R. Young share income on a 6 : 4 basis. They have capital balances of $100,000 and $70,000, respectively, when K. Twener is admitted to the partnership.

Journalize admission of a new partner by investment.
(SO 6)

Instructions
Prepare the journal entry to record the admission of K. Twener under each of the following assumptions.

(a) Investment of $90,000 cash for a 30% ownership interest with bonuses to the existing partners.
(b) Investment of $50,000 cash for a 30% ownership interest with a bonus to the new partner.

***E12-13** B. Cates, V. Elder, and S. Nguyen have capital balances of $50,000, $40,000, and $32,000, respectively. Their income ratios are 5 : 3 : 2. Nguyen withdraws from the partnership under each of the following independent conditions.

Journalize withdrawal of a partner with payment from partners' personal assets.
(SO 7)

1. Cates and Elder agree to purchase Nguyen's equity by paying $17,000 each from their personal assets. Each purchaser receives 50% of Nguyen's equity.
2. Elder agrees to purchase all of Nguyen's equity by paying $22,000 cash from her personal assets.
3. Cates agrees to purchase all of Nguyen's equity by paying $26,000 cash from her personal assets.

Instructions
Journalize the withdrawal of Nguyen under each of the assumptions above.

***E12-14** H. Barrajas, T. Dingler, and R. Fisk have capital balances of $95,000, $75,000, and $60,000, respectively. They share income or loss on a 5 : 3 : 2 basis. Fisk withdraws from the partnership under each of the following conditions.

Journalize withdrawal of a partner with payment from partnership assets.
(SO 7)

1. Fisk is paid $68,000 in cash from partnership assets, and a bonus is granted to the retiring partner.
2. Fisk is paid $56,000 in cash from partnership assets, and bonuses are granted to the remaining partners.

Instructions
Journalize the withdrawal of Fisk under each of the assumptions above.

***E12-15** Carson, Letterman, and O'Brien are partners who share profits and losses 50%, 30%, and 20%, respectively. Their capital balances are $100,000, $60,000, and $40,000, respectively.

Journalize entry for admission and withdrawal of partners.
(SO 6, 7)

Instructions
(a) Assume Stewart joins the partnership by investing $80,000 for a 25% interest with bonuses to the existing partners. Prepare the journal entry to record his investment.
(b) Assume instead that Carson leaves the partnership. Carson is paid $120,000 with a bonus to the retiring partner. Prepare the journal entry to record Carson's withdrawal.

EXERCISES: SET B

Visit the book's companion website at **www.wiley.com/college/weygandt**, and choose the Student Companion site, to access Exercise Set B.

PROBLEMS: SET A

Prepare entries for formation of a partnership and a balance sheet.

(SO 2, 4)

P12-1A The post-closing trial balances of two proprietorships on January 1, 2010, are presented below.

	Patrick Company		Samuelson Company	
	Dr.	**Cr.**	**Dr.**	**Cr.**
Cash	$ 14,000		$12,000	
Accounts receivable	17,500		26,000	
Allowance for doubtful accounts		$ 3,000		$ 4,400
Merchandise inventory	26,500		18,400	
Equipment	45,000		29,000	
Accumulated depreciation—equipment		24,000		11,000
Notes payable		18,000		15,000
Accounts payable		22,000		31,000
Patrick, Capital		36,000		
Samuelson, Capital				24,000
	$103,000	$103,000	$85,400	$85,400

Patrick and Samuelson decide to form a partnership, Pasa Company, with the following agreed upon valuations for noncash assets.

	Patrick Company	Samuelson Company
Accounts receivable	$17,500	$26,000
Allowance for doubtful accounts	4,500	4,000
Merchandise inventory	28,000	20,000
Equipment	23,000	16,000

All cash will be transferred to the partnership, and the partnership will assume all the liabilities of the two proprietorships. Further, it is agreed that Patrick will invest an additional $5,000 in cash, and Samuelson will invest an additional $19,000 in cash.

Instructions

(a) Patrick, Capital $38,000 Samuelson, Capital $24,000

(c) Total assets $172,000

(a) Prepare separate journal entries to record the transfer of each proprietorship's assets and liabilities to the partnership.
(b) Journalize the additional cash investment by each partner.
(c) Prepare a classified balance sheet for the partnership on January 1, 2010.

Journalize divisions of net income and prepare a partners' capital statement.

(SO 3, 4)

P12-2A At the end of its first year of operations on December 31, 2010, CNU Company's accounts show the following.

Partner	Drawings	Capital
Reese Caplin	$23,000	$48,000
Phyllis Newell	14,000	30,000
Betty Uhrich	10,000	25,000

The capital balance represents each partner's initial capital investment. Therefore, net income or net loss for 2010 has not been closed to the partners' capital accounts.

Instructions

(a) (1) Caplin $18,000
(2) Caplin $19,000
(3) Caplin $15,700

(c) Caplin $40,700

(a) Journalize the entry to record the division of net income for the year 2010 under each of the following independent assumptions.
(1) Net income is $30,000. Income is shared 6 : 3 : 1.
(2) Net income is $37,000. Caplin and Newell are given salary allowances of $15,000 and $10,000, respectively. The remainder is shared equally.
(3) Net income is $19,000. Each partner is allowed interest of 10% on beginning capital balances. Caplin is given a $12,000 salary allowance. The remainder is shared equally.
(b) Prepare a schedule showing the division of net income under assumption (3) above.
(c) Prepare a partners' capital statement for the year under assumption (3) above.

Prepare entries with a capital deficiency in liquidation of a partnership.

(SO 5)

P12-3A The partners in New Yorker Company decide to liquidate the firm when the balance sheet shows the following.

NEW YORKER COMPANY
Balance Sheet
May 31, 2010

Assets		Liabilities and Owners' Equity	
Cash	$ 27,500	Notes payable	$ 13,500
Accounts receivable	25,000	Accounts payable	27,000
Allowance for doubtful accounts	(1,000)	Wages payable	4,000
Merchandise inventory	34,500	M. Mantle, Capital	33,000
Equipment	21,000	W. Mays, Capital	21,000
Accumulated depreciation—equipment	(5,500)	D. Snider, Capital	3,000
Total	$101,500	Total	$101,500

The partners share income and loss 5 : 3 : 2. During the process of liquidation, the following transactions were completed in the following sequence.

1. A total of $55,000 was received from converting noncash assets into cash.
2. Gain or loss on realization was allocated to partners.
3. Liabilities were paid in full.
4. D. Snider paid his capital deficiency.
5. Cash was paid to the partners with credit balances.

Instructions

(a) Prepare the entries to record the transactions.
(b) Post to the cash and capital accounts.
(c) Assume that Snider is unable to pay the capital deficiency.
 (1) Prepare the entry to allocate Snider's debit balance to Mantle and Mays.
 (2) Prepare the entry to record the final distribution of cash.

(a) Loss on realization $19,000
Cash paid: to Mantle $23,500; to Mays $15,300

Journalize admission of a partner under different assumptions.

(SO 6)

***P12-4A** At April 30, partners' capital balances in SKG Company are: S. Seger $52,000, J. Kensington $54,000, and T. Gomez $18,000. The income sharing ratios are 5:4:1, respectively. On May 1, the SKGA Company is formed by admitting D. Atchley to the firm as a partner.

Instructions

(a) Journalize the admission of Atchley under each of the following independent assumptions.
 (1) Atchley purchases 50% of Gomez's ownership interest by paying Gomez $16,000 in cash.
 (2) Atchley purchases 33⅓% of Kensington's ownership interest by paying Kensington $15,000 in cash.
 (3) Atchley invests $66,000 for a 30% ownership interest, and bonuses are given to the old partners.
 (4) Atchley invests $46,000 for a 30% ownership interest, which includes a bonus to the new partner.
(b) Kensington's capital balance is $32,000 after admitting Atchley to the partnership by investment. If Kensington's ownership interest is 20% of total partnership capital, what were (1) Atchley's cash investment and (2) the bonus to the new partner?

(a) (1) Atchley $9,000
(2) Atchley $18,000
(3) Atchley $57,000
(4) Atchley $51,000

Journalize withdrawal of a partner under different assumptions.

(SO 7)

***P12-5A** On December 31, the capital balances and income ratios in FAD Company are as follows.

Partner	Capital Balance	Income Ratio
J. Fagan	$60,000	50%
P. Ames	40,000	30%
K. Durham	26,000	20%

Instructions

(a) Journalize the withdrawal of Durham under each of the following assumptions.
 (1) Each of the continuing partners agrees to pay $18,000 in cash from personal funds to purchase Durham's ownership equity. Each receives 50% of Durham's equity.
 (2) Ames agrees to purchase Durham's ownership interest for $25,000 cash.

(a) (1) Ames, Capital $13,000
(2) Ames, Capital $26,000
(3) Bonus $8,000
(4) Bonus $4,000

(3) Durham is paid $34,000 from partnership assets, which includes a bonus to the retiring partner.
(4) Durham is paid $22,000 from partnership assets, and bonuses to the remaining partners are recognized.

(b) If Ames's capital balance after Durham's withdrawal is $42,400 what were (1) the total bonus to the remaining partners and (2) the cash paid by the partnership to Durham?

PROBLEMS: SET B

Prepare entries for formation of a partnership and a balance sheet.

(SO 2, 4)

P12-1B The post-closing trial balances of two proprietorships on January 1, 2010, are presented below.

	John Company		Calvin Company	
	Dr.	**Cr.**	**Dr.**	**Cr.**
Cash	$ 10,000		$ 8,000	
Accounts receivable	18,000		30,000	
Allowance for doubtful accounts		$ 2,000		$ 3,000
Merchandise inventory	35,000		20,000	
Equipment	60,000		35,000	
Accumulated depreciation—equipment		28,000		15,000
Notes payable		20,000		
Accounts payable		30,000		40,000
John, Capital		43,000		
Calvin, Capital				35,000
	$123,000	$123,000	$93,000	$93,000

John and Calvin decide to form a partnership, John-Calvin Company, with the following agreed upon valuations for noncash assets.

	John Company	Calvin Company
Accounts receivable	$18,000	$30,000
Allowance for doubtful accounts	2,500	4,000
Merchandise inventory	38,000	25,000
Equipment	40,000	22,000

All cash will be transferred to the partnership, and the partnership will assume all the liabilities of the two proprietorships. Further, it is agreed that John will invest an additional $3,500 in cash, and Calvin will invest an additional $16,000 in cash.

Instructions

(a) John, Capital $53,500
Calvin, Capital $41,000

(a) Prepare separate journal entries to record the transfer of each proprietorship's assets and liabilities to the partnership.
(b) Journalize the additional cash investment by each partner.

(c) Total assets $204,000

(c) Prepare a classified balance sheet for the partnership on January 1, 2010.

Journalize divisions of net income and prepare a partners' capital statement.

(SO 3, 4)

P12-2B At the end of its first year of operations on December 31, 2010, KAT Company's accounts show the following.

Partner	Drawings	Capital
H. Krik	$15,000	$40,000
N. Andres	10,000	25,000
S. Thabo	5,000	15,000

The capital balance represents each partner's initial capital investment. Therefore, net income or net loss for 2010 has not been closed to the partners' capital accounts.

Instructions

(a) Journalize the entry to record the division of net income for 2010 under each of the independent assumptions shown on the next page.

(1) Net income is $50,000. Income is shared 5:3:2.
(2) Net income is $40,000. Kirk and Andres are given salary allowances of $15,000 and $10,000, respectively. The remainder is shared equally.
(3) Net income is $37,000. Each partner is allowed interest of 10% on beginning capital balances. Kirk is given an $20,000 salary allowance. The remainder is shared equally.

(b) Prepare a schedule showing the division of net income under assumption (3) above.
(c) Prepare a partners' capital statement for the year under assumption (3) above.

(a) (1) Kirk $25,000
(2) Kirk $20,000
(3) Kirk $27,000

(c) Kirk $52,000

P12-3B The partners in Apache Company decide to liquidate the firm when the balance sheet shows the following.

Prepare entries and schedule of cash payments in liquidation of a partnership

(SO 5)

APACHE COMPANY
Balance Sheet
April 30, 2010

Assets		Liabilities and Owners' Equity	
Cash	$30,000	Notes payable	$20,000
Accounts receivable	25,000	Accounts payable	30,000
Allowance for doubtful accounts	(2,000)	Wages payable	2,500
Merchandise inventory	35,000	Scottie, Capital	28,000
Equipment	20,000	Spock, Capital	13,650
Accumulated depreciation—equipment	(8,000)	Kirk, Capital	5,850
Total	$100,000	Total	$100,000

The partners share income and loss 5:3:2. During the process of liquidation, the transactions below were completed in the following sequence.

1. A total of $57,000 was received from converting noncash assets into cash.
2. Gain or loss on relization was allocated to partners.
3. Liabilities were paid in full.
4. Cash was paid to the partners with credit balances.

Instructions

(a) Prepare a schedule of cash payments.
(b) Prepare the entries to record the transactions.
(c) Post to the cash and capital accounts.

(a) Loss on realization $13,000
Cash paid: to Scottie $21,500; to Kirk $3,250

***P12-4B** At April 30, partners' capital balances in BAB Company are: Barney $30,000. Andy $16,000, and Bea $15,000. The income-sharing ratios are 5:3:2, respectively. On May 1, the BABE Company is formed by admitting Ellen to the firm as a partner.

Journalize admission of a partner under different assumptions.

(SO 6)

Instructions

(a) Journalize the admission of Ellen under each of the following independent assumptions.
(1) Ellen purchases 50% of Bea's ownership interest by paying Bea $6,000 in cash.
(2) Ellen purchases 50% of Andy's ownership interest by paying Andy $10,000 in cash.
(3) Ellen invests $29,000 cash in the partnership for a 40% ownership interest that includes a bonus to the new partner.
(4) Ellen invests $24,000 in the partnership for a 20% ownership interest, and bonuses are given to the old partners.

(b) Andy's capital balance is $24,000 after admitting Ellen to the partnership by investment. If Andy's ownership interest is 24% of total partnership capital, what were (1) Ellen's cash investment and (2) the total bonus to the old partners?

(a) (1) Ellen, Capital $7,500
(2) Ellen $8,000
(3) Ellen $36,000
(4) Ellen $17,000

***P12-5B** On December 31, the capital balances and income ratios in Canasta Company are as follows.

Journalize withdrawal of a partner under different assumptions.

(SO 7)

Partner	Capital Balance	Income Ratio
A. Heart	$100,000	60%
L. Club	51,000	30
B. Spade	25,000	10

(a) (1) Club, Capital $12,500
(2) Club, Capital $25,000
(3) Bonus $9,000
(4) Bonus $6,000

Instructions

(a) Journalize the withdrawal of Spade under each of the following independent assumptions.

(1) Each of the remaining partners agrees to pay $15,000 in cash from personal funds to purchase Spade's ownership equity. Each receives 50% of Spade's equity.

(2) Club agrees to purchase Spade's ownership interest for $22,000 in cash.

(3) From partnership assets, Spade is paid $34,000, which includes a bonus to the retiring partner.

(4) Spade is paid $19,000 from partnership assets. Bonuses to the remaining partners are recognized.

(b) If Club's capital balance after Spade's withdrawal is $55,000, what were (1) the total bonus to the remaining partners and (2) the cash paid by the partnership to Spade?

PROBLEMS: SET C

Visit the book's companion website at **www.wiley.com/college/weygandt**, and choose the Student Companion site, to access Problem Set C.

CONTINUING COOKIE CHRONICLE

(*Note:* This is a continuation of the Cookie Chronicle from Chapters 1 through 11.)

CCC12 Natalie's high school friend, Katy Peterson, has been operating a bakery for approximately 18 months. Because Natalie has been so successful operating Cookie Creations, Katy would like to have Natalie become her partner. Katy believes that together they will create a thriving cookie-making business. Natalie is quite happy with her current business set-up. Up until now, she had not considered joining forces with anyone. However, Natalie thinks that it may be a good idea to establish a partnership with Katy, and decides to look into it.

Go to the book's companion website,
www.wiley.com/college/weygandt,
to see the completion of this problem.

BROADENING YOUR PERSPECTIVE

FINANCIAL REPORTING AND ANALYSIS

Exploring the Web

BYP12-1 This exercise is an introduction to the Big Four accounting firms, all of which are partnerships.

Addresses

Deloitte & Touche	**www.deloitte.com/**
Ernst & Young	**www.ey.com/**
KPMG	**www.us.kpmg.com/**
PricewaterhouseCoopers	**www.pw.com/**

or go to **www.wiley.com/college/weygandt**

Steps

1. Select a firm that is of interest to you.
2. Go to the firm's homepage.

Instructions

(a) Name two services provided by the firm.
(b) What is the firm's total annual revenue?
(c) How many clients does it service?
(d) How many people are employed by the firm?
(e) How many partners are there in the firm?

CRITICAL THINKING

Decision Making Across the Organization

BYP12-2 Richard Powers and Jane Keckley, two professionals in the finance area, have worked for Eberhart Leasing for a number of years. Eberhart Leasing is a company that leases high-tech medical equipment to hospitals. Richard and Jane have decided that, with their financial expertise, they might start their own company to provide consulting services to individuals interested in leasing equipment. One form of organization they are considering is a partnership.

If they start a partnership, each individual plans to contribute $50,000 in cash. In addition, Richard has a used IBM computer that originally cost $3,700, which he intends to invest in the partnership. The computer has a present market value of $1,500.

Although both Richard and Jane are financial wizards, they do not know a great deal about how a partnership operates. As a result, they have come to you for advice.

Instructions

With the class divided into groups, answer the following.

(a) What are the major disadvantages of starting a partnership?
(b) What type of document is needed for a partnership, and what should this document contain?
(c) Both Richard and Jane plan to work full-time in the new partnership. They believe that net income or net loss should be shared equally. However, they are wondering how they can provide compensation to Richard Powers for his additional investment of the computer. What would you tell them?
(d) Richard is not sure how the computer equipment should be reported on his tax return. What would you tell him?
(e) As indicated above, Richard and Jane have worked together for a number of years. Richard's skills complement Jane's and vice versa. If one of them dies, it will be very difficult for the other to maintain the business, not to mention the difficulty of paying the deceased partner's estate for his or her partnership interest. What would you advise them to do?

Communication Activity

BYP12-3 You are an expert in the field of forming partnerships. Daniel Ortman and Sue Stafford want to establish a partnership to start "Pasta Shop," and they are going to meet with you to discuss their plans. Prior to the meeting you will send them a memo discussing the issues they need to consider before their visit.

Instructions

Write a memo in good form to be sent to Ortman and Stafford.

Ethics Case

BYP12-4 Elizabeth and Laurie operate a beauty salon as partners who share profits and losses equally. The success of their business has exceeded their expectations; the salon is operating quite profitably. Laurie is anxious to maximize profits and schedules appointments from 8 a.m. to 6 p.m. daily, even sacrificing some lunch hours to accommodate regular customers. Elizabeth schedules her appointments from 9 a.m. to 5 p.m. and takes long lunch hours. Elizabeth regularly makes significantly larger withdrawals of cash than Laurie does, but, she says, "Laurie, you needn't worry, I never make a withdrawal without you knowing about it, so it is properly recorded in my drawing account and charged against my capital at the end of the year." Elizabeth's withdrawals to date are double Laurie's.

Instructions

(a) Who are the stakeholders in this situation?
(b) Identify the problems with Elizabeth's actions and discuss the ethical considerations of her actions.
(c) How might the partnership agreement be revised to accommodate the differences in Elizabeth's and Laurie's work and withdrawal habits?

"All About You" Activity

BYP12-5 As the text in this chapter indicates, the partnership form of organization has advantages and disadvantages. The chapter noted that different types of partnerships have been developed to minimize some of these disadvantages. Alternatively, an individual or company can choose the proprietorship or corporate form of organization.

Instructions

Go to two local businesses that are different, such as a restaurant, a retailer, a construction company, a professional office (dentist, doctor, etc.), and find the answers to the following questions.

(a) What form of organization do you use in your business?
(b) What do you believe are the two major advantages of this form of organization for your business?
(c) What do you believe are the two major disadvantages of this form of organization for your business?
(d) Do you believe that eventually you may choose another form of organization?
(e) Did you have someone help you form this organization (attorney, accountant, relative, etc.)?

Answers to Insight and Accounting Across the Organization Questions

p. 530 Limited Liability Companies Gain in Popularity

Q: Why do you think that the use of the limited liability company is gaining in popularity?

A: *The LLC is gaining in popularity because owners in such companies have limited liability for business debts even if they participate in management. As a result, the LLC form has a distinct advantage over regular partnerships. In addition, the other limited type partnerships discussed in Illustration 12-1 are restrictive as to their use. As a result, it is not surprising that limited liability companies are now often used as the form of organization when individuals want to set up a partnership.*

p. 533 How to Part Ways Nicely

Q: How can partnership conflicts be minimized and more easily resolved?

A: *First, it is important to develop a business plan that all parties agree to. Second, it is vital to have a well-thought-out partnership agreement. Third, it can be useful to set up a board of mutually agreed upon and respected advisors to consult when making critical decisions.*

Answers to Self-Study Questions

1. a **2.** c **3.** b **4.** c **5.** a **6.** b **7.** c **8.** c **9.** d **10.** a **11.** b **12.** d ***13.** d ***14.** d ***15.** b

Remember to go back to the Navigator box on the chapter-opening page and check off your completed work.