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ACCOUNTING PRINCIPLES

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TWELFTH EDITION

WILEY

12

Accounting for Partnerships

Learning Objectives

1

Discuss and account for the formation of a partnership.

2

Explain how to account for net income or net loss of a partnership.

3

Explain how to account for the liquidation of a partnership.

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

Type of Business:

- ◆ Small retail, service, or manufacturing companies.
- ◆ Accountants, lawyers, and doctors.

Characteristics of Partnerships

ASSOCIATION OF INDIVIDUALS

- ◆ Legal entity.
- ◆ Accounting entity.
- ◆ Net income not taxed as a separate entity.

MUTUAL AGENCY

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

Characteristics of Partnerships

LIMITED LIFE

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

UNLIMITED LIABILITY

- ◆ Each partner is personally and individually liable for all partnership liabilities.

Characteristics of Partnerships

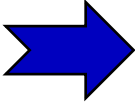
CO-OWNERSHIP OF PROPERTY

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

Characteristics of Partnerships

Question

All of the following are characteristics of partnerships except:

- a. co-ownership of property.
- b. mutual agency.
- c. limited life.
-  d. limited liability.

Organizations with Partnerships Characteristics

Special forms of business organizations are often used to provide protection from unlimited liability.

Special partnership forms are:

- ◆ Limited Partnerships,
- ◆ Limited Liability Partnerships, and
- ◆ Limited Liability Companies.

Helpful Hint In an LLP, *all* partners have limited liability. There are no general partners.

Organizations with Partnerships Characteristics

Regular Partnership

Regular Partnership



General Partners

Major Advantages

- ◆ Simple and inexpensive to create and operate.

Major Disadvantages

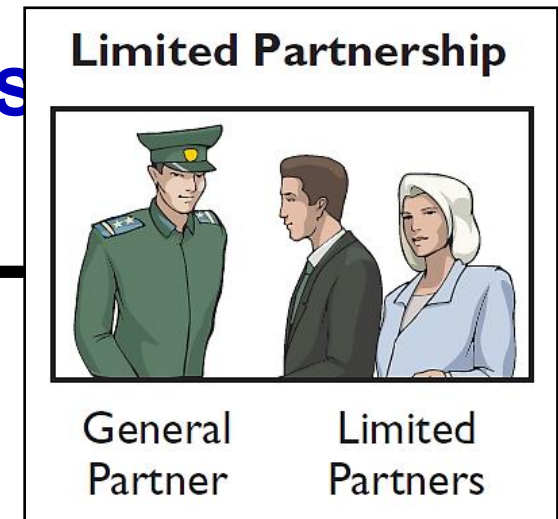
- ◆ Owners (partners) personally liable for business debts.

Organizations with Partnerships Characteristics

Major Advantages

- ◆ 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.

“Ltd.,” or
“LP”



Major Disadvantages

- ◆ General partners personally liable for business debts.
- ◆ More expensive to create than regular partnership.
- ◆ Suitable for companies that invest in real estate.

Organizations with Partnerships Characteristics



“LLP”

Major Advantages

- ◆ 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.

Major Disadvantages

- ◆ Partners remain personally liable for many types of obligations owed to business creditors, lenders, and landlords.
- ◆ Often limited to a short list of professions.

Organizations with Partnerships Characteristics

Limited Liability Company



“LLC”

Major Advantages

- ◆ Owners have limited personal liability for business debts even if they participate in management.

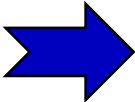
Major Disadvantages

- ◆ More expensive to create than regular partnership.

Partnership Form of Organization

Question

Under which of the following business organization forms do limited partners have little, if any, active role in the management of the business?

- a. Limited liability partnership.
-  b. Limited partnership.
- c. Limited liability companies.
- d. None of the above.

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.

Advantages and Disadvantages of Partnerships

Illustration 12-2

Advantages

- Combining skills and resources of two or more individuals
- Ease of formation
- Freedom from governmental regulations and restrictions
- Ease of decision-making

Disadvantages

- Mutual agency
- Limited life
- Unlimited liability

Partnership Agreement

Should specify relationships among the partners:

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

Accounting Across the Organization

Dividing Up the Pie

What should you do when you and your business partner disagree 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 each other, eventually destroying the business. In some cases, 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. 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.

Accounting for a Partnership Formation

Illustration: A. Rolfe and T. Shea combine their proprietorships to start a partnership named U.S. Software. Rolfe and Shea have the following assets prior to the formation of the partnership.

	Book Value		Fair Value	
	A. Rolfe	T. Shea	A. Rolfe	T. Shea
Cash	\$ 8,000	\$ 9,000	\$ 8,000	\$ 9,000
Equipment	5,000		4,000	
Accumulated depreciation—equipment	(2,000)			
Accounts receivable		4,000		4,000
Allowance for doubtful accounts		(700)		(1,000)
	<u>\$11,000</u>	<u>\$12,300</u>	<u>\$12,000</u>	<u>\$12,000</u>

Illustration 12-3
Book and fair values
of assets invested

Accounting for a Partnership Formation

Illustration: Prepare the entry to record the investment of **A. Rolfe**.

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

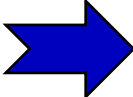
Prepare the entry to record the investment of **T. Shea**.

Cash	9,000	
Accounts Receivable	4,000	
Allowance for Doubtful Accounts		1,000
T. Shea, Capital		12,000

Accounting for a Partnership Formation

Question

When a partner invests noncash assets in a partnership, the assets should be recorded at their:

- a. book value.
- b. carrying value.
-  c. fair market value.
- d. original cost.

DO IT!

1

Partnership Organization

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

False 1. Partnerships have unlimited life. Corporations do not.

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

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

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

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

Dividing Net Income or Net Loss

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

CLOSING ENTRIES:

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

Dividing Net Income or Net Loss

INCOME RATIOS

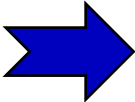
Partnership agreement should specify the basis for sharing net income or net loss. Typical income ratios:

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

Dividing Net Income or Net Loss

Question

Which of the following statements is correct?

- a. Salaries to partners and interest on partners' capital are expenses of the partnership.
- b. Salaries to partners are an expense of the partnership but not interest on partners' capital.
- c. Interest on partners' capital are expenses of the partnership but not salaries to partners.
-  d. Neither salaries to partners nor interest on partners' capital are expenses of the partnership.

Dividing Net Income or Net Loss

Illustration: Sara King and Ray 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 2017, partnership net income is \$22,000. The division of net income is as follows.

Instructions

- (a) Prepare a schedule showing the distribution of net income.
- (b) Journalize the allocation of net income.

Dividing Net Income or Net Loss

Illustration 12-5

Division of Net Income For the Year Ended December 31, 2017			
Net income	<u>\$ 22,000</u>		
<u>Division of Net Income</u>			
	<u>Sara King</u>	<u>Ray Lee</u>	<u>Total</u>
Salary allowance	\$ 8,400	\$6,000	\$14,400
Interest allowance on partners' capital			
Sara King ($\$28,000 \times 10\%$)	2,800		
Ray Lee ($\$24,000 \times 10\%$)		2,400	
Total interest allowance			5,200
Total salaries and interest	<u>11,200</u>	<u>8,400</u>	<u>19,600</u>
Remaining income, \$2,400 ($\$22,000 - \$19,600$)			
Sara King ($\$2,400 \times 50\%$)	1,200		
Ray Lee ($\$2,400 \times 50\%$)		1,200	
Total remainder			2,400
Total division of net income	<u><u>\$12,400</u></u>	<u><u>\$9,600</u></u>	<u><u>\$22,000</u></u>

Dividing Net Income or Net Loss

Illustration: (b) Journalize the allocation of income.

Dec. 31

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

Dividing Net Income or Net Loss

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

	<u>Sara King</u>	<u>Ray Lee</u>	<u>Total</u>
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	<u><u>\$10,400</u></u>	<u><u>\$7,600</u></u>	<u><u>\$18,000</u></u>

Illustration 12-6
Division of net income—
income deficiency

Partnership Financial Statements

Illustration 12-7

KINGSLEE COMPANY Partners' Capital Statement For the Year Ended December 31, 2017

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

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

Partnership Financial Statements

KINGSLEE COMPANY Balance Sheet (partial) December 31, 2017

Total liabilities (assumed amount)		\$115,000
Owners' equity		
Sara King, capital	\$35,400	
Ray Lee, capital	<u>28,600</u>	
Total owners' equity		<u>64,000</u>
Total liabilities and owners' equity		<u><u>\$179,000</u></u>

Illustration 12-8

Owners' equity section of a partnership balance sheet

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

DO IT!

2

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.

DO IT!

2

Division of Net Income

The division of net income is as follows.

	<u>L. Lee</u>	<u>R. May</u>	<u>Total</u>
Salary allowance			
Remaining income \$30,000 (\$57,000 – \$27,000)			
L. Lee			
R. May			
Total remaining income	_____	_____	_____
Total division of net income	=====	=====	=====

The closing entry for net income therefore is:

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

Ends both the legal and economic life of the entity.

To liquidate, it is necessary to:

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

Partnership Liquidation

No Capital
Deficiency

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

<u>Assets</u>		<u>Liabilities and Owners' Equity</u>	
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
	<u>\$65,000</u>		<u>\$65,000</u>

Illustration 12-9

Account balances prior to
liquidation

Partnership Liquidation

No Capital
Deficiency

Illustration: 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.

Partnership Liquidation

No Capital
Deficiency

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

Cash	75,000	
Accumulated Depreciation	8,000	
Accounts Receivable		15,000
Inventory		18,000
Equipment		35,000
Gain on Realization		15,000

Partnership Liquidation

No Capital
Deficiency

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

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

Partnership Liquidation

No Capital
Deficiency

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

Notes Payable	15,000	
Accounts Payable	16,000	
Cash		31,000

Partnership Liquidation

No Capital
Deficiency

Illustration: (4) Record the distribution of cash.

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

Cash		R. Arnet, Capital		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

Partnership Liquidation

**No Capital
Deficiency**

SCHEDULE OF CASH PAYMENTS

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

Illustration 12-11

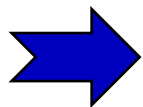
Schedule of cash payments,
no capital deficiency

Partnership Liquidation

Question

The first step in the liquidation of a partnership is to:

- a. allocate gain/loss on realization to the partners.
- b. distribute remaining cash to partners.
- c. pay partnership liabilities.

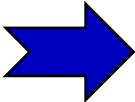


- d. sell noncash assets and recognize a gain or loss on realization.

Partnership Liquidation

Question

If a partner with a capital deficiency is unable to pay the amount owed to the partnership, the deficiency is allocated to the partners with credit balances:

- a. equally.
-  b. on the basis of their income ratios.
- c. on the basis of their capital balances.
- d. on the basis of their original investments.

DO IT!

3

No Capital Deficiency

The partners of Grafton Company have decided to liquidate their business. Noncash assets were sold for \$115,000. The income ratios of the partners Kale D., Croix D., and Marais K. are 2:3:3, respectively. Complete the following schedule of cash payments for Grafton Company.

	A	B	C	D	E	F	G	H	I	J	K	L
1	Item	Cash	+	Noncash Assets	=	Liabilities	+	Kale D., Capital	+	Croix D., Capital	+	Marais K., Capital
2	Balances before liquidation	10,000		85,000		40,000		15,000		35,000		5,000
3	Sale of noncash assets and allocation of gain											
4	New balances											
5	Pay liabilities											
6	New balances											
7	Cash distribution to partners											
8	Final balances											
9												
10	^a 30,000 x 2/8											
11	^b 30,000 x 3/8											

Partnership Liquidation

Capital Deficiency

Illustration: Ace Company's ledger shows the following assets, liabilities, and owners' equity accounts.

Assets		Liabilities and Owners' Equity	
Cash	\$ 5,000	Notes Payable	\$15,000
Accounts Receivable	15,000	Accounts Payable	16,000
Inventory	18,000	R. Arnet, Capital	15,000
Equipment	35,000	P. Carey, Capital	17,800
Accum. Depr.—Equipment	(8,000)	W. Eaton, Capital	1,200
	<u>\$65,000</u>		<u>\$65,000</u>

Illustration 12-9

Account balances prior to liquidation

Partnership Liquidation

Capital Deficiency

Illustration: Ace Company is on the brink of bankruptcy. They sell merchandise at substantial discounts, and sell the equipment at auction. Cash proceeds from these sales and collections from customers totals \$42,000. (1) Prepare the entry for the realization of noncash assets.

Cash	42,000	
Accumulated Depreciation	8,000	
Loss on Realization	18,000	
Accounts Receivable		15,000
Inventory		18,000
Equipment		35,000

Partnership Liquidation

Capital Deficiency

Illustration: (2) Ace allocates the loss on realization to the partners on the basis of their income ratios. The entry is:

R. Arnet, Capital ($\$18,000 \times 3/6$)	9,000	
P. Carey, Capital ($\$18,000 \times 2/6$)	6,000	
W. Eaton, Capital ($\$18,000 \times 1/6$)	3,000	
Loss on realization		18,000

Partnership Liquidation

Capital
Deficiency

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

Notes Payable	15,000	
Accounts Payable	16,000	
Cash		31,000

Partnership Liquidation

**Capital
Deficiency**

Payment of Deficiency

	Cash	R. Arnet Capital	P. Carey Capital	W. Eaton Capital
Balances before liquidation	\$ 16,000	\$ (6,000)	\$ (11,800)	\$ 1,800
Eaton payment	1,800			(1,800)
Balance	\$ 17,800	\$ (6,000)	\$ (11,800)	\$ -

Cash	1,800		
W. Eaton, Capital			1,800
R. Arnet, Capital	6,000		
P. Carey, Capital	11,800		
Cash			17,800

Partnership Liquidation

**Capital
Deficiency**

Nonpayment of Deficiency

	Cash	R. Arnet Capital	P. Carey Capital	W. Eaton Capital
Balances before liquidation	\$ 16,000	\$ (6,000)	\$ (11,800)	\$ 1,800
Allocation of deficiency		1,080	720	(1,800)
Balance	\$ 16,000	\$ (4,920)	\$ (11,080)	\$ -

R. Arnet, Capital	1,080		
P. Carey, Capital	720		
Farley, Capital			1,800
R. Arnet, Capital	4,920		
P. Carey, Capital	11,080		
Cash			16,000

Admission of a Partner

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

Purchase of a Partner's Interest

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

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

Illustration 12A-1

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

Investment of Assets in a Partnership

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

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

Illustration 12A-2

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

Admission of a Partner

<u>Purchase of an Interest</u>		<u>Admission by Investment</u>	
<u>Net assets</u>	<u>\$60,000</u>	<u>Net assets</u>	<u>\$90,000</u>
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	<u>\$60,000</u>	Total capital	<u>\$90,000</u>

Illustration 12A-3

Comparison of purchase of an interest and admission by investment

Investment of Assets in a Partnership

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.

- ◆ Bonus results in an increase in the capital balances of the old partners.
- ◆ Partnership allocates the bonus to them on the basis of their income ratios before the admission of the new partner.

BONUS TO OLD PARTNERS

Illustration: 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.

Total capital of existing partnership	\$ 120,000
Investment by new partner, Eden	<u>80,000</u>
Total capital of new partnership	<u><u>\$ 200,000</u></u>

BONUS TO OLD PARTNERS

Illustration: 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.

2. Determine the new partner's capital credit.

Total capital of new partnership	\$ 200,000
New partner's ownership interest	x 25%
	<hr/>
New partner's capital credit	\$ 50,000
	<hr/> <hr/>

BONUS TO OLD PARTNERS

Illustration: 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.

3. Determine the amount of bonus.

New partner's capital credit	\$ 80,000
New partner's investment	<u>- 50,000</u>
Bonus amount	<u><u>\$ 30,000</u></u>

BONUS TO OLD PARTNERS

Illustration: 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.

- 4. Allocate the bonus to the old partners on the basis of their income ratios. (Assume Bart 60% and Cohen 40%)**

Bart ($\$30,000 \times 60\%$)	\$ 18,000
Cohen ($\$30,000 \times 40\%$)	12,000
Total bonus	<u>\$ 30,000</u>

BONUS TO OLD PARTNERS

Illustration: 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.

Journal 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

Investment of Assets in a Partnership

BONUS TO NEW PARTNER

Results when the new partner's investment in the firm is less than his or her capital credit.

- ◆ Bonus results in an decrease in the capital balances of the old partners.
- ◆ Decrease for each partner is based on the income ratios before the admission of the new partner.

BONUS TO NEW PARTNER

Illustration: 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 \$20,000.

The computations for Eden's capital credit and the bonus are as follows along with the journal entry to record the admission of Eden into the partnership.

BONUS TO NEW PARTNER

1. Total capital of Bart–Cohen partnership

Investment by new partner, Eden

Total capital of new partnership

2. Eden's capital credit (2)

3. Bonus to Eden (3)

4. Allocation of bonus to old partners:

Bart

Cohen

Cash

Sam Bart, Capital

Tom Cohen, Capital

Lea Eden, Capital

20,000

9,000

6,000

35,000

Withdrawal of a Partner

- ◆ A partner may withdraw from a partnership **voluntarily**, by selling his or her equity in the firm.
- ◆ Or, he or she may withdraw **involuntarily**, by reaching mandatory retirement age or by dying.
- ◆ The withdrawal of a partner, like the admission of a partner, legally dissolves the partnership.

Payment from Partners' Personal Assets

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

J. Odom, Capital	10,000	
A. Morz, Capital		5,000
M. Nead, Capital		5,000

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

Payment from Partners' Personal Assets

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

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

Payment from Partnership Assets

BONUS TO RETIRING PARTNER

A partnership may pay a bonus to a retiring partner when:

1. The fair 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.

Payment from Partnership Assets

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

Journal entry to record the withdrawal of Terk:

B. Terk, Capital	20,000	
F. Roman, Capital	3,000	
D. Sand, Capital	2,000	
Cash		25,000

Payment from Partnership 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.
3. The partner is eager to leave the partnership.

The partnership allocates (credits) the bonus to the capital accounts of the remaining partners on the basis of their income ratios.

Payment from Partnership Assets

Illustration: Assume that the partnership pays Terk only \$16,000 for her \$20,000 equity when she withdraws from the partnership. In that case:

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 ($\$4,000 \times 3/5$) and Sand \$1,600 ($\$4,000 \times 2/5$).

The entry to record the withdrawal is as follows.

B. Terk, Capital	20,000	
F. Roman, Capital		2,400
D. Sand, Capital		1,600
Cash		16,000

Death of a Partner

Dissolves the partnership.

Partnership agreements usually contain a provision for the surviving partners to continue operations.

Surviving partners may

- ◆ agree to purchase the deceased partner's equity from their personal assets.
- ◆ use partnership assets to settle with the deceased partner's estate.

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