12 Partnerships

Learning Objectives

1. Identify the characteristics of a partnership
2. Account for partner investments
3. Allocate profits and losses to the partners
4. Account for the admission of a new partner
5. Account for a partner's withdrawal from the firm
6. Account for the liquidation of a partnership
7. Prepare partnership financial statements

Previous chapters saw you start your own business, In Motion T-Shirts, to imprint logos for groups around your college. Suppose Jonathan Demski, a friend, wants to join In Motion—not as an employee but as a partner. This guy could sell a Ford to General Motors. He can help you double your profits.

What does Jonathan bring to the table besides a good personality? After all, he's joining a business that earned $20,000 last year. Here are some of the issues you will need to address:

- Should you require Jonathan to invest money in your business?
- How will you and Jonathan share profits and losses?
- If Jonathan withdraws from the business, what assets can he take?

If you let Jonathan join you as a co-owner, you will automatically form a partnership. A **partnership** is an association of two or more persons who co-own a business for profit. As you can see, a partnership is more complex than the proprietorships of preceding chapters. 🟩

Forming a partnership is easy. It requires no permission from the government and no outside legal procedures. A partnership combines the assets and abilities of the partners. New opportunities may open up as you and Jonathan pool your talents and resources. You can offer a fuller range of goods and services than you alone can provide.

Partnerships come in all sizes. Many have one or two owners, but some are quite large. Exhibit 12-1 lists the largest U.S. accounting firms that are organized as partnerships. The largest of these firms have over 2,000 partners.

EXHIBIT 12-1 **The Six Largest Accounting Firms in the United States**

Deloitte & Touche
Ernst & Young
PricewaterhouseCoopers
KPMG
Grant Thornton
RSM/McGladrey & Pullen*

*The RSM unit of the firm is not a partnership.
Source: Adapted from *Accounting Today* (March 14–April 3, 2005).

Characteristics of a Partnership

1 Identify the characteristics of a partnership

A partnership is voluntary. You can't be forced to join one, and you can't be forced to accept another person as a partner. Partnerships differ from proprietorships and corporations in the following ways.

The Written Agreement

A partnership is somewhat like a marriage. To be successful, the partners must cooperate. But the partners don't vow to remain together for life. To increase the partners' understanding of how the business is run, they should draw up a **partnership agreement**, also called the **articles of partnership**. This agreement is a contract between the partners and is governed by contract law. The articles of partnership should specify the following:

1. Name, location, and nature of the business
2. Name, investment, and duties of each partner
3. Procedures for admitting a new partner
4. Method of sharing profits and losses among the partners
5. Withdrawals of assets by the partners
6. Procedures for settling up with a partner who withdraws from the firm
7. Procedures for liquidating the partnership—selling the assets, paying the liabilities, and giving any remaining cash to the partners

You'll cover these points as you work through the chapter. A partnership has some special features.

Limited Life

A partnership has a limited life. If a partner withdraws, the old partnership dissolves. **Dissolution** is the ending of a partnership. The addition of a new partner dissolves the old partnership and creates a new one.

Mutual Agency

Mutual agency means that every partner is a mutual agent of the firm. Any partner can bind the business to a contract within the scope of its operations. If Stephanie Jones, a partner in the law firm of Willis & Jones, contracts to pay a debt, then the firm of Willis & Jones—not just Jones—owes the liability. If Jones signs a contract to buy her own car, however, the partnership is not liable because that is a personal matter for Jones.

Unlimited Liability

Each partner has **unlimited personal liability** for the debts of the business. When a partnership can't pay its debts, the partners must pay with their personal assets.

Suppose Willis & Jones can't pay a $20,000 business debit that Jones created. Then Willis and Jones each become personally liable for the $20,000 because each partner has *unlimited liability* for the business's debts. If either partner can't pay his or her part of the debt, the other partner must pay the total. For example, if Jones can pay only $5,000 of the liability, Willis must pay $15,000. If Jones can't pay anything, Willis must pay the full $20,000.

Co-Ownership of Property

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

No Partnership Income Tax

A partnership pays no business income tax. Instead, the net income of the business flows through and becomes the taxable income of the partners. Suppose the Willis & Jones law firm earned net income of $200,000, shared equally by the partners. The firm pays no income tax *as a business entity*. But Willis and Jones each pay personal income tax on $100,000 of partnership income.

Partners' Capital Accounts

Accounting for a partnership is much like accounting for a proprietorship. But a partnership has more than one owner, so it needs a separate capital account for each partner. For example, the equity account for Blake Willis is Willis, Capital. Similarly, each partner has a withdrawal account such as Blake Willis, Drawing.

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

- Limited life
- Unlimited liability
- No business income tax

EXHIBIT 12-2 Advantages and Disadvantages of Partnerships

Partnership Advantages

Versus Proprietorships:

1. Partnership can raise more capital.
2. Partnership brings together the abilities of more than one person.
3. Partners working well together can add more value than by working alone. 1 + 1 > 2 in a good partnership.

Versus Corporations:

1. Partnership is less expensive to organize than a corporation, which requires a charter from the state.
2. There's no double taxation. Partnership income is taxed only to the partners as individuals.

Partnership Disadvantages

1. Partnership agreement may be difficult to formulate. Each time a new partner is admitted or a partner withdraws, the business needs a new partnership agreement.
2. Relations among partners may be fragile.
3. Mutual agency and unlimited liability create personal obligations for each partner.

Types of Partnerships

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

General Partnership

A **general partnership** is the basic form. Each partner is a co-owner of the business with all the privileges and risks of ownership. The profits and losses of the partnership pass through to the partners, who then pay personal income tax on their income. All the other features we just covered also apply to a general partnership.

Limited Partnership

A **limited partnership** has at least two classes of partners. There must be at least one *general partner,* who takes primary responsibility. The general partner also takes most of the risk if the partnership goes bankrupt. Usually, the general partner is the last owner to receive a share of profits and losses. But the general partner often gets all the excess profit after the limited partners get their share of the income.

The *limited partners* have limited liability for partnership debts. Their liability is limited to their investment in the business. Limited partners usually have first claim to profits and losses, but only up to a certain limit. In exchange for their limited liability, their potential for profits is also limited.

Most accounting firms—including those in Exhibit 12-1—are organized as **limited liability partnerships**, or **LLPs**. That means each partner's personal liability for business debts is limited to a certain amount. The LLP must carry a large insurance policy to protect the public in case the partnership is found guilty of malpractice. Medical, legal, and other professional firms are also organized as LLPs.

Limited-Liability Company (LLC)

A limited-liability company is its own form of business organization—neither a partnership nor a corporation. It combines the advantages of both. The LLC form is perhaps the most flexible way to organize a business because the owners, called *members*, have numerous choices.

The features of a limited-liability company that parallel a *corporation* are:

- The LLC must file articles of organization with the state.
- The business name must include "LLC" or a similar designation to alert the public about the limited liability of the members.
- The members are *not* personally liable for the business's debts. This is one of the chief advantages of an LLC compared to a proprietorship or a partnership.

The features of an LLC similar to a *partnership* are:

- The LLC can elect *not* to pay business income tax. The income of the LLC can be taxed to the members as though they were partners. This is the other big advantage of an LLC, as compared to a corporation. Corporations pay a corporate income tax. Then the stockholders pay personal income tax on any dividends they receive from the corporation. This is why we say that corporations face *double taxation*.
- The members (owners of the LLC) can participate actively in management of the business.
- The accounting for an LLC follows the pattern for a partnership.

S Corporation

An **S corporation** is a corporation taxed as a partnership. This form of business organization comes from Subchapter S of the U.S. Internal Revenue Code. An S corporation offers its owners the benefits of a corporation—no personal liability for business debts—and of a partnership—no double taxation. An ordinary (Subchapter C) corporation is subject to double taxation.

An S corporation pays no corporate income tax. Instead, the corporation's income flows through to the stockholders, who pay personal income tax on their share of the corporation's income, as in a partnership.

Exhibit 12-3 summarizes this section by showing the features of the different types of business organization.

EXHIBIT 12-3 **Features of the Different Types of Business Organization**

Organization	Legal Entity	Personal Liability of the Owners	Pays Business Income Tax
Proprietorship	No	Unlimited	No
Partnership	No		No
General partners		Unlimited	
Limited partners		Limited	
Limited-Liability Company (LLC)	Yes	Limited	No*
S Corporation	Yes	Limited	No
C Corporation	Yes	Limited	Yes

*In some states, a limited-liability company can elect to pay corporate income tax.

The Start-Up of a Partnership

2 Account for partner investments

Let's examine the start-up of a partnership. The partners may invest both assets and liabilities. These contributions are journalized the same as for a proprietorship—debit the assets and credit the liabilities. The excess—assets minus liabilities—measures each partner's capital.

Suppose Lisa Lane and Don Reed form a partnership to sell computer software. The partners agree on the following values:

Lane's Investment

- Cash, $10,000; inventory, $40,000; and accounts payable, $80,000 (The current market values for these items equal Lane's values.)
- Computer equipment—cost, $800,000; accumulated depreciation, $200,000; *current market value, $450,000*

Reed's Investment

- Cash, $5,000
- Computer software: cost, $20,000; *market value, $100,000*

Let's form a partnership.
I have a computer network.
Okay, I've got
some software.
Lane
Reed

The partnership records the partners' investments at *current market value*. Why? Because the partnership is buying the assets and assuming the liabilities at their current market values. The partnership entries follow.

	Lane's Investment		
June 1	Cash	10,000	
	Inventory	40,000	
	Computer Equipment	450,000	
	Accounts Payable		80,000
	Lane, Capital		420,000
	To record Lane's investment.		
	Reed's Investment		
June 1	Cash	5,000	
	Computer Software	100,000	
	Reed, Capital		105,000
	To record Reed's investment.		

The initial partnership balance sheet appears in Exhibit 12-4. The assets and liabilities are the same for a proprietorship and a partnership.

EXHIBIT 12-4 Partnership Balance Sheet

L&R SOFTWARE
Balance Sheet
June 1, 2008

Assets		Liabilities	
Cash	$ 15,000	Accounts payable	$ 80,000
Inventory	40,000	**Capital**	
Computer equipment	450,000	Lane, capital	420,000
Computer software	100,000	Reed, capital	105,000
		Total liabilities	
Total assets	$605,000	and capital	$605,000

Sharing Profits and Losses, and Partner Drawings

3 Allocate profits and losses to the partners

Allocating profits and losses among partners can be challenging. The partners can agree to any profit-and-loss-sharing method they desire. Typical arrangements include the following:

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

If the partners have no agreement as to how to divide profits and losses, then they share equally. If the agreement specifies a method for sharing profits but not losses, then losses are shared the same way as profits. For example, a partner who gets 75% of the profits will absorb 75% of any losses.

Let's see how some of these profit-and-loss plans work.

Sharing Based on a Stated Fraction

The agreement may state each partner's fraction of the profits and losses. Suppose Jason Cruz and Susan Moore allocate 2/3 of the profits and losses to Cruz and 1/3 to Moore. This sharing rule can also be expressed as 2:1. If their net income for the year is $60,000, the Income Summary account has a credit balance of $60,000 prior to closing.

Income Summary

	Bal. 60,000

The entry to close net income to the partners' capital accounts is:

Dec. 31	Income Summary	60,000	
	Cruz, Capital ($60,000 × 2/3)		40,000
	Moore, Capital ($60,000 × 1/3)		20,000
	To close net income to the partners.		

Suppose Cruz's beginning capital balance was $50,000 and Moore's $10,000. After posting, the accounts appear as follows:

Income Summary

Clo.	60,000		60,000

Cruz, Capital

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

Moore, Capital

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

If the partnership had a net loss of $15,000, the Income Summary account would have a debit balance of $15,000, as follows:

Income Summary

Bal.	15,000		

In that case Cruz takes a hit for 2/3 of the loss, and the closing entry is:

Dec. 31	Cruz, Capital ($15,000 × 2/3)	10,000	
	Moore, Capital ($15,000 × 1/3)	5,000	
	Income Summary		15,000
	To close net loss to the partners.		

Sharing Based on Capital Balances and on Service

One partner may invest more capital. Another may put more work into the business. Even among partners who log equal time, one person may be worth more to the firm. To reward the more-valuable person, the profits and losses may be divided based on a combination of partner capital balances *and* service.

Chris Hilton and Dana Lee formed a partnership in which Hilton invested $60,000 and Lee $40,000, for total capital of $100,000. But Lee devotes more time to the business and earns more from the firm. Accordingly, the two partners have agreed to share profits as follows:

1. The first $50,000 is allocated based on partner capital balances.
2. The next $60,000 is allocated based on service, with Hilton getting $24,000 and Lee $36,000.
3. Any remaining profit is allocated equally.

The partnership's net income for the first year is $125,000, and the partners share this profit as follows:

	Hilton	Lee	Total
Total net income			$125,000
Sharing of first $50,000 of net income,			
based on capital balances:			
Hilton ($60,000/$100,000 × $50,000)	$30,000		
Lee ($40,000/$100,000 × $50,000)		$20,000	
Total			50,000
Net income remaining for allocation			75,000
Sharing of next $60,000, based on service:			
Hilton	24,000		
Lee		36,000	
Total			60,000
Net income remaining for allocation			15,000
Remainder shared equally:			
Hilton ($15,000 × 1/2)	7,500		
Lee ($15,000 × 1/2)		7,500	
Total			15,000
Net income remaining for allocation			$ 0
Net income remaining for the partners	$61,500	$63,500	$125,000

For this allocation, the closing entry is:

Dec. 31	Income Summary	125,000	
	Hilton, Capital		61,500
	Lee, Capital		63,500
	To close net income to the partners.		

Partner Drawings of Cash and Other Assets

Partners need cash for personal expenses like everyone else. The written agreement usually allows partners to withdraw assets from the business. Drawings (withdrawals) from a partnership are recorded exactly as for a proprietorship. Assume that Kay Neal and Gina Chen each get monthly withdrawals of $3,000. The partnership records the March withdrawals with this entry:

Mar. 31	Neal, Drawing	3,000	
	Chen, Drawing	3,000	
	Cash		6,000
	Partner withdrawals of cash.		

During the year, each partner gets 12 monthly withdrawals, a total of $36,000 ($3,000 × 12). At year-end, the general ledger shows these partner drawing accounts:

Neal, Drawing		Chen, Drawing	
Dec. 31 Bal. 36,000		**Dec. 31 Bal. 36,000**	

The drawing accounts are closed at the end of the period, exactly as for a proprietorship: Credit each partner's drawing account and debit his or her capital account.

Admission of a Partner

4 Account for the admission of a new partner

Admitting a new partner dissolves the old partnership and begins a new one. Often, the new partnership continues the old one's business. Let's look at the ways a new owner can be added to a partnership.

Admission by Purchasing a Partner's Interest

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

Jan Fisher and Benny Garcia have a partnership that carries these figures:

Cash.................	$ 40,000	Total liabilities	$120,000
Other assets	360,000	Fisher, capital..........................	170,000
		Garcia, capital	110,000
Total assets........	$400,000	Total liabilities and capital	$400,000

Suppose Fisher wants out and Barry Holt, an outside party, buys Fisher's interest.

I'll sell you my interest in the partnership.
How much will you take for your interest?
Garcia
Fisher
Holt

Garcia accepts Holt as a partner, and Fisher agrees to accept $150,000. The firm records the transfer of capital interest with this entry:

Apr. 16	Fisher, Capital	170,000	
	Holt, Capital		170,000
	To transfer Fisher's equity to Holt.		

Fisher, Capital		Holt, Capital		Garcia, Capital	
170,000	170,000		170,000		110,000

The debit closes Fisher's capital account, and the credit sets up Holt's capital, as shown in the T-accounts. The entry amount is Fisher's capital balance ($170,000) and not the $150,000 that Holt paid Fisher. Why $170,000?

In this example, the partnership receives no cash because the transaction was between Holt and Fisher, not between Holt and the partnership. The full $150,000 went to Fisher. Suppose Holt pays Fisher more than her capital balance—say, $200,000. The entry on the partnership books is not affected. Fisher's equity is transferred to Holt at book value ($170,000).

The old partnership of Fisher & Garcia has dissolved. Garcia and Holt draw up a new agreement with a new profit-and-loss ratio and continue in business. If Garcia does not accept Holt as a partner, then Holt gets no voice in management. But under the Uniform Partnership Act, Holt shares in the profits and losses of the firm and in its assets at liquidation.

Admission by Investing in the Partnership

A person can enter a partnership by investing directly in the business. (This is different from buying out an existing partner, as in the preceding example.)

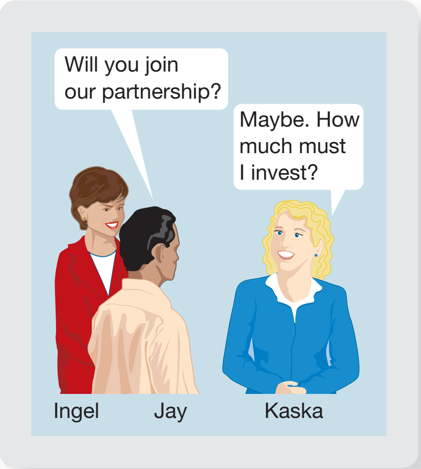
Here the new partner invests assets—for example, cash or equipment—in the business. Assume that the partnership of Ingel and Jay has the following:

Cash..................	$ 20,000	Total liabilities	$ 60,000
Other assets	200,000	Ingel, capital	70,000
		Jay, capital	90,000
Total assets........	$220,000	Total liabilities and capital	$220,000

Let's consider several possible investments by a new partner.

Admission by Investing in the Partnership at Book Value—No Bonus to Amy Partner

Cheryl Kaska wants into the Ingel & Jay partnership.


Will you join our partnership?
Maybe. How much must I invest?
Ingel
Jay
Kaska

Kaska can invest equipment and land (labeled Other Assets) with a market value of $80,000. Ingel and Jay agree to dissolve their partnership and start up a new one, giving Kaska a 1/3 interest for her $80,000 investment, as follows:

Partnership capital before Kaska is admitted ($70,000 + $90,000)	$160,000
Kaska's investment in the partnership	80,000
Partnership capital after Kaska is admitted	$240,000
Kaska's capital in the new partnership ($240,000 × 1/3)	$ 80,000

Notice that Kaska is buying into the partnership at book value because her 1/3 investment ($80,000) equals 1/3 of the new firm's total capital ($240,000). The partnership's entry to record Kaska's investment is:

July 18	Other Assets	80,000	
	Kaska, Capital		80,000
	To admit Kaska as a partner.		

After this entry, the new partnership's books show:

Cash	$ 20,000	Total liabilities	$ 60,000
Other assets		Ingel, capital	70,000
($200,000 + $80,000) .	280,000	Jay, capital	90,000
		Kaska, capital	80,000
Total assets	$300,000	Total liabilities and capital..	$300,000

Kaska's 1/3 interest does not necessarily entitle her to 1/3 of the profits. Remember: The sharing of profits and losses is a separate element in the partnership agreement.

Admission by Investing in the Partnership—Bonus to the Old Partners

A successful partnership may require a higher payment from a new partner. The old partners may demand a bonus, which will increase their capital accounts.

The Kaga & Opper partnership has earned above-average profits for 10 years. The partners share profits and losses equally. Their balance sheet carries these figures:

Cash	$ 40,000	Total liabilities	$100,000
Other assets	210,000	Kaga, capital	70,000
		Opper, capital	80,000
Total assets	$250,000	Total liabilities and capital	$250,000

Kaga and Opper admit Nancy Fry to a 1/4 interest in return for Fry's cash investment of $90,000. Fry's capital balance on the new partnership books is only $60,000, computed as follows:

Partnership capital before Fry is admitted ($70,000 + $80,000)	$150,000
Fry's investment in the partnership	90,000
Partnership capital after Fry is admitted	$240,000
Fry's capital in the partnership ($240,000 × 1/4)	$ 60,000
Bonus to the old partners ($90,000 − $60,000)	$ 30,000

In effect, Fry had to buy into the partnership at a price ($90,000) above the book value of her 1/4 interest ($60,000). Fry's higher-than-book-value investment creates a *bonus* for Kaga and Opper. The partnership entry to record the receipt of Fry's investment is:

Mar. 1	Cash	90,000	
	Fry, Capital		60,000
	Kaga, Capital ($30,000 × 1/2)		15,000
	Opper, Capital ($30,000 × 1/2)		15,000
	To admit Fry as a partner.		

Fry's capital account got credited for her 1/4 interest in the partnership. The *bonus* was allocated to Kaga and Opper based on their profit-and-loss ratio.

The new partnership's balance sheet reports these amounts:

Cash ($40,000 + $90,000).	$130,000	Total liabilities	$100,000
Other assets	210,000	Kaga, capital ($70,000 + $15,000)	85,000
		Opper, capital ($80,000 + $15,000)	95,000
		Fry, capital	60,000
Total assets	$340,000	Total liabilities and capital	$340,000

Admission by Investing in the Partnership—Bonus to the New Partner

A new partner may be so important that the old partners offer a partnership share that includes a bonus to the new person. For example, it's common in big-league cities for a restaurant owner to go into partnership with a sports star.

Suppose Page and Franco have a restaurant. Their partnership balance sheet follows.

Cash	$140,000	Total liabilities	$120,000
Other assets	360,000	Page, capital	230,000
		Franco, capital	150,000
Total assets	$500,000	Total liabilities and capital	$500,000

Page and Franco admit Tiger Jones, a famous golfer, as a partner with a 1/3 interest in exchange for Jones's cash investment of $100,000. Page and Franco share profits and losses in the ratio of 2/3 to Page and 1/3 to Franco. The computation of Jones's equity in the new partnership is:

Partnership capital before Jones is admitted ($230,000 + $150,000)	$380,000
Jones's investment in the partnership	100,000
Partnership capital after Jones is admitted	$480,000
Jones's capital in the partnership ($480,000 × 1/3)	$160,000
Bonus to the new partner ($160,000 − $100,000)	$ 60,000

What they're thinking:
We need Jones. He'll attract lots of customers.
What they say to Jones:
We'd like to offer you a deal.
Jones
Franco
Page

In this case, Jones entered the partnership at a price ($100,000) below the book value of his equity ($160,000). The bonus of $60,000 went to Jones from the other partners so their capital accounts are debited for the bonus. The old partners share this decrease in capital as though it were a loss, on the basis of their profit-and-loss ratio. The entry to record Jones's investment is:

Aug. 24	Cash	100,000	
	Page, Capital ($60,000 × 2/3)	40,000	
	Franco, Capital ($60,000 × 1/2)	20,000	
	Jones, Capital		160,000
	To admit T. Jones as a partner.		

The new partnership's balance sheet reports these amounts:

Cash		Total liabilities	$120,000
($140,000 + $100,000)	$240,000	Page, capital	
Other assets	360,000	($230,000 − $40,000)	190,000
		Franco, capital	
		($150,000 − $20,000)	130,000
		Jones, capital	160,000
Total assets	$600,000	Total liabilities and capital	$600,000

Now let's see how to account for the withdrawal of a partner from the firm.

Withdrawal of a Partner

5 Account for a partner's withdrawal from the firm

A partner may leave the business for many reasons, including retirement or a dispute. The withdrawal of a partner dissolves the old partnership. The agreement should specify how to settle up with a withdrawing partner.

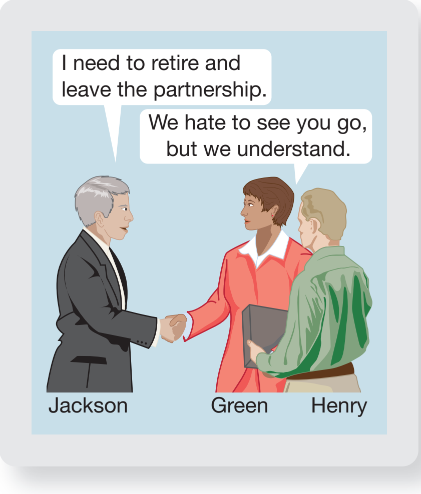
In the simplest case, a partner may sell his or her interest to another party in a personal transaction. This is the same as admitting a new person who purchases an existing partner's interest, as we saw earlier. The journal entry simply debits the withdrawing partner's capital account and credits the new partner's capital. The dollar amount is the old partner's capital balance, as illustrated for Fisher and Holt on page 604.

Often, however, the withdrawal is more complex, as we shall see next.

Revaluation of Assets

The withdrawing partner may receive assets other than cash. Then the question is what value to assign the assets—book value or current market value? The settlement procedure often specifies an independent appraisal to determine current market value because market values may have changed. In that case the partnership must revalue its assets. The partners share any market-value changes in their profit-and-loss ratio.

Suppose Keith Jackson retires from the partnership of Green, Henry, and Jackson.


I need to retire and leave the partnership.
We hate to see you go, but we understand.
Jackson
Green
Henry

Before any asset appraisal, the partnership balance sheet reports the following:

Cash		$ 70,000	Total liabilities	$ 80,000
Inventory		40,000	Green, capital	50,000
Land		50,000	Henry, capital	40,000
Building	$90,000		Jackson, capital	20,000
Less Accum. depr.	(60,000)	30,000	Total liabilities and	
Total assets		$190,000	capital	$190,000

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

The partnership agreement allocates 1/4 of the profits to Green, 1/2 to Henry, and 1/4 to Jackson. (This ratio may be written 1:2:1 for one part to Green, two parts to Henry, and one part to Jackson.) For each share that Green or Jackson has, Henry gets two. The entries to record the revaluation of the inventory and land are:

July 31	Green, Capital ($6,000 × 1/4)	1,500	
	Henry, Capital ($6,000 × 1/2)	3,000	
	Jackson, Capital ($6,000 × 1/4)	1,500	
	Inventory ($40,000 – $34,000)		6,000
	To revalue the inventory.		
31	Land ($100,0000 – $50,000)	50,000	
	Green, Capital ($50,000 × 1/4)		12,500
	Henry, Capital ($50,000 × 1/2)		25,000
	Jackson, Capital ($50,000 × 1/4)		12,500
	To revalue the land.		

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

Cash		$ 70,000	Total liabilities..	$ 80,000
Inventory		34,000	Green, capital ($50,000 − $1,500 + $12,500)......	61,000
Land		100,000	Henry, capital ($40,000 − $3,000 + $25,000)	62,000
Building	$90,000		Jackson, capital ($20,000 − $1,500 + $12,500)...	31,000
Less Accum. depr. ..	(60,000)	30,000		
Total assets		$234,000	Total liabilities and capital	$234,000

The books now carry the assets at market value, which becomes the new book value, and the capital accounts are up-to-date. As the balance sheet shows, Jackson has a claim to $31,000 in partnership assets. Now we can account for Jackson's withdrawal from the business.

Withdrawal at Book Value

If Jackson withdraws by receiving cash for his book value, the entry will be:

July 31	Jackson, Capital	31,000	
	Cash		31,000
	To record withdrawal of Jackson.		

Withdrawal at Less Than Book Value

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

Because Jackson has withdrawn from the partnership, a new agreement—and a new profit-and-loss ratio—is needed. In forming a new partnership, Henry and Green may decide on any ratio they wish. Let's assume they agree that Henry will get 2/3 of the profits and losses and Green 1/3. The entry to record Jackson's withdrawal at less than his book value is:

July 31	Jackson, Capital	31,000	
	Cash		10,000
	Note Payable to K. Jackson		15,000
	Green, Capital ($6,000 × 1/3)		2,000
	Henry, Capital ($6,000 × 2/3)		4,000
	To record withdrawal of Jackson.		

Jackson's account is closed, and Henry and Green may or may not continue the partnership.

Withdrawal at More Than Book Value

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

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

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

Death of a Partner

The death of a partner dissolves a partnership. The accounts are adjusted to measure net income or loss for the period up to the date of death. Then the accounts are closed to determine all partners' capital balances on that date. Settlement with the deceased partner's estate is based on the partnership agreement. There may or may not be an asset revaluation. The estate commonly receives assets equal to the partner's capital balance.

Suppose Susan Green (of the partnership on page 610) dies, and her capital balance is $61,000. Green's estate may request cash for her final share of the business's assets. The partnership's journal entry is:

Aug. 1	Green, Capital	61,000	
	Cash		61,000
	To record withdrawal of Green.		

Alternatively, a remaining partner may purchase the deceased partner's equity. The deceased partner's capital account is debited, and the purchaser's capital is credited. The journal entry to record this transaction follows the pattern given on page 604 for the transfer of Fisher's equity to Holt. The amount of this entry is the ending capital balance of the deceased partner.

Liquidation of a Partnership

6 Account for the liquidation of a partnership

As we've seen, the admission or withdrawal of a partner dissolves the partnership. However, it may continue operating with no apparent change to outsiders. In contrast, **liquidation** shuts down the firm by selling its assets and paying its liabilities.

The final step in liquidation is to *distribute any remaining cash to the owners*. Before a business is liquidated, its books should be adjusted and closed. Liquidation includes three steps:

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

The liquidation of a business can stretch over weeks or months—a year or longer for a big company. To avoid excessive detail in our illustrations, we include only two asset categories—Cash and Noncash Assets—and a single liability—Liabilities. Our examples assume that the business sells the assets in a single transaction and then pays the liabilities at once.

Akers, Bloch, and Crane have shared profits and losses in the ratio of 3:1:1. (This ratio is equal to 3/5, 1/5, 1/5, or 60%, 20%, 20%, respectively.) The partners decide to liquidate. After the books are adjusted and closed, these accounts remain.

Cash	$ 10,000	Liabilities	$ 30,000
Noncash assets	90,000	Akers, capital	40,000
		Bloch, capital	20,000
		Crane, capital	10,000
Total assets	$100,000	Total liabilities and capital	$100,000

Sale of Assets at a Gain

Assume that Akers, Bloch, and Crane sell the noncash assets for $150,000 (book value, $90,000). The partnership realizes a gain of $60,000, allocated to the partners based on their profit-and-loss ratio. The entry to record this sale and allocate the gain is:

Oct. 31	Cash	150,000	
	Noncash Assets		90,000
	Akers, Capital ($60,000 × 0.60)		36,000
	Bloch, Capital ($60,000 × 0.20)		12,000
	Crane, Capital ($60,000 × 0.20)		12,000
	To sell assets.		

Now the partner capital accounts have the balances shown.

Akers, Capital		Bloch, Capital		Crane, Capital	
	40,000		20,000		10,000
	36,000		12,000		12,000
	76,000		32,000		22,000

The partnership then pays off its liabilities:

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

The final liquidation transaction pays all remaining cash to the partners *according to their capital balances.*

The amount of cash left in the partnership is $130,000, as follows:

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

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

Oct. 31	Akers, Capital	76,000	
	Bloch, Capital	32,000	
	Crane, Capital	22,000	
	Cash		130,000
	To pay cash in liquidation.		

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

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

EXHIBIT 12-5 **Partnership Liquidation—Sale of Assets at a Gain**

							Capital				
	Cash	+	Noncash Assets	=	Liabilities	+	Akers (60%)	+	Bloch (20%)	+	Crane (20%)
Balance before sale of assets	$ 10,000		$90,000		$30,000		$40,000		$20,000		$10,000
Sale of assets and sharing of gain	150,000		(90,000)				36,000		12,000		12,000
Balances	160,000		0		30,000		76,000		32,000		22,000
Payment of liabilities	(30,000)				(30,000)						
Balances	130,000		0		0		76,000		32,000		22,000
Payment of cash to partners	(130,000)						(76,000)		(32,000)		(22,000)
Final balances	$ 0		$ 0		$ 0		$ 0		$ 0		$ 0

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

Sale of Assets at a Loss

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

Partnership Financial Statements

7 Prepare partnership financial statements

Partnership financial statements are much like the statements of a proprietorship, but with the following differences:

- A partnership income statement shows the division of net income to the partners. For example, the partnership of Gray & Hayward can report its income statement as shown in Exhibit 12-6. All amounts are assumed.
- A partnership balance sheet reports a separate capital account for each partner, as shown in Exhibit 12-6.

EXHIBIT 12-6 **Financial Statements of a Partnership**

GRAY & HAYWARD
Income Statement
Year Ended December 31, 2008

Revenues	$470,000
Expenses	270,000
Net income	$200,000
Allocation of net income:	
To Gray	$120,000
To Hayward	80,000
Total net income	$200,000

GRAY & HAYWARD
Balance Sheet
December 31, 2008

Assets		
Cash and other assets		$800,000
Liabilities		
Accounts payable and other liabilities		$300,000
Owners' Equity		
Gray, capital		400,000
Hayward, capital		100,000
Total capital		500,000
Total liabilities and owners' equity		$800,000

Now turn to the Decision Guidelines for a summary of the accounting for partnerships.

Decision Guidelines

Accounting for Partnerships

Suppose you have a friend who's a biology major. He has achieved amazing success growing plants hydroponically (in water). He knows plants but has no sense for business, so the two of you form a partnership to take advantage of your respective skills. How do you organize? What decisions must you make? Consider these decision guidelines.

Decision	Guidelines
How to organize the business?	A partnership offers both advantages and disadvantages in comparison with proprietorships and corporations. (Exhibit 12-2, page 598)
On what matters should the partners agree?	See "The Written Agreement" on page 596.
At what value does the partnership record assets and liabilities?	Current market value on the date of acquisition, because the partnership is buying its assets at their current market value.
How are partnership profits and losses shared among the partners?	• Equally if there is no profit-and-loss-sharing agreement. • As provided in the partnership agreement. Can be based on the partners' a. Stated fractions b. Capital contributions c. Service to the partnership d. Any combination of the above.
What happens when a partner withdraws from the firm?	The old partnership dissolves. The remaining partners may or may not form a new partnership.
How are new partners admitted to the partnership?	• *Purchase a partners inte rest*. The old partnership is dissolved. The remaining partners may admit the new partner to the partnership. If not, the new partner gets no voice in management but shares in the profits and losses. Close the withdrawing partner's Capital account, and open a Capital account for the new partner. Carry over the old partner's Capital balance to the Capital account of the new partner. • *Invest in the partnership*. Buying in at book value creates no bonus to any partner. Buying in at a price above book value creates a bonus to the old partners. Buying in at a price below book value creates a bonus for the new partner.
How to account for the withdrawal of a partner from the business?	• First, adjust and close the books up to the date of the partner's withdrawal from the business. • Second, appraise the assets and liabilities at current market value. • Third, account for the partner's withdrawal. a. At book value (no change in remaining partners' Capital balances) b. At less than book value (increase the remaining partners' Capital balances) c. At more than book value (decrease the remaining partners' Capital balances)

continued . . .

Decision	Guidelines
What happens if the partnership goes out of business?	Liquidate the partnership, as follows: a. Adjust and close the books up to the date of liquidation. b. Sell the partnership's assets. Allocate gain or loss to the partners based on their profit-and-loss ratio. c. Pay the partnership liabilities. d. Pay any remaining cash to the partners based on their Capital balances.

Summary Problem

The partnership of Uno & Dos admits Tres as a partner on January 1, 2008. The partnership has these balances on that date:

Cash	$ 9,000	Total liablilities	$ 50,000
Other assets	110,000	Uno, capital	45,000
		Dos, capital	24,000
Total assets	$119,000	Total liabilities and capital	$119,000

Uno's share of profits and losses is 60%, and Dos gets 40%.

Requirements (Items 1 and 2 are independent)

1. Suppose Tres pays Dos $30,000 to buy out Dos. Uno approves Tres as a partner.
   a. Record the transfer of equity on the partnership books.
   b. Prepare the partnership balance sheet immediately after Tres is admitted as a partner.

2. Suppose Tres becomes a partner by investing $31,000 cash to acquire a one-fourth interest in the business.
   a. Compute Tres's capital balance, and determine whether there's any bonus. If so, who gets the bonus?
   b. Record Tres's investment in the business.
   c. Prepare the partnership balance sheet immediately after Tres is admitted as a partner. Include the heading.

Solution

Requirement 1

a.

Jan. 1	Dos, Capital	24,000	
	Tres, Capital		24,000
	To transfer Dos's equity to Tres.		

b. The balance sheet for the partnership of Uno and Tres is identical to the balance sheet given for Uno and Dos in the problem, except that Tres replaces Dos in the title and in the listing of Capital accounts.

Requirement 2

a. Computation of Tres's capital balance.

Partnership capital before Tres is admitted ($45,000 + $24,000)	$ 69,000
Tres's investment in the partnership	31,000
Partnership capital after Tres is admitted	$100,000
Tres's capital in the partnership ($100,000 × 1/4)	$ 25,000
Bonus to the old partners ($31,000 − $25,000)	$ 6,000

continued . . .

b. Journal entry to record Tres's investment:

Jan. 1	Cash	31,000	
	Tres, Capital		25,000
	Uno, Capital ($6,000 × 0.60)		3,600
	Dos, Capital ($60,000 × 0.40)		2,400
	To admit Tres as a partner.		

c. New partnership balance sheet:

UNO, DOS, & TRES
Balance Sheet
January 1, 2008

Cash ($9,000 + $31,000)	$ 40,000	Total liabilities	$ 50,000
Other assets	110,000	Uno, capital	
		($45,000 + $3,600)	48,600
		Dos, capital	
		($24,000 + $2,400)	26,400
		Tres, capital	25,000
Total assets	$150,000	Total liabilities and capital	$150,000

Review *Partnerships*

Accounting Vocabulary

Articles of Partnership
The contract between partners that specifies such items as the name, location, and nature of the business; the name, capital investment, and duties of each partner; and the method of sharing profits and losses among the partners. Also called **partnership agreement**.

Dissolution
Ending of a partnership.

General Partnership
A form of partnership in which each partner is an owner of the business with all the privileges and risks of ownership.

Limited Liability Partnership
A form of partnership in which each partner's personal liability for the business's debts is limited to a certain amount. Also called **LLPs**.

Limited Partnership
A partnership with at least two classes of partners: a general partner and limited partners.

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

LLPs
A form of partnership in which each partner's personal liability for the business's debts is limited to a certain amount. Also called **limited liability partnership**.

Mutual Agency
Every partner can bind the business to a contract within the scope of the partnership's regular business operations.

Partnership
An association of two or more persons who co-own a business for profit.

Partnership Agreement
The contract between partners that specifies such items as the name, location, and nature of the business; the name, capital investment, and duties of each partner; and the method of sharing profits and losses among the partners. Also called **articles of partnership**.

S Corporation
A corporation taxed in the same way as a partnership.

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

Quick Check

1. How does a partnership get started?

a. The partners reach an agreement and begin operations.
b. The partners get a charter from the state.
c. The partners register under the Uniform Partnership Act.
d. All of the above.

2. Which characteristic identifies a partnership?

a. Unlimited life
b. No business income tax
c. Limited personal liability
d. All of the above

3. An S corporation is taxed like a

a. Corporation
b. Partnership
c. Either a or b, depending on the stockholders' decision
d. None of the above

4. The partnership of Abbot and Brown splits profits 2/3 to Abbot and 1/3 to Brown. There is no provision for losses. The partnership has a net loss of $150,000. What is Brown's share of the loss?

a. $150,000
b. $100,000
c. $50,000
d. Cannot be determined because the loss-sharing ratio is not given.

5. Partner drawings

a. Increase partnership liabilities
b. Decrease partnership net income
c. Increase partnership capital
d. Decrease partnership capital

6. Malcolm pays $50,000 to Lloyd to acquire Lloyd's $25,000 interest in a partnership. The journal entry to record this transaction is

a.	Lloyd, Capital............	75,000	
	Malcolm, Capital....		75,000
b.	Lloyd, Capital............	50,000	
	Malcolm, Capital....		50,000
c.	Lloyd, Capital............	25,000	
	Malcolm, Capital....		25,000
d.	Malcolm, Capital........	25,000	
	Lloyd, Capital.........		25,000

7. Clark and Douglas admit Evans to their partnership, with Evans paying $50,000 more than the book value of her equity in the new business. Clark and Douglas have no formal profit-and-loss agreement. What effect does admitting Evans to the partnership have on the capital balances of Clark and Douglas?

a. Cannot be determined because there's no profit-and-loss ratio

b. Credit the Clark and Douglas capital accounts for $25,000 each

c. Credit the Clark and Douglas capital accounts for $50,000 each

d. Debit the Clark and Douglas capital accounts for $25,000 each

8. Tate retires from the partnership of Roberts, Smith, and Tate. The partners share profits and losses in the ratio of 4:3:3. Tate's capital balance is $40,000, and he receives $47,000 in final settlement. What is the effect on the capital accounts of Roberts and Smith?

a. Smith's capital decreases by $7,000.

b. Roberts' capital decreases by $7,000.

c. Roberts' capital increases by $4,000.

d. Roberts' capital decreases by $4,000.

9. The book value of the assets of the KLM partnership is $100,000. In liquidation, the partnership sells the assets for $130,000. How should the partnership account for the sale of the assets?

a. Credit the assets for $100,000

b. Debit cash for $130,000

c. Increase the partners' capital accounts

d. All of the above

10. Partnership financial statements report

a. Revenues on the income statement

b. Liabilities on the income statement

c. Net income on the balance sheet

d. Expenses on the balance sheet

Answers are given after Apply Your Knowledge (p. 635).

Assess Your Progress

Short Exercises

Partnership characteristics
1

S12-1 Study the characteristics of a partnership. Then, in your own words, write two short paragraphs, as follows:

1. Explain the *advantages* of a partnership over a proprietorship and a corporation. (pp. 597–598)
2. Explain the *disadvantages* of a partnership compared to a proprietorship and a corporation. (pp. 597–598)

A partner's investment in a partnership
2

S12-2 Marty Stubbs invests land in a partnership with Lee Dix. Stubbs purchased the land in 2007 for $200,000. A real estate appraiser now values the land at $500,000. Stubbs wants $400,000 capital in the new partnership, but Dix objects. Dix believes that Stubbs' capital investment should be measured by the book value of his land.

Dix and Stubbs seek your advice. Which value of the land is appropriate for measuring Stubbs' capital—book value or current market value? State the reason for your answer. Give the partnership's journal entry to record Stubbs' investment in the business. (pp. 600–601)

Investments by partners
2

S12-3 Joe Brown and Chris White are forming a partnership to develop a theme park near Panama City, Florida. Brown invests cash of $1 million and land valued at $10 million. When Brown purchased the land in 2007, its cost was $8 million. The partnership will assume Brown's $3 million note payable on the land. White invests cash of $3 million and equipment worth $7 million.

1. Journalize the partnership's receipt of assets and liabilities from Brown and from White. (p. 601)
2. Compute the partnership's total assets, total liabilities, and total owners' equity immediately after organizing. (p. 602)

Partners' profits, losses, and capital balances
3

S12-4 Abel and Baker had beginning capital balances of $20,000 and 16,000, respectively. The two partners fail to agree on a profit-and-loss ratio. For the first month (June 2008), the partnership lost $8,000.

1. How much of this loss goes to Abel? How much goes to Baker? (p. 602)
2. The partners withdrew no assets during June. What is each partner's capital balance at June 30? Prepare a T-account for each partner's capital. (p. 602)

Dividing partnership profits based on capital contributions and service
3

S12-5 Lee, Muse, and Nall have capital balances of $20,000, $30,000, and $50,000, respectively. The partners share profits and losses as follows:

a. The first $40,000 is divided based on the partners' capital balances. (pp. 602–603)

b. The next $40,000 is based on service, shared equally by Lee and Nall.

c. The remainder is divided equally. (pp. 602–603)

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

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

S12-6 Ann Todd has a capital balance of $30,000; Vic Carlson's balance is $25,000. Claire Reynaldo pays $100,000 to purchase Carlson's interest in the Todd & Carlson partnership. Carlson gets the full $100,000.

1. Journalize the partnership's transaction to admit Reynaldo to the partnership. (pp. 604–605)
2. Must Todd accept Reynaldo as a full partner? What right does Reynaldo have after purchasing Carlson's interest in the partnership? (pp. 604–605)

Admitting a partner who invests in the business
4

S12-7 The partnership of Ecru and Falcon has these capital balances:

- Ecru $60,000
- Falcon $80,000

Joan Gray invests cash of $70,000 to acquire a 1/3 interest in the partnership.

1. Does Gray's investment in the firm provide a bonus to the partners? Show your work. (pp. 605–606)
2. Journalize the partnership's receipt of the $70,000 from Gray. (pp. 605–606)

Admitting a new partner; bonus situation
4

S12-8 Bo and Go have partner capital balances of $250,000 and $150,000, respectively. Bo gets 60% of profits and losses, and Go gets 40%. Assume Mo invests $100,000 to acquire a 25% interest in the new partnership of Bogomo.

1. Is there a bonus? If so, who gets it?
2. Journalize the partnership's receipt of cash from Mo. (pp. 605–606)

Withdrawal of a partner
5

S12-9 Adam, Eve, and Cain each have a $100,000 capital balance. They share profits and losses as follows: 25% to Adam, 50% to Eve, and 25% to Cain. Suppose Cain is withdrawing from the business, and the partners agree that no appraisal of assets is needed. How much in assets can Cain take from the partnership? Give the reason for your answer. What role does the profit-and-loss ratio play in this situation? (pp. 610–611)

Withdrawal of a partner; asset revaluation
5

S12-10 Abraham, Isaac, and Jacob each have a $50,000 capital balance. Abraham is very old and is retiring from the business. The partners agree to revalue the assets at current market value. A real-estate appraiser values the land at $140,000 (book value is $100,000). The profit-and-loss ratio is 1:2:1. Journalize (a) the revaluation of the land on July 31 and (b) payment of $60,000 to Abraham upon his retirement the same day. (pp. 608–611)

Liquidation of a partnership at a loss
6

S12-11 Use the data in Exhibit 12-5, page 613. Suppose the partnership of Akers, Bloch, and Crane liquidates by selling all noncash assets for $80,000. Complete the liquidation schedule as shown in Exhibit 12-5. (p. 613)

Liquidation of a partnership
6

S12-12 This exercise builds on the solution to Short Exercise 12-11. After completing the liquidation schedule in Short Exercise 12-11, journalize the partnership's (a) sale of noncash assets for $80,000 (use a single account for Noncash Assets), (b) payment of liabilities, and (c) payment of cash to the partners. Include an explanation with each entry. (pp. 613–614)

S12-13 The partnership of Bush and Carter had these balances at September 30, 2007:

Cash	$20,000	Service revenue	$145,000
Liabilities	40,000	Bush, capital	30,000
Carter, capital	10,000	Total expenses	85,000
Other assets	60,000		

Partnership income statement
7

Bush gets 60% of profits and losses, and Carter 40%. Prepare the partnership's income statement for the year ended September 30, 2007. (pp. 613–614)

Exercises

Organizing a partnership

1

E12-14 Monique Coty, a friend from college, asks you to form a partnership to import fragrances. Since graduating, Coty has worked for the French Embassy, developing important contacts among government officials. Coty believes she is in a unique position to capitalize on an important market. With expertise in accounting, you would have responsibility for the partnership's accounting and finance.

Requirements

Discuss the advantages and disadvantages of organizing the business as a partnership rather than a proprietorship. Comment on how partnership income is taxed and how your taxes would change if you organized as a limited-liability company (LLC) or an S corporation. (pp. 597–599)

Recording a partner's investment

2

E12-15 Nan Fuentes has been operating an apartment-locator service as a proprietorship. She and Misti Fulmer have decided to form a partnership. Fuentes's investment consists of cash, $8,000; accounts receivable, $10,000; furniture, $1,000; a building, $55,000; and a note payable, $10,000.

To determine Funtes's equity in the partnership, she and Fulmer hire an independent appraiser. The appraiser values all the assets and liabilities at their book value except the building, which has a current market value of $90,000. Also there are accounts payable of $3,000.

Requirement

Make the entry on the partnership books to record Fuentes's investment. (pp. 600–601)

Computing partners' shares of net income and net loss

3

E12-16 Bob Fultz and Jack Hardie form a partnership, investing $40,000 and $80,000, respectively. Determine their shares of net income or net loss for each of the following situations:

a. Net loss is $90,000 and the partners have no written partnership agreement. (p. 602)

b. Net income is $60,000, and the partnership agreement states that the partners share profits and losses on the basis of their capital balances. (pp. 602–603)

c. Net income is $100,000. The first $60,000 is shared on the basis of partner capital balances. The next $30,000 is based on partner service, with Fultz getting 40% and Hardie 60%. The remainder is shared equally. (pp. 602–603)

Computing partners' capital balances

3

E12-17 Bob Fultz and Jack Hardie each withdrew cash of $40,000 for personal use during the year. Using the data from situation (c) in Exercise 12-16, journalize the entries to close (1) net income to the partners and (2) the partners' drawing accounts. Explanations are not required. What was the overall effect of these events on partnership capital? (pp. 602–603)

Admitting a new partner
4

E12-18 Heather Hollis is admitted to the partnership of Rose & Novak. Prior to her admission, the partnership books show Ginny Rose's capital balance at $100,000 and Chris Novak's at $50,000. Compute each partner's equity on the books of the new partnership under the following plans:

a. Hollis pays $70,000 for Novak's equity. Hollis pays Novak directly. (pp. 603–605)

b. Hollis invests $50,000 to acquire a 1/4 interest in the partnership. (pp. 605–606)

c. Hollis invests $90,000 to acquire a 1/4 interest in the partnership. (pp. 605–606)

Admitting a new partner
4

E12-19 Make the partnership journal entry to record the admission of Hollis under plans (a), (b), and (c) in Exercise 12-18. Explanations are not required. (pp. 603–606)

Withdrawal of a partner
5

E12-20 The O'Brien and Pope partnership balance sheet reports capital of $60,000 for O'Brien and $90,000 for Pope. O'Brien is withdrawing from the firm. The partners agree to write partnership assets up by $30,000. They have shared profits and losses in the ratio of 1/3 to O'Brien and 2/3 to Pope. The partnership agreement states that a withdrawing partner will receive assets equal to the book value of his owner's equity.

1. How much will O'Brien receive? (pp. 609–610)

2. Pope will continue to operate the business as a proprietorship. What is Pope's beginning capital on the books of his new proprietorship? (pp. 609–610)

Withdrawal of a partner
5

E12-21 On May 31, Sam retires from the partnership of Sam, Bob, and Tim. The partner capital balances are Sam, $36,000; Bob, $51,000; and Tim, $22,000. The partners have the assets revalued to current market values. The appraiser reports that the value of the inventory should be decreased by $12,000, and the land should be increased by $32,000. The profit-and-loss ratio has been 4:3:3 for Sam, Bob, and Tim, respectively. In retiring from the firm, Sam receives $60,000 cash.

Requirement

Journalize (a) the asset revaluations and (b) Sam's withdrawal from the firm. (pp. 608–611)

Liquidation of a partnership
6

E12-22 Ray, Scott, and Van are liquidating their partnership. Before selling the assets and paying the liabilities, the capital balances are Ray $33,000; Scott, $28,000; and Van, $19,000. The partnership agreement specifies no division of profits and losses.

Requirements

1. After selling the assets and paying the liabilities, the partnership has cash of $80,000. How much cash will each partner receive in final liquidation? (pp. 612–613)

2. After selling the assets and paying the liabilities, the partnership has cash of $50,000. How much cash will each partner receive in final liquidation? (pp. 612–614)

Liquidation of a partnership
6

E12-23 Prior to liquidation, the accounting records of Boyd, Carl, and Dove included the following balances and profit-and-loss percentages:

						Capital				
	Cash	+	Noncash Assets	=	Liabilities	+	Boyd (40%)	+	Carl (30%)	+	Dove (30%)
Balances before sale of assets.........	$9,000		$57,000		$20,000		$20,000		$15,000		$11,000

The partnership sold the noncash assets for $77,000, paid the liabilities, and gave the remaining cash to the partners. Complete the summary of transactions in the liquidation of the partnership. Use the format illustrated in Exhibit 12-5, page 613.

Liquidation of a partnership
6

E12-24 The partnership of Dodd, Gage, and Hamm is liquidating. Business assets, liabilities, and partners' capital balances prior to liquidation follow. The partners share profits and losses as follows: Dodd, 20%; Gage, 30%; and Hamm, 50%.

DODD, GAGE, & HAMM
Sale of Noncash Assets
(for $140,000)

	Cash	Noncash Assets	Liabilities	Dodd Capital	Gage Capital	Hamm Capital
	$ 6,000	$126,000	$77,000	$12,000	$37,000	$6,000
	140,000	(126,000)		?	?	?
	$146,000	$ 0	$77,000	$?	$?	$?

Requirement

Create a spreadsheet or solve manually—as directed by your instructor—to compute the ending balances in all accounts after the noncash assets are sold for $140,000. (pp. 613–614)

Partnership balance sheet
7

E12-25 On December 31, 2008, Dana Farrell and Lou Flores agree to combine their proprietorships as a partnership. Their balance sheets on December 31 are shown on this and the next page.

Requirement

Prepare the partnership balance sheet at December 31, 2008. (pp. 600–601)

	Farrell's Business		Flores's Business	
	Book Value	Current Market Value	Book Value	Current Market Value
Assets				
Cash...	$ 10,000	$ 10,000	$ 4,000	$ 4,000
Accounts receivable..................	22,000	20,000	8,000	6,000
Inventory	51,000	45,000	35,000	35,000
Plant assets (net)	121,000	103,000	53,000	57,000
Total assets................................	$204,000	$178,000	$100,000	$102,000

continued . . .

	Farrell's Business		Flores's Business	
	Book Value	Current Market Value	Book Value	Current Market Value
Liabilities and Capital				
Accounts payable	$ 25,000	$ 25,000	$ 10,000	$ 10,000
Accrued expenses payable	9,000	9,000		
Notes payable	56,000	56,000		
Farrell, capital	114,000	?		
Flores, capital			90,000	?
Total liabilities and capital	$204,000	$178,000	$100,000	$102,000

Problems (Group A)

Writing a partnership agreement
1

P12-26A Gina Romero and Carlo Ponti are forming a partnership, Italian Leather Goods, to import from Italy. Romero is especially artistic and will travel to Italy to buy the merchandise. Ponti is a super salesman and has already lined up several department stores to sell the leather goods.

Requirement

Write a partnership agreement to cover all elements essential for the business to operate smoothly. Make up names, amounts, profit-and-loss percentages, and so on as needed. (pp. 596–598)

Investments by partners
2 7

P12-27A Nicole LeBlanc and Keith Rollins formed a partnership on March 15. The partners agreed to invest equal amounts of capital. LeBlanc invested her proprietorship's assets and liabilities (credit balances in parentheses). See the table that follows.

	LeBlanc's Book Values	Current Market Values
Accounts receivable	$12,000	$10,000
Inventory	43,000	31,000
Prepaid expenses	3,700	3,000
Store equipment	36,000	26,000
Accounts payable	(20,000)	(20,000)

On March 15, Rollins invested cash in an amount equal to the current market value of LeBlanc's partnership capital. The partners decided that LeBlanc will earn 70% of partnership profits because she will manage the business. Rollins agreed to accept 30% of the profits. During the period ended December 31, the partnership earned net income of $70,000. LeBlanc's drawings were $41,000, and Rollins's drawings totaled $27,000.

continued . . .

Requirements

1. Journalize the partners' initial investments. (pp. 600–601)
2. Prepare the partnership balance sheet immediately after its formation on March 15. (p. 601)

Admitting a new partner
4

P12-28A Hasselback, Krooch & Kinney, a partnership, is considering admitting Ken Rosenzweig as a new partner. On July 31 of the current year, the capital accounts of the three existing partners and their shares of profits and losses are as follows:

	Capital	Profit-and-Loss %
Hasselback	$40,000	20
Krooch	60,000	25
Kinney...................	80,000	55

Requirements

Journalize the admission of Rosenzweig as a partner on July 31 for each of the following independent situations:

1. Rosenzweig pays Kinney $110,000 cash to purchase Kinney's interest. (pp. 603–605)
2. Rosenzweig invests $60,000 in the partnership, acquiring a 1/4 interest in the business. (pp. 605–606)
3. Rosenzweig invests $60,000 in the partnership, acquiring a 1/6 interest in the business. (pp. 605–606)

Computing partners' shares of net income and net loss; preparing the partnership income statement
3 7

P12-29A Evans, Furr, and Good formed the EF&G partnership. Evans invested $20,000; Furr, $40,000; and Good, $60,000. Evans will manage the store; Furr will work in the store three-quarters of the time; and Good will not work.

Requirements

1. Compute the partners' shares of profits and losses under each of the following plans:
   a. Net loss is $40,000, and the partnership agreement allocates 45% of profits to Evans, 35% to Furr, and 20% to Good. The agreement does not discuss the sharing of losses. (pp. 601–602)
   b. Net income for the year ended September 30, 2009, is $90,000. The first $30,000 is allocated on the basis of partner capital balances. The next $30,000 is based on service, with $20,000 going to Evans and $10,000 going to Furr. Any remainder is shared equally. (pp. 602–603)
2. Revenues for the year ended September 30, 2009, were $190,000, and expenses were $100,000. Under plan (b) above, prepare the partnership income statement for the year. (p. 614)

Withdrawal of a partner
4 5

P12-30A Ho-Kim-Li Oriental Design is a partnership owned by three individuals. The partners share profits and losses in the ratio of 30% to Ho, 40% to Kim, and 30% to Li. At December 31, 2008, the firm has this balance sheet:

Cash		$ 13,000	Total liabilities	$105,000
Accounts receivable	$16,000			
Less allowance for				
uncollectibles	(1,000)	15,000		
Inventory		92,000		
Equipment	130,000		Ho, capital	30,000
Less accumulated			Kim, capital	45,000
depreciation	(30,000)	100,000	Li, capital	40,000
Total assets		$220,000	Total liabilities and capital	$220,000

Ho withdraws from the partnership on this date.

Requirements

Record Ho's withdrawal from the partnership under the following plans:

1. In a personal transaction, Ho sells her equity to Win, who pays Ho $75,000 for her interest. Kim and Li agree to accept Win as a partner. (pp. 608–610)
2. The partnership pays Ho cash of $10,000 and gives her a note payable for the remainder of her book equity in settlement of her partnership interest. (pp. 608–611)
3. The partnership pays Ho $44,000 for her book equity. (p. 611)
4. The partners agree that the equipment is worth $160,000 and that accumulated depreciation should remain at $30,000. After the revaluation, the partnership settles with Ho by giving her cash of $5,000 and inventory for the remainder of her book equity. (pp. 608–610)

Liquidation of a partnership
6

P12-31A The partnership of King, Queen, & Page has experienced operating losses for three consecutive years. The partners—who have shared profits and losses in the ratio of King, 15%; Queen, 60%; and Page, 25%—are liquidating the business. They ask you to analyze the effects of liquidation. They present the following condensed partnership balance sheet at December 31, end of the current year:

Cash	$ 7,000	Liabilities	$ 63,000
Noncash assets	163,000	King, capital	24,000
		Queen, capital	66,000
		Page, capital	17,000
Total assets	$170,000	Total liabilities and capital	$170,000

Requirements

1. Prepare a summary of liquidation transactions (as illustrated in Exhibit 12-5). The noncash assets are sold for $103,000. (p. 613)
2. Journalize the liquidation transactions. (pp. 613–614)

Capital amounts for the balance sheet of a partnership
7

P12-32A ABACUS is a partnership owned by Allen, Bacon, and Cush, who share profits and losses in the ratio of 1:3:4. The account balances of the partnership at June 30 follow.

ABACUS
Adjusted Trial Balance
June 30, 2009

Account Title	Debit	Credit
Cash	$ 20,000	
Noncash assets	110,000	
Liabilities		$ 30,000
Allen, capital		20,000
Bacon, capital		40,000
Cush, capital		50,000
Allen, drawing	10,000	
Bacon, drawing	30,000	
Cush, drawing	50,000	
Revenues		160,000
Expenses	80,000	
Totals	$300,000	$300,000

Requirements

1. Prepare the June 30 entries to close the revenue, expense, income summary, and drawing accounts. (pp. 205, 602, 603)
2. Insert the opening capital balances in the partners' capital accounts, post the closing entries to their accounts, and determine each partner's ending capital. (p. 602)

Problems (Group B)

Writing a partnership agreement
1

P12-33B Dave Clinton and Andi Groff are forming a partnership, Compass Web Designs, to create Web sites for clients. Clinton can create designs that draw large sales volumes. Groff is a super salesperson and has already lined up several clients.

Requirement

Write a partnership agreement to cover all elements essential for Compass Web Designs to operate smoothly. Make up names, amounts, profit-and-loss percentages, and so on as needed. (pp. 596–598)

Investments by partners
2 7

P12-34B On June 30, Allie Hayes and Mandy McKay formed a partnership. The women agree to invest equal amounts of capital. Hayes invests her proprietorship's assets and liabilities (credit balances in parentheses), as follows:

continued . . .

	Hayes's Book Values	Current Market Values
Accounts receivable	$ 7,200	$ 7,000
Inventory	22,000	24,000
Prepaid expenses	1,700	1,000
Office equipment	45,000	27,000
Accounts payable	(19,000)	(19,000)

On June 30, McKay invests cash in an amount equal to the current market value of Hayes' partnership capital. The partners decide that Hayes will earn two-thirds of partnership profits because she will manage the business. McKay agrees to accept one-third of the profits. During the remainder of the year, the partnership earns net income of $90,000. Hayes' drawings are $39,000, and McKay's drawings are $31,000.

Requirements

1. Journalize the partners' initial investments. (pp. 600–601)
2. Prepare the partnership balance sheet immediately after its formation on June 30. (p. 601)

Admitting a new partner
4

P12-35B Pike, Quinn, and Reed are considering adding Shipp as a new partner. On March 31 of the current year, the capital accounts of the three existing partners and their shares of profits and losses are as follows:

	Capital	Profit-and-Loss %
Pike	$ 50,000	20%
Quinn	100,000	30%
Reed	150,000	50%

Requirements

Journalize the admission of Shipp as a partner on March 31 for each of the following independent situations:

1. Shipp pays Reed $200,000 cash to purchase Reed's interest in the partnership. (pp. 603–605)
2. Shipp invests $100,000 in the partnership, acquiring a one-fourth interest in the business. (pp. 605–606)
3. Shipp invests $80,000 in the partnership, acquiring a one-fourth interest in the business. (pp. 607–608)

Computing partners' shares of net income and net loss; preparing the partnership income statement
3 7

P12-36B Beau, Cole, and Drake formed a partnership. Beau invested $15,000, Cole $20,000, and Drake $25,000. Beau will manage the store; Cole will work in the store half-time; and Drake will not work in the business.

Requirements

1. Compute the partners' shares of profits and losses under each of the following plans:
   a. Net loss is $50,000, and the partnership agreement allocates 40% of profits to Beau, 25% to Cole, and 35% to Drake. The agreement does not specify the sharing of losses. (pp. 601–602)

continued . . .

b. Net income for the year ended January 31, 2009, is $177,000. The first $75,000 is allocated based on partner capital balances, and the next $36,000 is based on service, with Beau receiving $28,000 and Cole receiving $8,000. Any remainder is shared equally. (pp. 602–603)

2. Revenues for the year ended January 31, 2009, were $507,000, and expenses were $330,000. Under plan (b) above, prepare the partnership income statement for the year. (p. 614)

Withdrawal of a partner

4 5

P12-37B El Paso Physicians is a partnership of three doctors. The partners share profits and losses in the ratio of 20% to Juan Hernandez, 40% to Rosa Garcia, and 40% to Eva Cahill. At December 31, 2008, the firm has the following balance sheet:

Cash		$ 12,000	Total liabilities	$ 75,000
Accounts receivable	$22,000			
Less allowance for				
uncollectibles	(4,000)	18,000		
Building	$310,000		Hernandez, capital	83,000
Less accumulated			Garcia, capital	50,000
depreciation	(70,000)	240,000	Cahill, capital	62,000
Total assets		$270,000	Total liabilities and capital	$270,000

Garcia withdraws from the partnership on December 31, 2008, to establish her own medical practice.

Requirements

Record Garcia's withdrawal from the partnership under the following plans:

1. In a personal transaction, Garcia sells her equity to Maria Martinez, who pays Garcia $100,000 for her interest. Hernandez and Cahill accept Martinez as a partner. (pp. 608–610)
2. The partnership pays Garcia cash of $20,000 and gives her a note payable for the remainder of her book equity in settlement of her partnership interest. (pp. 608–611)
3. The partnership pays Garcia cash of $80,000. (pp. 610–611)
4. The partners agree that the building is worth only $250,000 and that its accumulated depreciation should remain at $70,000. After the revaluation, the partnership settles with Garcia by giving her cash of $10,000 and a note payable for the remainder of her book equity. (pp. 608–611)

Liquidation of a partnership

6

P12-38B The partnership of Donald, Healey & Jaguar has experienced operating losses. The partners—who have shared profits and losses in the ratio of Donald, 10%; Healey, 30%; and Jaguar, 60%—are liquidating the business. They ask you to analyze the effects of liquidation and present the following partnership balance sheet at December 31, end of the current year:

continued . . .

Cash	$ 27,000	Liabilities	$131,000
Noncash assets	202,000	Donald, capital	21,000
		Healey, capital	39,000
		Jaguar, capital	38,000
Total assets	$229,000	Total liabilities and capital	$229,000

Requirements

1. Prepare a summary of liquidation transactions (as illustrated in Exhibit 12-5). The noncash assets are sold for $192,000. (p. 613)
2. Journalize the liquidation transactions. (pp. 613–614)

Capital amounts for the balance sheet of a partnership

7

P12-39B LM&N is a partnership owned by Lee, Mah, and Nguyen, who share profits and losses in the ratio of 5:3:2. The account balances of the partnership at September 30 follow.

LM&N
Adjusted Trial Balance
September 30, 2008

Account Title	Debit	Credit
Cash	$ 10,000	
Noncash assets	177,000	
Liabilities		$ 65,000
Lee, capital		57,000
Mah, capital		44,000
Nguyen, capital		21,000
Lee, drawing	45,000	
Mah, drawing	35,000	
Nguyen, drawing	20,000	
Revenues		281,000
Expenses	181,000	
Totals	$468,000	$468,000

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Requirements

1. Prepare the September 30 entries to close the revenue, expense, income summary, and drawing accounts. (pp. 205, 602, 603)
2. Insert the opening capital balances in the partners' capital accounts, post the closing entries to their accounts, and determine each partner's ending capital. (p. 602)

Apply Your Knowledge

Decision Cases

Partnership issues
1 5

Case 1. The following questions relate to issues faced by partnerships.

1. The text states that a written partnership agreement should be drawn up between the partners. One benefit of an agreement is that it provides a mechanism for resolving disputes between the partners. List five areas of dispute that might be resolved by a partnership agreement.
2. The statement has been made that "if you must take on a partner, make sure the partner is richer than you are." Why is this statement valid?
3. Loomis & Nelson is a law partnership. Don Loomis is planning to retire from the partnership and move to Canada. What options are available to Loomis to enable him to convert his share of the partnership assets to cash?

Settling disagreements among partners
3

Case 2. Jana Bell invested $20,000 and Matt Fischer $10,000 in a public relations firm that has operated for 10 years. Bell and Fischer have shared profits and losses in the 2:1 ratio of their investments in the business. Bell manages the office, supervises employees, and does the accounting. Fischer, the moderator of a television talk show, is responsible for marketing. His high profile generates important revenue for the business. During the year ended December 2006, the partnership earned net income of $220,000, shared in the 2:1 ratio. On December 31, 2006, Bell's capital balance was $150,000, and Fischer's capital balance was $100,000. (Bell drew more cash out of the business than Fischer.)

Requirements

Respond to each of the following situations.

1. During January 2007, Bell learned that revenues of $60,000 were omitted from the reported 2006 income. She brings this omission to Fischer's attention, pointing out that Bell's share of this added income is two-thirds, or $40,000, and Fischer's share is one-third, or $20,000. Fischer believes they should share this added income on the basis of their capital balances—60%, or $36,000, to Bell and 40%, or $24,000, to himself. Which partner is correct? Why?
2. Assume that the 2006 omission of $60,000 was an account payable for an operating expense. On what basis would the partners share this amount?

Ethical Issue

Hart Nance and Jason Symington operate gift boutiques in shopping malls. The partners split profits and losses equally, and each takes an annual drawing of $80,000. To even out the workload, Nance travels around the country inspecting their properties. Symington manages the business and serves as the accountant. From time to time, they use small amounts of store merchandise for personal use. In preparing for his daughter's wedding, Symington took inventory that cost $10,000. He recorded the transaction as follows:

		Cost of Goods Sold	10,000	
		Inventory		10,000

1. How should Symington have recorded this transaction?

2. Discuss the ethical aspects of Symington's action.

Team Project

Visit a business partnership in your area and interview one or more of the partners. Obtain answers to the following questions and ask your instructor for directions. As directed by your instructor, either (a) prepare a written report of your findings or (b) make a presentation to your class.

Requirements

1. Why did you organize the business as a partnership? What advantages does the partnership form of organization offer the business? What are the disadvantages of the partnership form of organization?

2. Is the business a general partnership or a limited partnership?

3. Do the partners have a written partnership agreement? What does the agreement cover? Obtain a copy if possible.

4. Who manages the business? Do all partners participate in day-to-day management, or is management the responsibility of only certain partners?

5. If there is no written agreement, what is the mechanism for making key decisions?

6. Has the business ever admitted a new partner? If so, when? What are the partnership's procedures for admitting a new partner?

7. Has a partner ever withdrawn from the business? If so, when? What are the partnership's procedures for settling up with a withdrawing partner?

8. If possible, learn how the partnership divides profits and losses among the partners.

9. Ask for any additional insights the partner you interview can provide about the business.

For Internet Exercises, Excel in Practice, and additional online activities, go to the Web site www.prenhall.com/horngren.

Quick Check Answers

1. *a* 2. *b* 3. *b* 4. *c* 5. *d* 6. *c* 7. *b* 8. *d* 9. *d* 10. *a*