# Accounting Principles

**Thirteenth Edition**

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## Chapter 12

# Accounting for Partnerships

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# Chapter Outline

## Learning Objectives

**LO 1** Discuss and account for the formation of a partnership.

**LO 2** Explain how to account for net income or net loss of a partnership.

**LO 3** Explain how to account for the liquidation of a partnership.

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# Forming 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


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# 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 act appears to be appropriate for partnership


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# Characteristics of Partnerships

## Limited Life

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

## Unlimited Liability

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


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# Characteristics of Partnerships

## Co-Ownership of Property

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


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# Characteristics of Partnerships

Which of the following is **not** a characteristic of a partnership?

a. Taxable entity
b. Mutual agency
c. Co-ownership of property
d. Limited life


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# Organizations with Partnership 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.


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# Organizations with Partnership Characteristics

**Regular Partnership**

### Major Advantages

- Simple and inexpensive to create and operate

### Major Disadvantages

- Owners (partners) personally liable for business debts


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# Organizations with Partnership Characteristics

**"Ltd.," or "LP"**

### 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

### Major Disadvantages

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


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# Organizations with Partnership 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


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# Organizations with Partnership Characteristics

**"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


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# Advantages and Disadvantages of Partnerships

## Advantages

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


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# Advantages and Disadvantages of Partnerships

## Disadvantages

- Mutual agency
- Limited life
- Unlimited liability


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# The 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 withdrawal or addition of a partner.
7. Rights and duties of surviving partners in event of a partner's death.


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# Accounting for a Partnership Formation

**Illustration:** Assume that 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 | (2,000) | | | |
| Accounts receivable | | 4,000 | | **4,000** |
| Allowance for doubtful accounts | | (700) | | **(1,000)** |
| | $11,000 | $12,300 | **$12,000** | **$12,000** |

**ILLUSTRATION 12.3**


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# Accounting for a Partnership Formation

**Illustration:** Prepare the journal entry to record the investment in 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 |


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# Accounting for a Partnership Formation

Upon formation of a partnership, each partner's initial investment of assets should be recorded at their:

a. book values

b. fair values

c. cost

d. appraised values


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# 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 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.


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# Accounting for Net Income or Net Loss

## Dividing Net Income or Net Loss

### 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


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# Closing Entries

**Illustration:** Assume that AB Company has net income of $32,000 for 2020. The partners, L. Arbor and D. Barnett, share net income and net loss equally. Drawings for the year were Arbor $8,000 and Barnett $6,000. The two closing entries are as follows.


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# Closing Entries

| | | |
|---|---|---|
| Income Summary | 32,000 | |
| L. Arbor, Capital ($32,000 × 50%) | | 16,000 |
| D. Barnett, Capital ($32,000 × 50%) | | 16,000 |

**L. Arbor, Capital**

| | |
|---|---|
| | 1/1 Bal. 47,000 |

**D. Barnett, Capital**

| | |
|---|---|
| | 1/1 Bal. 36,000 |

**L. Arbor, Drawings**

| | |
|---|---|
| 12/31 Bal. 8,000 | |

**D. Barnett, Drawing**

| | |
|---|---|
| 12/31 Bal. 6,000 | |


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# Closing Entries

| | | |
|---|---|---|
| L. Arbor, Capital | 8,000 | |
| D. Barnett, Capital | 6,000 | |
| L. Arbor, Drawings | | 8,000 |
| D. Barnett, Drawings | | 6,000 |

**L. Arbor, Capital**

| | |
|---|---|
| | 1/1 Bal. 47,000 |
| | 12/31 **Clos. 16,000** |

**D. Barnett, Capital**

| | |
|---|---|
| | 1/1 Bal. 36,000 |
| | 12/31 **Clos. 16,000** |

**L. Arbor, Drawings**

| | |
|---|---|
| 12/31 Bal. 8,000 | |

**D. Barnett, Drawing**

| | |
|---|---|
| 12/31 Bal. 6,000 | |


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# Closing Entries

To close a partner’s drawings account, an entry must be made that:

a. debits that partner’s drawings account and credits Income Summary.

b. debits that partner’s drawings account and credits that partner’s capital account.

c. credits that partner’s drawings account and debits that partner’s capital account.

d. credits that partner’s drawings account and debits the firm’s dividend account.


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# 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


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# 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 2020, 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.


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ILLUSTRATION 12.5

# Kingslee Company
## Division of Net Income
## For the Year Ended December 31, 2020

| Net income $22,000 | Sara King | Ray Lee | Total |
|---|---|---|---|
| **Salary allowance** | | | |
| **Interest allowance on partners' capital** | | | |
| Sara King | | | |
| Ray Lee | | | |
| Total interest allowance | | | |
| Total salaries and interest | | | |
| **Remaining income** | | | |
| Sara King | | | |
| Ray Lee | | | |
| Total remainder | | | |
| **Total division of net income** | | | |


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# Dividing Net Income or Net Loss

**Illustration:** Kingslee records the division of net income as follows.

| | | | |
|---|---|---|---|
| Dec. 31 | Income Summary | 22,000 | |
| | Sara King, Capital | | 12,400 |
| | Ray Lee, Capital | | 9,600 |


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# Dividing Net Income or Net Loss

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

| **Net income $18,000** | **Sara King** | **Ray Lee** | **Total** |
|---|---|---|---|
| Total salaries and interest | $11,200 | $8,400 | $19,600 |
| **Remaining income ($18,000 – $19,600)** | | | |
| Sara King | | | |
| Ray Lee | | | |
| Total remainder | | | (1,600) |
| **Total division of net income** | | | |

ILLUSTRATION 12.6


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# Partnership Financial Statements

ILLUSTRATION 12.7

**Kingslee Company**
**Partners' Capital Statement**
**For the Year Ended December 31, 2020**

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


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# Partnership Financial Statements

**ILLUSTRATION 12.8**
Owners' equity section of a partnership balance sheet

**Kingslee Company**
**Balance Sheet (partial)**
**December 31, 2020**

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

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


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# DO IT! 2 | Partnership Organization

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.


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# DO IT! 2 | Partnership Organization

The division of the $57,000 of net income is as follows.

| | L. Lee | R. May | Total |
| --- | --- | --- | --- |
| Salary allowance | | | |
| Remaining income | | | |
| L. Lee | | | |
| R. May | | | |
| Total remaining income | | | |
| Total division of net income | | | |

| | | |
| --- | --- | --- |
| Income Summary | 57,000 | |
| L. Lee, Capital | | 33,000 |
| R. May, Capital | | 24,000 |


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# Liquidation of a Partnership

**Ends both** the legal and economic life of the entity.

**To liquidate**, it is necessary to:

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


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# Liquidation of a Partnership

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

| Assets | | Liabilities and Owners' Equity | |
|---|---|---|---|
| Cash | $ 5,000 | Notes Payable | $15,000 |
| Accounts Receivable | 15,000 | Accounts Payable | 16,000 |
| Inventory | 18,000 | R. Arnet, Capital | 15,000 |
| Equipment | 35,000 | P. Carey, Capital | 17,800 |
| Accumulated Depreciation | (8,000) | W. Eaton, Capital | 1,200 |
| | $65,000 | | $65,000 |

ILLUSTRATION 12.9


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# Liquidation of a Partnership

## 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.


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# Liquidation with No Capital Deficiency

**Illustration:** 1. Ace sells 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). Ace realizes a gain of $15,000 on the sale. The entry is:

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


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# Liquidation with No Capital Deficiency

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

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


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# Liquidation with No Capital Deficiency

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

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


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# Liquidation with No Capital Deficiency

**Illustration:** 4. Ace distributes the remaining cash to the partners on the basis of **their capital balances**.

| | | |
|---|---|---|
| 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


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# Liquidation with No Capital Deficiency

**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** | **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 | 49,000 | + | 0 | = | 0 | + | 22,500 | + | 22,800 | + | 3,700 |
| **Cash distribution to partners** | **(49,000)** | | | **=** | | | **(22,500)** | **+** | **(22,800)** | **+** | **(3,700)** |
| Final balances | 0 | | 0 | | 0 | | 0 | | 0 | | 0 |

ILLUSTRATION 12.10


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# Liquidation of a Partnership

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

a. (2), (3), (4), (1).

b. (2), (3), (1), (4).

c. (3), (2), (1), (4).

d. (3), (2), (4), (1).


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# DO IT! 3a | 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.


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# DO IT! 3a | No Capital Deficiency

**Gafton Company**
**Schedule of Cash Payments**

| Item | Cash | + | Noncash Assets | = | Liabilities | + | Kale D., Capital | + | Croix D., Capital | + | Marais K., Capital |
|---|---|---|---|---|---|---|---|---|---|---|---|
| Balances before liquidation | 10,000 | + | 85,000 | = | 40,000 | + | 15,000 | + | 35,000 | + | 5,000 |
| **Sale of noncash assets and allocation of gain** | | + | | = | | | | + | | + | |
| New balances | | + | | = | | + | | + | | + | |
| **Pay liabilities** | | | | = | | | | | | | |
| New balances | | + | | = | | + | | + | | + | |
| **Cash distribution to partners** | | | | = | | | | + | | + | |
| Final balances | 0 | | 0 | | 0 | | 0 | | 0 | | 0 |


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# Liquidation of a Partnership

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

| Assets | | Liabilities and Owners' Equity | |
|---|---|---|---|
| Cash | $ 5,000 | Notes Payable | $15,000 |
| Accounts Receivable | 15,000 | Accounts Payable | 16,000 |
| Inventory | 18,000 | R. Arnet, Capital | 15,000 |
| Equipment | 35,000 | P. Carey, Capital | 17,800 |
| Accumulated Depreciation | (8,000) | W. Eaton, Capital | 1,200 |
| | $65,000 | | $65,000 |

ILLUSTRATION 12.9


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# Liquidation of a Partnership

## Capital Deficiency

**Illustration:** A capital deficiency may result from recurring net losses, excessive drawings, or losses from realization suffered during liquidation. To illustrate, assume that Ace Company is on the brink of bankruptcy. The partners decide to liquidate by having a "going-out-of-business" sale. They sell merchandise at substantial discounts, and sell the equipment at auction.


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# Liquidation with a Capital Deficiency

**Illustration:** Ace Cash proceeds from these sales and collections from customers total only $42,000. Thus, the loss from liquidation is $18,000 ($60,000 – $42,000). The **first step** is to record the entry for the realization of noncash assets.

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


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# Liquidation with a Capital Deficiency

**Illustration:** The **second step** is to allocate the loss on realization to the partners on the basis of their income ratios. The entry is:

| | | |
|---|---|---|
| R. Arnet, Capital ($18,000 × 3/6) | 9,000 | |
| P. Carey, Capital ($18,000 × 2/6) | 6,000 | |
| W. Eaton, Capital ($18,000 × 1/6) | 3,000 | |
| Loss on Realization | | 18,000 |


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# Liquidation with a Capital Deficiency

**Illustration:** The **third step** is for to pay the partnership liabilities. The entry is:

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


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# Liquidation with a Capital Deficiency

**Illustration:** The next step is for W. Eaton to pay the partnership $1,800 for the deficiency.

| | | |
|---|---|---|
| Cash | 1,800 | |
| W. Eaton, Capital | | 1,800 |

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


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# Liquidation with a Capital Deficiency

**Illustration:** Next Ace records the distribution of cash to the partners.

| | | |
|---|---|---|
| R. Arnet, Capital | 6,000 | |
| P. Carey, Capital | 11,800 | |
| Cash | | 17,800 |

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

ILLUSTRATION 12.13


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# Liquidation with a Capital Deficiency

**Illustration:** If the deficiency is not paid, an entry to write-off the deficiency would be made as follows.

| | | |
|---|---|---|
| R. Arnet, Capital | 1,080 | |
| P. Carey, Capital | 720 | |
| W. Eaton, Capital | | 1,800 |

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

ILLUSTRATION 12.14


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# Liquidation with a Capital Deficiency

**Illustration:** The remaining cash would then be distributed to the remaining partners.

| | | |
|---|---|---|
| R. Arnet, Capital | 4,920 | |
| P. Carey, Capital | 11,080 | |
| Cash | | 16,000 |

| Cash | | | |
|---|---|---|---|
| Bal. | 5,000 | (3) | 31,000 |
| (1) | 42,000 | | |
| | | | 16,000 |
| **Bal.** | **0** | | |

| R. Arnet, Capital | | | |
|---|---|---|---|
| (2) | 9,000 | Bal. | 15,000 |
| | 1,080 | | |
| | 4,920 | | |
| | | **Bal.** | **0** |

| P. Carey, Capital | | | |
|---|---|---|---|
| (2) | 6,000 | Bal. | 17,800 |
| | 720 | | |
| | 11,080 | | |
| | | **Bal.** | **0** |

| W. Eaton, Capital | | | |
|---|---|---|---|
| (2) | 3,000 | Bal. | 1,200 |
| | | | 1,800 |
| | | **Bal.** | **0** |


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# Appendix 12A Admission and Withdrawals of Partners

## Admission of a Partner

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


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# 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. Baker, Capital | 10,000 | |
| L. Carson, Capital | | 20,000 |

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

ILLUSTRATION 12A.1


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# Investment of Assets in a Partnership

**Illustration:** Assume that instead of purchasing an interest, Carson invests $30,000 in cash in the Ames-Barker partnership for a 33 1/3% capital interest. In such a case, the entry is:

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

| Net Assets | | C. Ames, Capital | | D. Barker, Capital | | L. Carson, Capital | |
|---|---|---|---|---|---|---|---|
| 60,000 | | | 30,000 | | 30,000 | | |

ILLUSTRATION 12A.2


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# Investment of Assets in a Partnership

| Purchase of an Interest | |
|---|---|
| **Net assets** | **$60,000** |
| **Capital** | |
| C. Ames | $20,000 |
| D Barker | 20,000 |
| L. Carson | 20,000 |
| **Total capital** | **$60,000** |

| Admission by Investment | |
|---|---|
| **Net assets** | **$90,000** |
| **Capital** | |
| C. Ames | $30,000 |
| D Barker | 30,000 |
| L. Carson | 30,000 |
| **Total capital** | **$90,000** |

**ILLUSTRATION 12A.3**
Comparison of purchase of an interest and admission by investment


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# 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 capital balances of **old partners**
- Partnership allocates bonus to them on basis of their income ratios before admission of new partner


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# Investment 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 | 80,000 |
| Total capital of new partnership | $200,000 |


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# Investment 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% |
| New partner's capital credit | $ 50,000 |


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# Investment 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 investment | $ 80,000 |
| New partner's capital credit | - 50,000 |
| Bonus amount | $ 30,000 |


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# Investment 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. Allocate the bonus to Bart (60%) and Cohen (40%).

**The 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 |


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# 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 capital balances of **old partners**
- Decrease for each partner is based on income ratios before admission of new partner


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# 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.


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# Bonus to New Partner

**Illustration:** 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.

| | | | |
|---|---|---|---|
| 1. | Total capital of Bart–Cohen partnership | | $120,000 |
| | Investment by new partner, Eden | | 20,000 |
| | Total capital of new partnership | | $140,000 |
| 2. | **Eden's capital credit** | | |
| 3. | **Bonus to Eden** | | |
| 4. | Allocation of bonus to old partners: | | |
| | Bart | | |
| | Cohen | | |


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# Bonus to New Partner

The partnership records the admission of Eden as follows.

4. Allocation of bonus to old partners:

| | | |
|---|---|---|
| Bart ($15,000 x 60%) | $9,000 | |
| Cohen ($15,000 x 40%) | 6,000 | $ 15,000 |

| | | |
|---|---|---|
| Cash | 20,000 | |
| Sam Bart, Capital | 9,000 | |
| Tom Cohen, Capital | 6,000 | |
| Lea Eden, Capital | | 35,000 |


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# 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
- Withdrawal of a partner, like admission of a partner, legally dissolves the partnership


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# 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 |


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# Investment of Assets in a Partnership

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.

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

**ILLUSTRATION 12A.5**
Ledger balances after payment from partners' personal assets


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# Payment from Partnership Assets

## Bonus to Retiring Partner

Partnership may pay a bonus to a retiring partner when:

1. Fair value of partnership assets is more than their book value
2. There is unrecorded goodwill
3. Remaining partners are eager to remove the partner from the firm

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


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# Payment from Partnership Assets

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

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


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# 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.

The partnership records the withdrawal of Terk as follows.

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


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# 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. Partnership has a poor earnings record
3. Partner is eager to leave the partnership

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


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# 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. Bonus to remaining partners is $4,000 ($20,000 - $16,000).
2. Allocation of $4,000 bonus is Roman $2,400 ($4,000 x 3/5) and Sand $1,600 ($4,000 x 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 |


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# Death of a Partner

- Dissolves the partnership
- Partnership agreements usually contain a provision for surviving partners to continue operations
- Surviving partners may
  - agree to purchase deceased partner’s equity from their personal assets
  - use partnership assets to settle with deceased partner’s estate


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