

Chapter Fifteen

Partnerships: Formation, Operation, and Changes in Membership

Multi-Corporate Entities
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Reporting Requirements
Partnerships
Formation, Operation, Changes
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THE EVOLUTION OF PRICEWATERHOUSECOOPERS (PwC)

All of today's "Big 4" accounting firms are partnerships and all have evolved over time through continual mergers of existing accounting firms. PricewaterhouseCoopers (PwC) has a long history dating back to the mid-1800s. Samuel Price set up his own accounting practice in London in 1849. A few years later in 1854, William Cooper established his accounting practice in London as well. It would take nearly 150 years for these two firms to eventually come together. In fact, they competed with one another during most of this time.

Price, Holyland, and Waterhouse joined forces in 1865 to form what would eventually become Price, Waterhouse & Company. Not until 1957 did several large accounting firms come together to form Coopers & Lybrand. These two firms became two of the "Big 8" accounting firms. Throughout most of the 20th century, the profession was dominated by these Big 8 accounting firms:

1. Arthur Andersen
2. Arthur Young
3. Coopers & Lybrand
4. Ernst & Whinney
5. Deloitte Haskins & Sells
6. Peat Marwick Mitchell
7. Price Waterhouse
8. Touche Ross

In 1989 due to intense competition, Ernst & Whinney merged with Arthur Young to form Ernst & Young. That same year, Deloitte, Haskins & Sells merged with Touche Ross to form Deloitte & Touche. These mergers narrowed the field to the "Big 6," and Price Waterhouse continued to compete with Coopers & Lybrand during the 1990s. Finally, in 1998, one of the largest mergers in the history of the public accounting profession occurred when Price Waterhouse merged with Coopers & Lybrand to form PricewaterhouseCoopers. This merger brought about the brief reign of the "Big 5" before the demise of Arthur Andersen in 2002 in the wake of the Enron scandal, which limited the playing field to the current "Big 4" accounting firms.

Most of the early mergers in the accounting profession were general partnerships. Not until the 1990s did a new type of legal entity, the limited liability partnership (LLP),

The PwC logo is displayed in a bold, lowercase, sans-serif font. Above the letters, there is a small graphic element consisting of a series of horizontal bars of varying lengths, creating a stepped or staircase effect.

emerge, allowing some protection to partners for liabilities incurred by other partners. Although only two states in the United States allowed LLPs in 1992, by the end of the decade, most had passed laws allowing LLPs. All of the Big 4 accounting firms are now LLPs.

According to the U.S. Census Bureau, as of 2008, 3.1 million partnerships filed tax returns compared to 22.6 million proprietorships and 5.8 million corporations. Accountants are often called on to aid in the formation and operation of partnerships to ensure proper measurement and valuation of the partnership's transactions. This chapter focuses on the formation and operation of partnerships, including accounting for the addition of new partners and the retirement of an existing partner. Chapter 16 presents the accounting for the termination and liquidation of partnerships.

LEARNING OBJECTIVES

When you finish studying this chapter, you should be able to:

- LO 15-1 Understand and explain the nature and regulation of partnerships.
- LO 15-2 Understand and explain the differences among different types of partnerships.
- LO 15-3 Make calculations and journal entries for the formation of partnerships.
- LO 15-4 Make calculations and journal entries for the operation of partnerships.
- LO 15-5 Make calculations and journal entries for the allocation of partnership profit or loss.
- LO 15-6 Make calculations and journal entries to account for changes in partnership ownership.

THE NATURE OF THE PARTNERSHIP ENTITY

LO 15-1

Understand and explain the nature and regulation of partnerships.

The *partnership* is a popular form of business because it is easy to form and allows several individuals to combine their talents and skills in a particular business venture. In addition, partnerships provide a means of obtaining more equity capital than a single individual can obtain and allow the sharing of risks for rapidly growing businesses.

Accounting for partnerships requires recognition of several important factors. First, from an accounting viewpoint, the partnership is a separate business entity. The Internal Revenue Code, however, views the partnership as a conduit only, not separable from the business interests of the individual partners. Therefore, tax and financial accounting rules for specific partnership events differ from those for other forms of business in several ways, such as the value assigned to assets contributed in the formation of the partnership. This chapter presents the generally accepted accounting principles of partnership accounting. We present a brief discussion of the tax aspects of a partnership in Appendix 15A.

Second, although many partnerships account for their operations using accrual accounting, others use the cash basis or modified cash basis of accounting. These alternatives are allowed because partnership records are maintained for the partners and must reflect their information needs. The partnership's financial statements are usually prepared only for the partners but occasionally for the partnership's creditors. Unlike publicly traded corporations, most partnerships are not required to have annual audits of their financial statements. Although many partnerships adhere to generally accepted accounting principles (GAAP), deviations from GAAP are found in practice. The partners' specific needs should be the primary criteria for determining the accounting policies to be used for a specific partnership.

Legal Regulation of Partnerships

The partnership form of business has several unique elements because of its legal and accounting status. Each state regulates the partnerships that are formed in it. Accountants advising partnerships must be familiar with partnership laws because these laws describe many of the rights of each partner and of creditors during the creation, operation, and

liquidation of the partnership. Each state tends to begin with a uniform or model act and then modifies it to fit that state's business culture and history. The Uniform Partnership Act of 1914 served for many years as the model for defining the rights and responsibilities of the partners to each other and to the creditors of the partnership. In 1994, the National Conference of Commissioners on Uniform State Laws (NCCUSL) approved the first major revision of the model act to better reflect current business practices while retaining many of the original act's valuable provisions. This 1994 revision was titled the Revised Uniform Partnership Act (RUPA). During the next three years, the NCCUSL continued to make small revisions to the model act and in 1997, it approved the final model as the **Uniform Partnership Act of 1997 (UPA 1997)**. Most states have now adopted the UPA 1997 model because, although the UPA 1997 includes many features of the Uniform Partnership Act of 1914, the UPA 1997 reflects today's more complex partnership events and transactions, and stresses the fiduciary responsibilities of the partners to each other. We use the UPA 1997 for discussion and illustration in this and the next chapter on partnerships.

Definition of a Partnership

Section 202 of the UPA 1997 states that “. . . the association of two or more persons to carry on as co-owners of a business for profit forms a partnership. . . .” This definition encompasses three distinct factors:

1. *Association of two or more persons.* The “persons” are usually individuals; however, they also may be corporations or other partnerships.
2. *To carry on as co-owners.* This means that each partner has the apparent authority, unless restricted by the partnership agreement, to act as an agent of the partnership for transactions in the ordinary course of business of the kind carried on by the partnership. These transactions can legally bind the partnership to third parties.
3. *Business for profit.* A partnership may be formed to perform any legal business, trade, profession, or other service. However, the partnership must attempt to make a profit; therefore, not-for-profit entities such as fraternal groups may not be organized as partnerships.

Formation of a Partnership

A primary advantage of the partnership form of entity is ease of formation. The agreement to form a partnership may be as informal as a handshake or as formal as a many-paged partnership agreement. Each partner must agree to the formation agreement, and partners are strongly advised to have a formal written agreement to avoid potential problems that could arise during the operation of the business. It is usually true that if the potential partners cannot agree on the various operating aspects before a partnership is formed, many future disputes that could cause severe management problems and seriously imperil the partnership's operations might arise. Each partner should sign the partnership agreement to indicate acceptance of its terms. A carefully prepared partnership agreement can prevent many of these problems in operations.

The partnership agreement should include the following items:

1. The name of the partnership and the names of the partners.
2. The type of business to be conducted by the partnership and the duration of the partnership agreement.
3. The initial capital contribution of each partner and the method by which to account for future capital contributions.
4. A complete specification of the profit or loss distribution, including salaries, interest on capital balances, bonuses, limits on withdrawals in anticipation of profits, and the percentages used to distribute any residual profit or loss.
5. Procedures used for changes in the partnership, such as admission of new partners and the retirement of a partner.
6. Other aspects of operations the partners decide on, such as each partner's management rights and the election procedures and accounting methods to use.

Other Major Characteristics of Partnerships

After a state adopts the provisions of the UPA 1997, the act regulates all partnerships formed in that state. For partnerships that do not have a formal partnership agreement, the act provides the legal framework that governs the relationships among the partners and the rights of creditors of the partnership; in essence, the UPA 1997 becomes the partnership agreement for those partnerships that do not have one. The following presents the sections of the UPA 1997 applicable to the formation and operation of a partnership. Chapter 16 will present the sections of the UPA 1997 applicable to the dissolution and liquidation of a partnership.

1. *Partnership agreement.* The UPA 1997 governs in those partnership relations that are not specifically presented in the partnership agreement; thus, the courts use the UPA 1997 when there is no partnership agreement. Several provisions of the UPA 1997 are not waivable by partnership agreement. For example, a partnership may not restrict a partner's rights of access to the partnership's books and records, eliminate the obligations of partners for good faith and fair dealing with the other partners and the partnership, restrict any rights of third parties under the UPA 1997, or reduce any legal rights of individual partners.
2. *Partnership as a separate entity.* A partnership is a separate business entity distinct from its partners. This **entity concept** means that a partnership can sue or be sued and that its property belongs to the partnership, not to any individual partner. Thus, there is no new partnership entity when a membership change in the partners occurs (a new partner is admitted or a partner leaves).
3. *Partner as an agent of the partnership.* Each partner is an agent of the partnership for transactions carried on in the ordinary course of the partnership business unless the partner did not have the authority to act for the partnership in that specific matter and the third party knew or had received a notification that the partner lacked authority. This agency relationship among the partners is very important. If the partnership determines that only specific partners have the authority for conducting specific business transactions, then the partnership must make third parties aware of the limitations of authority of other partners. This notice should be in a public form either as a formal filing of a statement of partnership authority (discussed in the next point) or in direct communications with third parties. Otherwise, third parties may presume a partner has the authority to act as an agent for the partnership in those normal business transactions engaged in for the business the partnership operates.
4. *Statement of partnership authority.* A **Statement of Partnership Authority** describes the partnership and identifies the specific authority of partners to transact specific types of business on behalf of the partnership. This voluntary statement is filed with the secretary of the state. The statement is a notice of any limitations on the rights of specific partners to enter into specific types of transactions. Partnerships should file these statements particularly for the firm's real estate transactions. The UPA 1997 states that a filed statement of partnership authority is sufficient constructive notice to third parties for partnership real estate transactions, but it is not necessarily sufficient notice for other types of partnership transactions.
5. *Partner's liability is joint and several.* All partners are liable jointly and severally for all obligations of the partnership unless otherwise provided by law. In the event a partnership fails and its assets are not sufficient to pay its obligations, partners are required to make contributions to the partnership in the proportion to which they share partnership losses. If a partner fails to make a contribution of the amount required, all other partners must contribute in the proportion to which those partners share partnership losses. Partnership creditors must first be satisfied from partnership assets, and additional partner contributions are classified as partnership assets. However, a partner is liable for partnership liabilities incurred prior to that partner's admission into the partnership only to the extent of the partner's capital credit. A new partner is not

personally liable for partnership debts incurred prior to his or her admission to the firm. If a partnership creditor takes legal action against an individual partner for a partnership obligation, the creditor does not have any superior rights to the partner's individual assets. In this case, the partnership creditor joins with the other personal creditors.

6. *Partner's rights and duties.* Each partner is to have a capital account showing the amount of his or her contributions to the partnership, net of any liabilities, and the partner's share of the partnership profits or losses, less any distributions. The partner is entitled to an equal share of the profits or losses unless otherwise agreed to in the partnership agreement. New partners can be admitted only with the consent of all of the partners. Each partner has a right of access to the partnership's books and records, and each partner has a duty to act for the partnership in good faith and fair dealing.
7. *Partner's transferable interest in the partnership.* Under the entity approach to a partnership stated in the act, a partner is not a co-owner of any partnership property. This means that the only **transferable interest** of a partner is his or her share of the profits and losses of the partnership and the right to receive distributions, including any liquidating distribution. A partner may not transfer any rights of management or authority to transact any of the partnership's business operations. Thus, the partner's individual creditors may not attach any of the partnership's assets, but a partner's personal creditor may obtain a legal judgment for attachment of the partner's transferable interest.
8. *Partner's dissociation.* A **partner's dissociation** means that the partner can no longer act on the firm's behalf. A partner is dissociated from a partnership when any of the following events occurs: (a) he or she gives notice to the partnership of his or her express will to withdraw as a partner, (b) the firm expels him or her the firm in accordance with the partnership agreement, typically or for violating some part of the partnership agreement or his or her continuance becomes unlawful, (c) one of several judicial determinations occurs (such as the partner's committing a material breach of the partnership agreement or engaging in serious conduct that materially and adversely affects the partnership), (d) the partner becomes a debtor in bankruptcy, or (e) the partner dies.

LO 15-2

Understand and explain the differences among different types of partnerships.

Types of Limited Partnerships

Many persons view the possibility of personal liability for a partnership's obligations as a major disadvantage of the general partnership form of business. For this reason, sometimes people become limited partners in one of the several limited partnership forms. A limited partnership (LP) differs from a limited liability partnership (LLP) and a limited liability limited partnership (LLLP). The variations are based on the degree of liability shield provided to the partners.

Limited Partnerships (LP) A limited partnership (LP) has at least one general partner and one or more limited partners. The general partner is personally liable for the partnership's obligations and has management responsibility. Limited partners are liable only to the extent of their capital contribution but do not have any management authority. The Uniform Limited Partnership Act of 2001 (ULPA 2001) is the model law regulating limited partnerships and has been adopted in many states. Accounting for the investment in a limited partnership is based on an evaluation of control. Typically, the general partner has the necessary elements of operational control of the limited partnership and consolidates the investment on her or his books. The limited partners typically use the equity method to account for their investments. However, **ASC 810** indicates that in cases in which the limited partners have either (1) the ability to dissolve the limited partnership or to remove the general partners without cause (the so-called kick-out right) or (2) substantive participating rights to be actively engaged in the significant decisions of the LP's business. The presumption of the general partners' control could be overcome and then each would account for its investment in the LP using the equity method of accounting. The identifier, LP or Limited Partnership, must be included in the name or identification of the limited partnership.

Limited Liability Partnerships (LLP) A limited liability partnership (LLP) is one in which each partner has some degree of liability shield. An LLP has no general or limited partners; thus, each partner has the rights and duties of a general partner but limited legal liability. A partner in a limited liability partnership is not personally liable for a partnership obligation. However, several states have determined that each partner in an LLP is fully liable for the partnership's obligations, though not for acts of professional negligence or malpractice committed by other partners. Some legal support for the LLP came as a result of the fact that most professional service partnerships, such as accounting firms, have significant amounts of insurance to cover judgments in lawsuits and other losses from offering services. An LLP must identify itself as such by adding the LLP letters following the partnership's name in all correspondence or other means of identifying the firm. Virtually all large public accounting firms are LLPs. This designation has not changed the nature of accounting services provided to clients and has been generally accepted in the business market.

Limited Liability Limited Partnership (LLLP) In most states, a limited partnership may elect to become a limited liability limited partnership. Each partner in an LLLP is liable only for the business obligations of the partnership, not for acts of malpractice or other wrongdoing by the other partners in the normal course of the partnership's business. The ULPA 2001 includes the regulatory guidance for LLLPs. The advantage of an LLLP is that general partners, even though responsible for management of the partnership, have no personal liability for partnership obligations, similar to the shield provided to limited partners. The identifier LLLP or the phrase Limited Liability Limited Partnership must be included in the entity's name or identification.

Accounting and Financial Reporting Requirements for Partnerships

Most partnerships are small or medium-size entities, although some are large. Partnerships do not issue stock; thus, its information needs typically differ from those of corporations that have stockholders. A partnership has much more flexibility to select specific accounting measurement and recognition methods and specific financial reporting formats.

If a partnership wishes to issue general-purpose financial statements for external users such as credit grantors, vendors, or others, it should use GAAP as promulgated by the FASB and other standard-setting bodies, and the independent auditor can issue an opinion that the statements are in accordance with GAAP. The FASB created the Private Company Financial Reporting Committee in June 2006 to provide input to the FASB on proposed and existing accounting standards as to their impact on nonpublic business entities. Thus, the FASB has a vehicle by which GAAP standards can be adapted to meet the cost/benefit perspective of nonpublic entities.

If a partnership has only internal reporting needs, the accounting and financial reporting should meet the partners' internal information needs. In this case, the partnership may use non-GAAP accounting methods and have financial reports in a format different from those required under GAAP. For example, some partnerships use the accounting methods prescribed by tax laws, thereby generating tax-based financial reports. Some partnerships use the cash-based accounting system, often with some adjustments, so the financial reports provide specific cash flow and cash positions. Other partnerships may use accounting methods that are proximate to GAAP with some adjustments that fit the partners' information needs, such as recognizing increases in the fair value of nonfinancial assets at the time of admission of a new partner. In these cases, if the financial statements are presented to users external to the partnership, such as banks, vendors, or regulatory bodies, the statements should clearly identify the specific accounting methods the entity used so that the users understand that the information presented does not conform to GAAP. An independent accountant's opinion on these financial statements

also would have to disclose the specific accounting methods used or the deviations from GAAP that affected the amounts reported. It is up to the partners to determine their financial information needs, and then the partnership accountant applies the necessary accounting measurement, recognition, and reporting methods that meet the partners' financial information needs.

International Financial Reporting Standards for Small and Medium-Size Entities and Joint Ventures

In 2009, the International Accounting Standards Board issued "International Financial Reporting Standard for Small and Medium-sized Entities," more commonly known as **International Financial Reporting Standards (IFRS)** for small and medium-size enterprises (SMEs). *SMEs* are defined as those entities that (1) do not have public accountability (i.e., do not have stock or issue bonds in a public capital market) and (2) publish general-purpose financial statements for external users. This standard presents the definitions of items and accounting concepts that are quite similar to those already in the international financial accounting and reporting standards except that less detail and fewer disclosures are mandated and more flexibility is provided for the formats of the financial statements. Moreover, **International Accounting Standards (IAS) 31** on the accounting for joint ventures, many of which are accounted as partnerships, also became effective in July 2009. Thus, the International Accounting Standards Board (IASB) is addressing the specific accounting and financial reporting requirements for SMEs and joint ventures that are required to provide general-purpose financial statements to external users. However, these standards do not apply to partnerships that do *not* have public accountability and do *not* issue general-purpose financial statements to external users.

ACCOUNTING FOR THE FORMATION OF A PARTNERSHIP¹

LO 15-3

Make calculations and journal entries for the formation of partnerships.



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At the formation of a partnership, it is necessary to assign a proper value to the noncash assets and liabilities contributed by the partners. Section 201 of the UPA 1997 specifies that a partnership is an entity distinct from its partners. Thus, an item contributed by a partner becomes partnership property. The partnership must clearly distinguish between capital contributions and loans made to the partnership by individual partners. Loan arrangements should be evidenced by promissory notes or other legal documents necessary to show that a loan arrangement exists between the partnership and an individual partner. Also, it is important to clearly distinguish between tangible assets that the partnership owns and those specific assets that individual partners own but are used by the partnership. Accurate records of the partnership's tangible assets must be maintained.

ASC 820 continues the long-held accounting concept that the contributed assets should be valued at their fair values, which may require appraisals or other valuation techniques. Liabilities assumed by the partnership should be valued at the present value of the remaining cash flows.

The individual partners must agree to the percentage of equity that each will have in the partnership's net assets. Generally, the capital balance is determined by the proportionate share of each partner's capital contribution. For example, if A contributes 70 percent of the net assets in a partnership with B, then A will have a 70 percent capital share and B will have a 30 percent capital share. In recognition of intangible factors, such as a partner's special expertise or necessary business connections, however, partners may agree to any proportional division of capital. Therefore, before recording the initial capital contribution, all partners must agree on the valuation of the net assets and on each partner's capital share.

¹ To view a video explanation of this topic, visit advancedstudyguide.com.

Illustration of Accounting for Partnership Formation

The following illustration is used as the basis for the remaining discussion in this chapter. Alt, a sole proprietor, has been developing software for several types of computers. The business has the following account balances as of December 31, 20X0:

Cash	\$ 3,000	Liabilities	\$10,000
Inventory	7,000	Alt, Capital	15,000
Equipment	20,000		
Less: Accumulated Depreciation	(5,000)		
Total Assets	<u>\$25,000</u>	Total Liabilities & Capital	<u>\$25,000</u>

Alt needs additional technical assistance to meet increasing sales and offers Blue an interest in the business. Alt and Blue agree to form a partnership. Alt's business is audited, and its net assets are appraised. The audit and appraisal disclose that \$1,000 of liabilities have not been recorded, inventory has a market value of \$9,000, and the equipment has a fair value of \$19,000.

Alt and Blue prepare and sign a partnership agreement that includes all significant operating policies. Blue will contribute \$10,000 cash for a one-third capital interest. The AB Partnership is to acquire all of Alt's business and assume its debts.

The entry to record the initial capital contribution on the partnership's books is

January 1, 20X1			
(1)	Cash	13,000	
	Inventory	9,000	
	Equipment	19,000	
	Liabilities		11,000
	Alt, Capital		20,000
	Blue, Capital		10,000

Record the formation of AB Partnership by capital contributions of Alt and Blue.

Key Observations from Illustration

Note that the partnership is an accounting entity separate from each of the partners and that the assets and liabilities are recorded at their market values at the time of contribution. No accumulated depreciation is carried forward from the sole proprietorship to the partnership. All liabilities are recognized and recorded.

The partnership's capital is \$30,000. This is the sum of the individual partners' capital accounts and is the value of the partnership's assets less liabilities. The fundamental accounting equation—assets less liabilities equals capital—is used often in partnership accounting. Blue is to receive a one-third capital interest in the partnership with a contribution of \$10,000. In this case, his capital interest equals his capital contribution.

Each partner's capital amount recorded does not necessarily have to equal his or her capital contribution. The partners could decide to divide the total capital equally regardless of the source of the contribution. For example, although Alt contributed \$20,000 of the \$30,000 partnership capital, he could agree to \$15,000 as his initial capital balance and permit Blue the remaining \$15,000 as a capital credit. On the surface, this may not seem to be a reasonable action by Alt, but it is possible that Blue has some particularly important business experience the partnership needs, and Alt agrees to the additional credit to Blue in recognition of her experience and skills. The key point is that the partners may allocate the capital contributions in any manner they desire. The accountant must be sure that all partners agree to the allocation and then record it accordingly.

ACCOUNTING FOR THE OPERATIONS OF A PARTNERSHIP

LO 15-4

Make calculations and journal entries for the operation of partnerships.

A partnership provides services or sells products in pursuit of profit. These transactions are recorded in the appropriate journals and ledger accounts. Many partnerships use accrual accounting and GAAP to maintain their books because its use provides better measures of income over time. Some creditors, such as banks, and some vendors, such as large suppliers to the partnership, may periodically require audited financial statements, and if GAAP is used, the financial statements can then receive a “clean” or unqualified audit opinion. Furthermore, the partners can compare the GAAP-based financial statements of their business to published financial profiles, such as Moody’s or many published by the U.S. government, or those of other companies in the same line of business so that the partners can evaluate their respective financial performance and position.

But some partnerships use alternative non-GAAP methods, such as the cash-basis method or the modified cash-basis method. These two methods have simplified record-keeping requirements and can continuously provide the partners the current cash position of their partnership. A few partnerships revalue all their assets at the end of each fiscal period in order to estimate the market value of their business as a whole at year-end. Some partnerships use federal income tax rules to account for transactions so the partners can determine the effects of transactions that will be reportable on their personal income tax returns. The accountant works with the partners to determine their specific information needs regarding the partnership and then applies the appropriate accounting and financial reporting methods to meet those needs.

Partners’ Accounts

The partnership may maintain several accounts for each partner in its accounting records. These *partners’ accounts* are capital, drawing, and loan accounts.

Capital Accounts

A partner’s initial investment, any subsequent capital contributions, profit or loss distributions, and any withdrawals of capital are ultimately recorded in the partner’s capital account. Each partner has one capital account, which usually has a credit balance. On occasion, a partner’s capital account may have a debit balance, called a *deficiency* or sometimes a *deficit*, which occurs because the partner’s share of losses and withdrawals exceeds his or her capital contribution and share of profits. A deficiency is usually eliminated by additional capital contributions. The balance in the capital account represents the partner’s share of the partnership’s net assets.

Drawing Accounts

Partners generally withdraw assets from the partnership during the year in anticipation of profits. A separate drawing account often is used to record the periodic withdrawals and is then closed to the partner’s capital account at the end of the period. For example, the following entry is made in the AB Partnership’s books for a \$3,000 cash withdrawal by Blue on May 1, 20X1:

May 1, 20X1			
(2)	Blue, Drawing	3,000	
	Cash		3,000
Record Blue’s withdrawal of \$3,000.			

Noncash drawings should be valued at their market values at the date of the withdrawal. A few partnerships make an exception to the rule of market value for partners’ withdrawals of inventory and record withdrawals of inventory at cost, thereby not recording a gain or loss on these drawings.

Loan Accounts

A partnership may look to its present partners for additional financing. Any loans between a partner and the partnership should always be accompanied by proper loan documentation such as a promissory note. A loan from a partner is shown as a payable on the partnership's books, the same as for any other loan. Unless all partners agree otherwise, the partnership is obligated to pay interest on the loan to the individual partner. Note that interest is *not* required to be paid on capital investments unless the partnership agreement states that capital interest is to be paid. The partnership records interest on loans as an operating expense. Alternatively, the partnership may lend money to a partner in which case it records a loan receivable from the partner. Again, unless all partners agree otherwise, these loans should bear interest, and the interest income should be recognized on the partnership's income statement. The following entry is made to record a \$4,000, 10 percent, one-year loan from Alt to the partnership on July 1, 20X1:

July 1, 20X1			
(3)	Cash	4,000	
	Loan Payable to Alt		4,000
Record loan agreement with partner Alt.			

The loan payable to Alt is reported in the partnership's balance sheet. A loan from a partner is a related-party transaction for which separate footnote disclosure is required, and it must be reported as a separate balance sheet item, not included with other liabilities.

ALLOCATING PROFIT OR LOSS TO PARTNERS

LO 15-5

Make calculations and journal entries for the allocation of partnership profit or loss.



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Profit or loss is allocated to the partners at the end of each period in accordance with the partnership agreement. If the entity does not have a formal partnership agreement, section 401 of the UPA 1997 indicates that all partners should share profits and losses equally. Virtually all partnerships have a profit or loss allocation agreement that must be followed precisely, and if it is unclear, the accountant should make sure that all partners agree to the profit or loss distribution. Many problems and later arguments can be avoided by carefully specifying the profit or loss distribution in the articles of copartnership.

A wide range of *profit distribution plans* is found in the business world. Some partnerships have straightforward distribution plans; others have extremely complex ones. It is the accountant's responsibility to distribute the profit or loss according to the partnership agreement regardless of how simple or complex that agreement is. Profit distributions are similar to a corporation's dividends: These distributions should not be included on the partnership's income statement regardless of how the profit is distributed. Profit distributions are recorded directly into the partner's capital accounts, not treated as expense items.

Most partnerships use one or more of the following distribution methods:

1. Preselected ratio.
2. Interest on capital balances.
3. Salaries to partners.
4. Bonuses to partners.



CAUTION

Note that the titles for these distribution methods can be deceiving. They simply describe different ways to allocate a fixed amount of partnership profit. For example, if a partnership earns \$100,000 in profit for a given period, these methods are simply four different ways to divide the \$100,000 among the partners.

Preselected ratios are usually the result of negotiations between the partners. Ratios for profit distributions may be based on the percentage of total partnership capital, time, and effort invested in the entity, or a variety of other factors. Small partnerships often split profits evenly among the partners. In addition, some

partnerships have different ratios if the firm suffers a loss rather than earns a profit. The partnership form of business allows a wide selection of profit distribution ratios to meet the partners' individual desires.

Distributing partnership income based on **interest on capital balances** simply means that the partners divide some or all of the \$100,000 among themselves based on the relative balances they have maintained in their capital accounts. This method recognizes the contribution of the partners' capital investments to the partnership's profit-generating capacity and requires the allocation of profits based on a fixed rate multiplied by the partner's capital account balance. This allocation of profits based on capital balances is generally not an expense of the partnership (like interest on a loan from a bank). It is simply a method for distributing profits.

If one or more of the partners' services are important to the partnership, the profit distribution agreement may provide for salaries or bonuses. Again, these represent fixed amounts allocated to partners from the \$100,000 earned during the period. They are simply a form of profit distribution, not a partnership expense. Think of a **salary** as a fixed amount of company profits allocated to a given partner and a **bonus** as a portion of profits allocated to a partner based on a predetermined performance formula. Occasionally, the distribution process may depend on the size of the profit or may differ if the partnership has a loss for the period. For example, salaries to partners might be paid only if revenue exceeds expenses by a certain amount. The accountant must carefully read the partnership agreement to determine the precise profit distribution plan for the specific circumstances at the time.

The profit or loss distribution is recorded with a closing entry at the end of each period. The revenue and expenses are often closed into an income summary account that is then allocated to the partners' capital accounts based on the formula prescribed in the partnership agreement (which could include one or more of the four methods described earlier). If the partnership earns \$100,000 for the period, the formula provided in the partnership agreement tells the accountant how to allocate this amount to the partners' capital accounts. Sometimes partnerships bypass the income summary account and close revenue and expense accounts directly to the partners' capital accounts. In the following examples, we use an income summary account. Its balance (either net income or net loss) is closed and distributed to the partners' capital accounts.

Illustrations of Profit Allocation

During 20X1, the AB Partnership earned \$45,000 of revenue and incurred \$35,000 in expenses, leaving a profit of \$10,000 for the year. Alt maintains a capital balance of \$20,000 during the year, but Blue's capital investment varies during the year as follows:

Date	Debit	Credit	Balance
January 1			\$10,000
May 1	\$3,000		7,000
September 1		\$500	7,500
November 1	1,000		6,500
December 31			6,500

The debits of \$3,000 and \$1,000 are recorded in Blue's drawing account; the additional investment is credited to her capital account.

Arbitrary Profit-Sharing Ratio

Alt and Blue could agree to share profits in a ratio unrelated to their capital balances or to any other operating feature of the partnership. For example, assume the partners agree to share profits or losses in the ratio of 60 percent to Alt and 40 percent to Blue.

Some partnership agreements specify this ratio as 3:2 (i.e., 3/5 to Alt and 2/5 to Blue). The following schedule illustrates how the net income is distributed using a 3:2 profit-sharing ratio:

	Alt	Blue	Total
Profit-sharing percentage	60%	40%	100%
Net income			\$10,000
Allocate 60:40	\$6,000	\$4,000	(10,000)
Total	<u>\$6,000</u>	<u>\$4,000</u>	<u>\$ 0</u>

This schedule shows how net income is distributed to the partners' capital accounts. The actual distribution is accomplished by closing the Income Summary account. In addition, the drawing accounts are closed to the capital accounts at the end of the period.

December 31, 20X1		
(4)	Blue, Capital	4,000
	Blue, Drawing	4,000
Close Blue's drawing account.		
(5)	Revenue	45,000
	Expenses	35,000
	Income Summary	10,000
Close revenue and expenses.		
(6)	Income Summary	10,000
	Alt, Capital	6,000
	Blue, Capital	4,000
Distribute profit in accordance with partnership agreement.		

Interest on Capital Balances

The partnership agreement may provide for interest to be credited on the partners' capital balances as part of the distribution of profits. The rate of interest is often a stated percentage, but some partnerships use a rate determined by reference to current U.S. Treasury rates or current money market rates.

As stated earlier, interest calculated on partners' capital is generally a form of profit distribution. The calculation is made after net income has been determined in order to decide how to distribute the income.

Particular caution must be exercised when interest on capital balances is included in the profit distribution plan. For example, the amount of the distribution can be significantly different depending on whether the interest is computed on beginning capital balances, ending capital balances, or average capital balances for the period. Most provisions for interest on capital specify that a weighted-average capital should be used. This method explicitly recognizes the time span for which each capital level is maintained during the period. For example, Blue's weighted-average capital balance for 20X1 is computed as follows:

Date	Debit	Credit	Balance	Months Maintained	Months Times Dollar Balance
January 1			\$10,000	4	\$40,000
May 1	\$3,000		7,000	4	28,000
September 1		\$500	7,500	2	15,000
November 1	1,000		6,500	2	13,000
Total				<u>12</u>	<u>\$96,000</u>
Average capital (\$96,000 ÷ 12 months)					<u>\$ 8,000</u>

Assume Alt and Blue agree to allocate profits first based on 15 percent of the weighted-average capital balances and then to any remaining profit based on a 60:40 ratio; the distribution of the \$10,000 profit would be calculated as follows:

	Alt	Blue	Total
Profit percentage	60%	40%	100%
Average capital	\$20,000	\$8,000	
Net income			\$10,000
Interest on average capital (15%)	\$ 3,000	\$1,200	(4,200)
Residual income			\$ 5,800
Allocate 60:40	3,480	2,320	(5,800)
Total	<u>\$ 6,480</u>	<u>\$3,520</u>	<u>\$ 0</u>

Salaries

Recall that salaries to partners are simply fixed amounts allocated to partners as part of the regular allocation of profits. They are generally included as part of the profit distribution plan to recognize and compensate partners for differing amounts of personal services provided to the business.

Section 401 of the UPA 1997 states that a partner is not entitled to compensation for services performed for the partnership except for reasonable compensation for services in winding up the partnership business. Some partnership agreements, however, do specify a management fee to be paid to a partner who provides very specific administration responsibilities.



STOP & THINK

What if the partnership experiences losses? Can salaries to the partners during the year be treated as a distribution of profits? Although any amounts actually paid to partners during the year are really drawings made in anticipation of profits, the agreed salary amounts usually are added to the loss, and that total is then distributed to the partners' capital accounts. Caution should be exercised if the partnership experiences a loss during the year. Some partnership agreements specify different distributions for profit than for losses. The accountant must be especially careful to follow precisely the partnership agreement when distributing the period's profit or loss to the partners.

As mentioned previously, a general precept of partnership accounting is that salaries to partners are not operating expenses but are part of the profit distribution plan. This precept is closely related to the proprietary concept of owner's equity. According to the proprietary theory, the proprietor invests capital and personal services in pursuit of income. The earnings are a result of those two investments. The same logic applies to the partnership form of organization. Some partners invest capital, and others invest personal time. Those who invest capital are typically rewarded with interest on their capital balances; those who invest personal time are rewarded with

salaries. However, both interest and salaries result from the respective investments and are used not to determine income but to determine the proportion of income to credit to each partner's capital account.

To illustrate the allocation of partnership profit based on salaries, assume that the partnership agreement provides for fixed allocations of \$2,000 to Alt and \$5,000 to Blue. Any remainder is to be distributed in the profit and loss-sharing ratio of 60:40 percent. The profit distribution is calculated as follows:

	Alt	Blue	Total
Profit percentage	60%	40%	100%
Net income			\$10,000
Salary	\$2,000	\$5,000	(7,000)
Residual income			\$ 3,000
Allocate 60:40	1,800	1,200	(3,000)
Total	<u>\$3,800</u>	<u>\$6,200</u>	<u>\$ 0</u>

Bonuses

Bonuses are sometimes used to provide additional compensation to partners who have provided services to the partnership, and are typically stated as a percentage of income either before or after subtracting the bonus. Sometimes the partnership agreement requires a minimum income to be earned before a bonus is calculated, which is easily done by deriving and solving an equation. To illustrate the difference between a bonus based on partnership profits *before* and a bonus *after* subtracting the bonus, we provide the following example. Assume that a bonus of 10 percent of income in excess of \$5,000 is to be credited to Blue's capital account before distributing the remaining profit. In Case 1, the bonus is computed as a percentage of income *before* subtracting the bonus amount. In Case 2, the bonus is computed as a percentage of income *after* subtracting it.

Case 1:

$$\text{Bonus} = X \% (\text{NI} - \text{MIN})$$

where: X = The bonus percentage

NI = Net income before bonus

MIN = Minimum amount of income before bonus

$$\begin{aligned}\text{Bonus} &= 0.10 (\$10,000 - \$5,000) \\ &= \$500\end{aligned}$$

Case 2:

$$\begin{aligned}\text{Bonus} &= X \% (\text{NI} - \text{MIN} - \text{Bonus}) \\ &= 0.10 (\$10,000 - \$5,000 - \text{Bonus}) \\ &= 0.10 (\$5,000 - \text{Bonus}) \\ &= \$500 - 0.10 \text{ Bonus}\end{aligned}$$

$$1.10 \text{ Bonus} = \$500$$

$$\begin{aligned}\text{Bonus} &= \$454.55 \\ &\approx \$455\end{aligned}$$

The distribution of net income based on Case 2 is calculated as follows:

	Alt	Blue	Total
Profit percentage	60%	40%	100%
Net income			\$10,000
Bonus to partner		\$ 455	(455)
Residual income			\$ 9,545
Allocate 60:40	\$5,727	\$3,818	(9,545)
Total	<u>\$5,727</u>	<u>\$4,273</u>	<u>\$ 0</u>



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Multiple Profit Allocation Bases

A partnership agreement may provide a formula describing several allocation procedures to be used to distribute profit. For example, assume the AB Partnership profit and loss agreement of specifies the following allocation process:

1. Interest of 15 percent on weighted-average capital balances.
2. Salaries of \$2,000 for Alt and \$5,000 for Blue.
3. A bonus of 10 percent of profits to be paid to Blue on partnership income exceeding \$5,000 before subtracting the bonus, partners' salaries, and interest on capital balances.
4. Any residual to be allocated in the ratio of 60 percent to Alt and 40 percent to Blue.

The partnership agreement also should specify the allocation process in the event that partnership income is not sufficient to satisfy all allocation procedures. Some partnerships specify a profit distribution to be followed but only to the extent possible (i.e., stop following the formula once profits are exhausted). Most agreements specify that the entire process is to be completed and any remainder at each step of the process (whether positive or negative) is to be allocated in the profit and loss ratio as illustrated in the following schedule:

	Alt	Blue	Total
Profit percentage	60%	40%	100%
Average capital	\$20,000	\$8,000	
Net income:			\$10,000
Step 1:			
Interest on average capital (15 percent)	\$ 3,000	\$1,200	(4,200)
Remaining after step 1			\$ 5,800
Step 2:			
Salary	2,000	5,000	(7,000)
Deficiency after step 2			\$ (1,200)
Step 3:			
Bonus		500	(500)
Deficiency after step 3			\$ (1,700)
Step 4:			
Allocate 60:40	(1,020)	(680)	1,700
Total	\$ 3,980	\$6,020	\$ 0

In this case, the first two distribution steps created a deficiency. The AB Partnership agreement provided that the entire profit distribution process must be completed and any deficiency distributed in the profit and loss ratio. A partnership agreement could specify that the profit distribution process should stop at any point in the event of an operating loss or the creation of a deficiency. Again, it is important for the accountant to have a thorough knowledge of the partnership agreement before beginning the profit distribution process.

Special Profit Allocation Methods

Some partnerships distribute net income on the basis of other criteria. For example, most public accounting partnerships distribute profit on the basis of partnership “units.” A new partner acquires a certain number of units, and a firmwide compensation committee assigns additional units for obtaining new clients, providing the firm specific areas of industrial expertise, serving as a local office’s managing partner, or accepting a variety of other responsibilities.

Other partnerships may devise profit distribution plans that reflect the firms’ earnings. For example, some medical or dental partnerships allocate profit on the basis of billed services. Other criteria may be number or size of clients, years of service with the firm, or the partner’s position within it. An obvious advantage of the partnership form of organization is the flexibility it allows partners for profits distribution.

PARTNERSHIP FINANCIAL STATEMENTS

A partnership is a separate reporting entity for accounting purposes, and the three financial statements—income statement, balance sheet, and statement of cash flows—typically are prepared for the partnership at the end of each reporting period. Interim statements also may be prepared to meet the partners’ information needs. In addition to the three basic financial statements, a *statement of partners’ capital* is usually prepared to present the changes in the partners’ capital accounts for the period. The statement of partners’

capital for the AB Partnership for 20X1 under the multiple-base profit distribution plan illustrated in the prior section follows:

AB PARTNERSHIP Statement of Partners' Capital For the Year Ended December 31, 20X1			
	Alt	Blue	Total
Balance, January 1, 20X1	\$20,000	\$10,000	\$30,000
Add: Additional investment		500	500
Net income distribution	3,980	6,020	10,000
	\$23,980	\$16,520	\$40,500
Less: Withdrawal		(4,000)	(4,000)
Balance, December 31, 20X1	<u>\$23,980</u>	<u>\$12,520</u>	<u>\$36,500</u>

CHANGES IN MEMBERSHIP

LO 15-6

Make calculations and journal entries to account for changes in partnership ownership.

Changes in the membership of a partnership occur with the addition of new partners or the dissociation of present partners. New partners are often a primary source of additional capital or needed business expertise. The legal structure of a partnership requires that the **admission of a new partner** be subject to the unanimous approval of the existing partners. Furthermore, public announcements are typically made about new partner additions that third parties transacting business with the partnership are aware of this to ensure change. Section 306 of the UPA of 1997 states that a person admitted as a new partner of an existing partnership is not personally liable for any partnership obligation incurred before the new partner was admitted. Thus, a new partner can be charged for partnership liabilities existing prior to admission only up to the amount of his or her capital contribution at the time of admission.

The retirement or withdrawal of a partner from a partnership is a *dissociation* of that partner. A partner's dissociation does not necessarily mean a dissolution and winding up of the partnership. Many partnerships continue in business and, under section 701 of the UPA 1997, the partnership may purchase the dissociated partner's interest at a **buyout price**. The buyout price is the estimated amount if (1) the assets were sold for a price equal to the higher of the liquidation value or the value based on a sale of the entire business as a going concern without the dissociated partner and (2) the partnership was wound up at that time with payment of all the partnership's creditors and termination of the business. Partners who simply wish to leave a partnership may be liable to the partnership for damages to the partnership caused by a *wrongful dissociation*, which occurs when the dissociation is in breach of an express provision of the partnership agreement or, for partnerships formed for a definite term or specific undertaking before the term or undertaking has been completed. Some events require judicial dissolution and winding up of the partnership. These will be discussed in Chapter 16.

General Concepts to Account for a Change in Membership in the Partnership

The Partnership as an Entity Separate from the Individual Partners and the Use of GAAP

The UPA of 1997 clearly defines a partnership as an entity separate from the individual partners. As such, the partnership entity does not change because of an individual partner's addition or withdrawal of. This is similar to the concept of the entity for the corporate form of business in which the business is not necessarily revalued each time there is a change in stockholders.

Some partnerships choose to comply with GAAP in their accounting and financial reporting. These partnerships follow the same standards established by the FASB and other regulatory bodies as those for public companies. Often venture capital firms or other credit suppliers may require that the private partnership company comply with GAAP so that financials can be compared with those of other public companies. Venture capital firms have a goal of eventually taking their investees public. Thus, a partnership that follows GAAP and is audited by external auditors can receive an audit opinion stating that it is in conformity with GAAP.

A partnership following GAAP and defining its company as an entity separate from the individual partners would account for a change in membership in the same manner as a corporate entity would account for changes in its investors. Additional investments would be recognized at their fair values along with the related increase in the company's total capital.²

Frequently, a partnership's existing assets are undervalued when a partner joins the partnership. The difficulty lies in recording the admission of additional partners in a manner that is fair and equitable to all parties involved. Two main methods for recording the admission of a new partner to a partnership are

1. The bonus method (follows GAAP).
2. The revaluation method (does not follow GAAP).

Both methods require the partnership to make journal entries based on fair value estimates. The problem with making journal entries based on estimates is that should the estimates not materialize in the future, inequalities among the partners can arise.³

Bonus Method Partners sometimes agree to use the **bonus method** to record the admission of a new partner. This method records an increase in the partnership's total capital only for the capital amount the new partner invests, in accordance with GAAP. However, the bonus method assigns partners' capital account balances based on the partners' agreement, which is often based on the value of the new partner's investment. In some cases, the existing partners assign some of their capital to a new partner; in others, a new partner agrees to assign a portion of his or her capital interest to the existing partners. Thus, the bonus method does not violate GAAP because partners may legally assign any or all of their transferable partnership capital interest to other partners.

Revaluation Method The partners in a private company may choose to follow non-GAAP accounting methods that meet their specific information needs. These partnerships may use the transactions surrounding the change of members as an opportunity for recognizing increases in the fair value of the partnership's existing nonfinancial assets or for recording previously unrecognized goodwill.

The practices of recognizing increases in a partnership's existing net assets using the **revaluation method**, or recognizing previously unrecorded goodwill (sometimes called the **goodwill recognition method**) are *not* in compliance with GAAP. Partnerships using these non-GAAP methods argue that revaluing all assets and liabilities at the time of

² In a few situations, GAAP allows for the recognition of decreases in the fair value of specific nonfinancial assets. One of these allowed decreases may be triggered by a change in partnership membership. For example, ASC 350 presents procedures for recognizing impairments of currently held goodwill. ASC 360 presents the accounting standards for recognizing impairment losses on long-lived assets. Net asset revaluations performed using the appropriate accounting standards are in accordance with GAAP. However, no GAAP standards provide for *increases* in the value of nonfinancial assets or recognition of new goodwill solely due to a change in partnership membership.

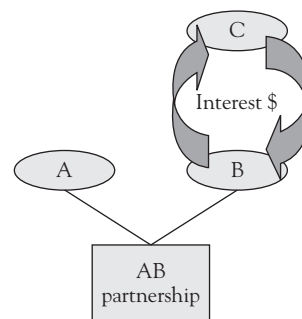
³ An alternative to these methods is to appraise assets and liabilities when a new partner joins the partnership and make special provisions in the partnership agreement on how gains or losses on existing assets and liabilities should be allocated to the partners. In this way, the partnership can avoid making journal entries based on estimates but wait until assets and liabilities have been disposed to make journal entries. The benefit of this approach is that the partnership agreement specifies how to deal with the admission date differential so that no inequalities arise in the future.

the change in partnership membership states fully the true economic condition at that point in time and properly assigns the partnership's changes in asset and liability values and goodwill to the partners who have been managing the business during the time the changes in value occurred.

Partners in private companies have free choice as to how they may account for changes in partnership membership. As noted, a private partnership may use either GAAP or non-GAAP methods based on the partners' information needs. Because some partnerships record increases in value by applying the revaluation (or goodwill recognition) method, the following sections of this chapter discuss these non-GAAP methods of accounting for the change in the partnership membership.

New Partner Purchases Partnership Interest Directly from an Existing Partner

An individual may acquire a partnership interest directly from one or more of the existing partners. In this type of transaction, cash or other assets are exchanged outside the partnership, and the only entry necessary on its books is a reclassification of the partnership's total capital. For example, a new partner, Cha, could purchase Blue's partnership interest directly from her (as depicted in the diagram). This simple example would result in an entry to remove Blue's capital account from the books with a debit and transfer the balance to Cha's new capital account with a credit.



FYI

Note that the bonus and revaluation methods mentioned previously do not apply when the new partner simply purchases a partnership interest directly from an existing partner and the journal entry simply transfers the investment's book value from the existing partner to the new partner.

This type of transaction focuses solely on a transfer of the selling partner's share of the partnership's book value to the new partner. The **book value of a partnership** is simply the total amount of partnership capital, which is just another name for the partnership's net assets (total assets minus total liabilities). Book value is important because it serves as a basis for asset and liability revaluations or goodwill recognition.

tions or goodwill recognition.

To provide a more complex example, assume that after operations and partners' withdrawals during 20X1 and 20X2, AB Partnership has a book value of \$30,000 and profit percentages on January 1, 20X3, as follows:

	Capital Balance	Profit Percentage
Alt	\$20,000	60
Blue	10,000	40
Total	<u>\$30,000</u>	<u>100</u>

The following information describes the case:

- On January 1, 20X3, Alt and Blue invite Cha to become a partner in their business. The resulting partnership will be called the ABC Partnership.

2. Cha purchases a 25 percent interest in the partnership capital directly from Alt and Blue for a total cost of \$9,000, paying \$5,900 to Alt and \$3,100 to Blue. Cha will have a capital credit of \$7,500 ($\$30,000 \times 0.25$) in a proportionate reclassification from Alt and Blue's capital accounts.
3. Cha will be entitled to a 25 percent interest in the partnership's profits or losses. The remaining 75 percent interest will be divided between Alt and Blue in their previous profit ratio of 60:40 percent. The resulting profit and loss percentages after Cha's admission follow:

Partner	Profit Percentage
Alt	45 (75% of 0.60)
Blue	30 (75% of 0.40)
Cha	25
Total	100

In this example, Cha's 25 percent share of partnership profits or losses is the same as her 25 percent capital interest. These two percentage shares do not have to be the same. As described previously, a partner's capital interest may change over time because of profit distributions, withdrawals, or additional investments in capital. Furthermore, Cha could have acquired her entire capital interest directly from either partner (or proportionately from both). It is not necessary that a new partner directly purchasing an interest do so in a proportionate reclassification from each of the existing partners.

The transaction is between Cha and the individual partners and is not reflected on the partnership's books. The only entry in this case is to reclassify the partnership capital. Both Alt and Blue provide 25 percent of their capital to Cha, as follows:

January 1, 20X3			
(7)	Alt, Capital	5,000	
	Blue, Capital	2,500	
	Cha, Capital		7,500
Reclassify capital to new partner:			
From Alt: $\$5,000 = \$20,000 \times 0.25$			
From Blue: $\$2,500 = \$10,000 \times 0.25$			

In this case, the capital credit to Cha is only \$7,500, although \$9,000 is paid for the 25 percent interest. The \$9,000 payment implies that the fair value of the partnership is \$36,000, calculated as follows:

$$\$9,000 = \text{Fair value} \times 0.25$$

$$\$36,000 = \text{Fair value}$$

The partnership's book value is \$30,000 before Cha's investment. The \$9,000 payment is made directly to the individual partners, but it does not become part of the firm's assets. The \$6,000 difference between the partnership's fair value and its new book value could be due to understated assets or to unrecognized goodwill.

Recognizing Fair Value Increases in the Partnership's Net Assets (Non-GAAP)

Up to this point, the partnership has followed GAAP because the partners may legally assign any or all of their transferable partnership capital interest to other persons or among themselves as they agree. If the partners wish to be in accordance with GAAP, they must follow the appropriate recognition and measurement methods for the net assets as prescribed in GAAP.

Assume that Alt and Blue decide to use the evidence from Cha's investment to recognize increases in fair values of the nonfinancial long-lived assets that have taken place before Cha's admission. The partnership's accountant has informed the members that this type of revaluation is not in accordance with GAAP. For example, if the partnership has land undervalued by \$6,000 and sells it after Cha is admitted to the partnership, she will share in the gain on the sale according to the profit ratio. To avoid this possible problem, some partnerships revalue the assets at the time a new partner is admitted even if the new partner purchases the partnership interest directly from the present partners. In this case, Alt and Blue could recognize the increase in the value of the land immediately before Cha's admission and allocate the increase to their capital accounts in their 60:40 profit ratio, as follows:

(8)	Land	6,000	
	Alt, Capital		3,600
	Blue, Capital		2,400

Revaluation of land before admission of new partner:
 To Alt: $\$3,600 = \$6,000 \times 0.60$
 To Blue: $\$2,400 = \$6,000 \times 0.40$.

Note that the partnership's total resulting capital is \$36,000 (\$30,000 prior plus the \$6,000 revaluation). The transfer of a 25 percent capital credit to Cha is recorded as follows:

(9)	Alt, Capital	5,900	
	Blue, Capital	3,100	
	Cha, Capital		9,000

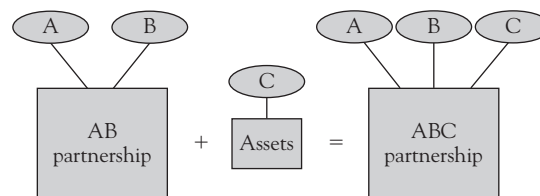
Reclassify capital to new partner:
 Cha = $(\$30,000 + \$6,000) \times 0.25 = \$9,000$
 From Alt = $(\$20,000 + \$3,600) \times 0.25 = \$5,900$
 From Blue = $(\$10,000 + \$2,400) \times 0.25 = \$3,100$.

The partnership's accountant should ensure that sufficient evidence exists for any revaluation of assets and liabilities to prevent valuation abuses. Corroborating evidence such as appraisals or an extended period of excess earnings helps support asset valuations.



New Partner Invests in Partnership

A new partner may acquire a share of the partnership by investing in the business. In this case, the partnership receives the cash or other assets.



Three cases are possible when a new partner invests in a partnership:

Case 1: The new partner's investment equals the new partner's proportion of the partnership's book value.

Case 2: The investment is for *more* than the new partner's proportion of the partnership's book value. This indicates that the partnership's prior net assets are undervalued on the books or that unrecorded goodwill exists.

Case 3: The investment is for *less* than the new partner's proportion of the partnership's book value. This suggests that the partnership's prior net assets are overvalued on its books or that the new partner may be contributing goodwill in addition to other assets.

The first step in determining how to account for the admission of a new partner is to compute the **new partner's proportion of the partnership's net book value** as follows:

$$\text{New partner's proportion of the partnership's net book value} = \left(\frac{\text{Prior capital of existing partners}}{\text{Investment of new partner}} + \frac{\text{Investment of new partner}}{\text{Investment of new partner}} \right) \times \frac{\text{Percentage of capital to new partner}}{\text{Investment of new partner}}$$

The new partner's proportion of the partnership's book value of net assets is compared with the new partner's investment to determine the procedures to follow in accounting for his or her admission. See Figure 15–1 for an overview of the three possible cases. Step 1 compares the new partner's investment with his or her proportion of the partnership's book value. Note that this is done before any revaluations or the recognition of goodwill. Step 2 determines the specific admission method. As explained previously, two methods are available to the partnership to account for the admission of a new partner when a difference exists between the new partner's investment and his or her proportion of the partnership's book value. The two methods are to (1) revalue existing net assets or recognize goodwill and (2) use the bonus method. Under the revaluation of net assets and goodwill recognition method, the historical cost bases of the partnership's net assets are adjusted at the time of the new partner's admission. Some partners object to this departure from historical cost and prefer the bonus method, which uses capital interest transfers among the partners to align the partnership's total resulting capital. Under the bonus method, net assets remain at their historical cost bases to the partnership. The choice of accounting method for the admission of a new partner is up to the partners.

The accounting for the admission of a new partner parallels the accounting for an investment in the stock of another company. If a new partner pays more than book value, the excess of cost over book value—that is, the positive differential—may be due to unrecognized goodwill or to undervalued assets, the same cases as in accounting for the differential for stock investments. If book value equals the investment cost, no differential exists, indicating that the book values of the net assets equal their fair values. If the new partner's investment is less than the proportionate book value—that is, an excess of book value over cost exists—the assets of the partnership may be overvalued. A concept unique to partnership accounting is the use of the bonus method. Figure 15–1 serves as a guide through the following discussion.

FIGURE 15–1 Overview of Accounting for Admission of a New Partner

Step 1: Compare Proportionate Book Value and Investment of New Partner	Step 2: Alternative Methods to Account for Admission	Key Observations
Investment cost > Book value (Case 2)	1. Revalue net assets up to market value, record unrecognized goodwill, and allocate to existing partners. 2. Assign bonus to existing partners.	• Existing partners receive asset valuation increase, goodwill, or bonus indicated by the excess of new partner's investment over book value of the capital share initially assignable to new partner. Alternatively, new partner is assigned goodwill or bonus as part of admission incentive. • Recording asset valuation increase or existing partners' goodwill increases total resulting partnership capital.
Investment cost = Book value (Case 1)	1. No revaluations, bonus, or goodwill.	• No additional allocations necessary because new partner will receive a capital share equal to the amount invested. • Total resulting partnership capital equals existing partners' capital plus investment of new partner.
Investment cost < Book value (Case 3)	1. Revalue existing net assets down to market value, allocate to existing partners, and recognize goodwill brought in by new partner. 2. Assign bonus to new partner.	• Existing partners are assigned the reduction of asset values occurring before admission of the new partner. • Recording the decrease in asset valuation reduces total resulting capital, and recording new partner goodwill increases total resulting capital.

We again use the AB Partnership example presented earlier to illustrate the three cases. A review of the major facts for this example follows:

1. The January 1, 20X3, capital of the AB Partnership is \$30,000. Alt's balance is \$20,000, and Blue's balance is \$10,000. Alt and Blue share profits in the ratio of 60:40.
2. Cha is invited into the partnership. Cha will have a 25 percent capital interest and a 25 percent share of profits. Alt and Blue will share the remaining 75 percent of profits in the ratio of 60:40, resulting in Alt having a 45 percent share of any profits and Blue having a 30 percent share.

Case 1: Investment Equals Proportion of the Partnership's Book Value

The partnership's total book value before the admission of the new partner is \$30,000, and the new partner, Cha, is buying a 25 percent capital interest for \$10,000.

The amount of a new partner's investment is often the result of negotiations between the existing partners and the prospective partner. As with any acquisition or investment, the investor must determine its market value. In a partnership, the prospective partner attempts to ascertain the market value and earning power of the partnership's net assets. The new partner's investment is then a function of the percentage of partnership capital being acquired. In this case, Cha must believe that the \$10,000 investment required is a fair price for a 25 percent interest in the resulting partnership; otherwise, she would not make the investment.

After the amount of investment is agreed on, it is possible to calculate the new partner's proportionate book value. For a \$10,000 investment, Cha will have a 25 percent interest in the partnership, as follows:

Investment in partnership	<u>\$10,000</u>
New partner's proportionate book value: $(\$30,000 + \$10,000) \times 0.25$	<u>(10,000)</u>
Difference (Investment = Book value)	<u>\$ 0</u>

Because the amount of the investment (\$10,000) equals the new partner's 25 percent proportionate book value ($\$10,000 = \$40,000 \times 0.25$), there is an implication that the net assets are fairly valued. Total resulting capital equals the original partners' capital (\$30,000) plus the new partner's tangible investment (\$10,000). Note that the capital credit assigned to the new partner is her share of the total resulting capital of the partnership after her admission as partner. The entry on the partnership's books is

January 1, 20X3		
(10)	Cash	10,000
	Cha, Capital	10,000

Admission of Cha for 25 percent interest upon investment of \$10,000.

The following schedule presents the key concepts in Case 1:

	Prior Capital	New Partner's Tangible Investment	New Partner's Proportion of Partnership's Book Value (25%)	Total Resulting Capital	New Partner's Share of Total Resulting Capital (25%)
Case 1					
New partner's investment equals proportionate book value	\$30,000	\$10,000	\$10,000		
No revaluations, bonus, or goodwill				\$40,000	\$10,000

Case 2: New Partner's Investment More than Proportion of the Partnership's Book Value

In some cases, a new partner may invest more in an existing partnership than his or her proportionate share of the partnership's book value. This means that the new partner perceives some value in the partnership that the books of account do not reflect.

For example, assume Cha invests \$11,000 for a 25 percent capital interest in the ABC Partnership. The first step is to compare her investment with her proportionate book value, as follows:

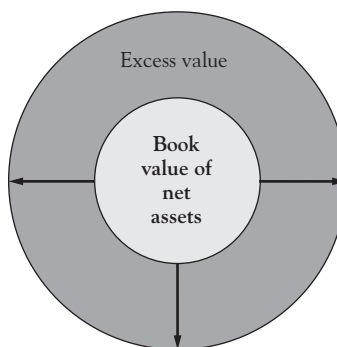
Investment in partnership	\$11,000
New partner's proportionate book value: $(\$30,000 + \$11,000) \times 0.25$	(10,250)
Difference (Investment > Book value)	<u>\$ 750</u>

Cha has invested \$11,000 for an interest with a book value of \$10,250, thus paying an excess of \$750 over the present book value.

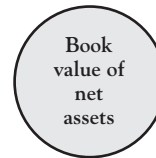
Generally, an excess of investment over the respective book value of the partnership interest indicates that the partnership's prior net assets are undervalued or that the partnership has some unrecorded goodwill. Two alternative accounting treatments can be used in this case:

1. *Revaluation method.* Under this alternative:
 - a. Increase the book values of existing net assets to their market values.
 - b. Record unrecognized goodwill.
 - c. Increase the existing partners' capital accounts for their respective shares of the increase in the book values of the net assets and the recorded goodwill.
 - d. The partnership's total resulting capital reflects the existing capital balances plus the amount of asset revaluation plus the new partner's investment.

Under the revaluation method, the partnership's assets (tangible and/or intangible) are revalued upward either to recognize unrecorded excess value or to record previously unrecorded goodwill. Thus, the size of the "pie" the partners are to divide among themselves becomes larger, so that the "slice" for each becomes proportionately larger.



2. *Bonus method.* Essentially, the bonus method is a transfer of capital balances among the partners. This method is used when the partners do not wish to record adjustments in asset and liability accounts or recognize goodwill. Thus, the size of the pie stays the same (the book value of existing equity plus the contribution of the new partner), but one or more partners will give some of his or her "slice" to the other partners.



Under this method:

- a. The existing partners' capital accounts are increased for their respective shares of the bonus paid by the new partner.
- b. The partnership's total resulting capital reflects the existing capital balances plus the new partner's investment.

The partnership may use either of the two alternatives. The decision is usually a result of negotiations between the existing partners and the prospective partner. Some accountants criticize the revaluation of net assets or recognition of goodwill because it results in a marked departure from the historical cost principle and differs from the accepted accounting principles in **ASC 350**, which prohibits corporations from recognizing goodwill that has not been acquired by purchase. Accountants who use the goodwill or asset revaluation methods argue that the goal of partnership accounting is to state fairly the relative capital equities of the partners, and this may require accounting procedures that differ from those that corporate entities use.

The accountant's function is to ensure that any estimates used in the valuation process are based on the best evidence available. Subjective valuations that could impair the fairness of the presentations made in the partnership's financial statements should be avoided or minimized.

Illustration of Revaluation Approach (Non-GAAP) Assume that Cha paid a \$750 excess (\$11,000 – \$10,250) over her proportionate book value because the partnership owns land on which it has constructed warehouse buildings. The land has a book value of \$4,000, but a recent appraisal indicates that it has a market value of \$7,000. The partnership expects to continue using the land for warehouse space for as long as the business operates. The accountant has informed the original partners that GAAP does not allow *increasing* the value of nonfinancial, long-lived assets held and used in the operations of the business. But the original partners decide to use the admission of the new partner to recognize the increase in the land's value and to assign this increase to their capital accounts. The increase in land value is allocated to the partners' capital accounts in the profit and loss ratio that existed during the time of the increase. Alt's capital increases by \$1,800 (60 percent of the \$3,000 increase), and Blue's capital increases by \$1,200 (40 percent of the \$3,000). The partnership makes the following entry for the revaluation of the land:

(11)	Land	3,000	
	Alt, Capital		1,800
	Blue, Capital		1,200

Revalue partnership land to market value.

Cha's \$11,000 investment brings the partnership's total resulting capital to \$44,000, as follows:

Prior capital of AB Partnership	\$30,000
Revaluation of land to market value	3,000
Cha's investment	11,000
Total resulting capital of ABC Partnership	<u>\$44,000</u>

Cha is acquiring a 25 percent interest in ABC Partnership's total resulting capital. Her capital credit, after revaluing the land, is calculated as follows:

$$\begin{array}{l} \text{New partner's share of} \\ \text{total resulting capital} \end{array} = (\$30,000 + \$3,000 + \$11,000) \times 0.25 = \$11,000$$

The entry to record Cha's admission into the partnership follows:

(12)	Cash	11,000	
	Cha, Capital		11,000

Admission of Cha for 25 percent capital interest in ABC Partnership.

When the land is eventually sold, Cha will participate in the gain or loss calculated on the basis of the new \$7,000 book value, which is the land's market value at the time of her admission into the partnership. The entire increase in the land value before Cha's admission belongs to the original partners.

An important key to remember is that the new partner's capital account balance should be equal to her respective ownership percentage multiplied by either the book value of net assets (the small pie) under the bonus method or the revalued net assets (the large pie) under the revaluation (or goodwill) method. In this case, the partners decided to revalue the balance sheet upward by recording the land's excess fair value at the time of Cha's admission. Thus, Cha's capital account balance upon admission is 25 percent of the newly expanded "pie," or \$11,000.

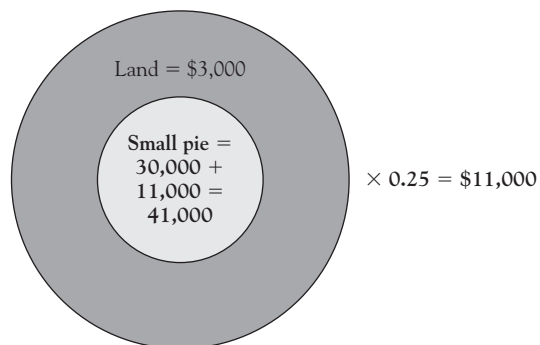


Illustration of Goodwill Recognition (Non-GAAP) An entering partner may pay an extra amount to compensate the existing partners for unrecognized goodwill, indicated by the partnership's high profitability. Some partnerships use the change in membership as an opportunity to record unrecognized goodwill created by the existing partners. Recording unrecognized goodwill is used for partnership accounting to establish appropriate capital equity among the partners. As noted earlier, this is not in accordance with the rule established in **ASC 350**, but the partners' information needs and the specific purposes of the partnership's financial statements could serve to support the use of this non-GAAP method.

Generally, the amount of goodwill is determined by negotiations between the current and prospective partners and is based on estimates of future earnings. For example, the current and new partners may agree that, due to the existing partners' efforts, the partnership has superior earnings potential and that \$3,000 of goodwill should be recorded to recognize this fact. The new partner's negotiated investment cost will be based partly on the partnership's earnings potential. Alternatively, goodwill may be estimated from the amount of the new partner's investment. For example, in this case, Cha is investing \$11,000 for a 25 percent interest; therefore, she must believe the total resulting partnership capital is \$44,000 (\$11,000 ÷ 0.25). The estimated goodwill is \$3,000:

<i>Step 1</i>	
25% of estimated total resulting capital	\$ 11,000
Estimated total resulting capital (\$11,000 ÷ 0.25)	<u>\$ 44,000</u>
<i>Step 2</i>	
Estimated total resulting capital	\$ 44,000
Total net assets not including goodwill (\$30,000 prior plus \$11,000 invested by Cha)	<u>(41,000)</u>
Estimated goodwill	<u>\$ 3,000</u>

Another way to view the creation of goodwill at the time of a new partner's admission is to use a T-account form for the partnership's balance sheet. Any additional net assets, such as goodwill recognition, must be balanced with additional capital, as follows:

Balance Sheet				
Prior to admission of new partner Cha	Net assets	\$30,000	Partners' capital	\$30,000
New partner's cash investment	Cash	<u>\$11,000</u>	New tangible capital	<u>\$11,000</u>
Capital prior to recognizing goodwill		\$41,000		\$41,000
Estimated new goodwill	Goodwill	<u>\$ 3,000</u>	Capital from goodwill	<u>\$ 3,000</u>
Total resulting capital	Net assets	<u>\$44,000</u>	Total resulting capital	<u>\$44,000</u>

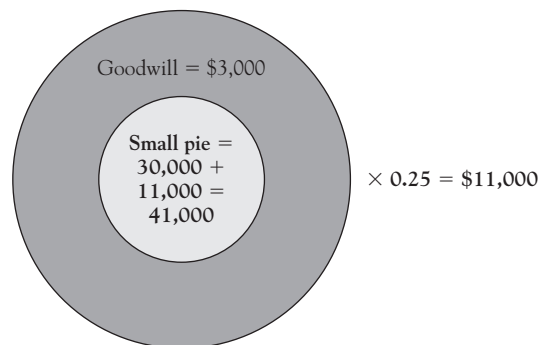
Once the new ABC Partnership's total resulting capital is estimated (\$44,000), the new goodwill (\$3,000) is the balance sheet balancing difference between the tangible capital (\$41,000), which includes the new partner's cash investment and the estimated total resulting capital of ABC Partnership (\$44,000).

The unrecorded goodwill is recorded, and the original partners' capital accounts are credited for the increase in assets. The adjustments to the capital accounts are in the profit and loss ratio that existed during the periods the goodwill was developed. This increased Alt's capital by 60 percent of the goodwill and Blue's by 40 percent. The entries to record goodwill and the admission of Cha are as follows:

(13)	Goodwill	3,000	
	Alt, Capital		1,800
	Blue, Capital		1,200
	Recognize unrecorded goodwill.		
(14)	Cash	11,000	
	Cha, Capital		11,000
	Admission of Cha to partnership for a 25 percent capital interest: \$44,000 $\times$ 0.25.		

Another reason for recording goodwill is that the new partner may want her capital balance to equal the amount of investment made. The investment is based on the partnership's market value, and for this equality to occur, the partnership must restate its previous net assets to their fair values.

Again, it is important to note that the \$11,000 credit to Cha's capital account is 25 percent of ABC Partnership's total resulting capital of \$44,000. Again, because the partners elected to revalue the balance sheet upward by recording goodwill, Cha's capital account balance is 25 percent of the larger pie (the newly expanded net assets).



In future periods, any goodwill impairment loss will be charged against partnership earnings before net income is distributed to the partners. Consequently, Cha's future profit distribution may be affected by the goodwill recognized at the time of her admission into the partnership.

Illustration of Bonus Method (GAAP) Some partnerships are averse to recognizing asset revaluations or unrecorded goodwill when a new partner is admitted. Instead, they record a portion of the new partner's investment as a bonus to the existing partners to align the capital balances properly at the time of the new partner's admission. In this case, the \$750 excess Cha is paid a bonus allocated to the original partners in their profit and loss ratio of 60 percent to Alt and 40 percent to Blue. ABC Partnership's total resulting capital consists of \$30,000 existing capital of Alt and Blue plus the \$11,000 investment of Cha. No additional capital is recognized by revaluing assets. Because the partners do not revalue the balance sheet, they simply divide the existing (small) pie based on their relative ownership percentages. Thus, Cha's capital account balance will be 25 percent of the small pie, \$10,250.

$$\begin{array}{l} \text{Small pie} = \\ 30,000 + \\ 11,000 = \\ 41,000 \end{array} \times 0.25 = \$10,250$$

The entry to record Cha's admission under the bonus method is as follows:

(15)	Cash	11,000	
	Alt, Capital		450
	Blue, Capital		300
	Cha, Capital		10,250

Admission of Cha with bonus to Alt and Blue.

Alt = $\$750 \times 0.60 = \450

Blue = $\$750 \times 0.40 = \300 .

Cha may dislike the bonus method because her capital balance is \$750 less than her investment in the partnership. This is a disadvantage of the bonus method.

The following schedule presents the key concepts for Case 2:

	Prior Capital	New Partner's Tangible Investment	New Partner's Proportion of Partnership's Book Value (25%)	Total Resulting Capital	New Partner's Share of Total Resulting Capital (25%)
Case 2					
New partner's investment of more than proportionate book value	\$30,000	\$11,000	\$10,250		
1. Revalue assets by increasing land \$3,000				\$44,000	\$11,000
2. Recognize \$3,000 goodwill for original partners				\$44,000	\$11,000
3. Bonus of \$750 to original partners				\$41,000	\$10,250

Case 3: New Partner's Investment Less than Proportion of the Partnership's Book Value

It is possible that a new partner may pay less than his or her proportionate share of the partnership's book value. For example, assume Cha invests \$8,000 for a 25 percent capital interest in the ABC Partnership. The first step is to compare the new partner's investment with her proportionate book value, as follows:

Investment in partnership	\$8,000
New partner's proportionate book value: $(\$30,000 + \$8,000) \times 0.25$	(9,500)
Difference (Investment < Share of book value)	<u>(1,500)</u>

The fact that Cha's investment is less than the book value of a 25 percent interest in the partnership indicates that the partnership has overvalued net assets or the original partners recognize that Cha is contributing additional value in the form of her expertise or skills that the partnership needs. In this case, Cha is investing \$8,000 in cash and an additional amount that may be viewed as goodwill.

As with Case 2, in which the investment is more than the book value acquired, there are two alternative approaches to account for the differential when the investment is less than the book value acquired. The two approaches are as follows:

1. *Revaluation method.* Under this alternative:
 - a. Decrease book values of net assets to recognize the reduction in their values.
 - b. Decrease the original partners' capital accounts for their respective share of the decrease in the values of the net assets.
 - c. Record goodwill or other intangible benefits brought in by the new partner and record the increase in the new partner's capital account.
 - d. Recognize that the partnership's total resulting capital reflects the prior capital balances less the amount of the net asset valuation write-down plus the new partner's investment and new goodwill.
2. *Bonus method.* Under the bonus method:
 - a. The new partner is assigned a bonus from the original partners' capital accounts, which are decreased for their respective shares of the bonus paid to the new partner.
 - b. The partnership's total resulting capital reflects the prior capital balances plus the new partner's investment.

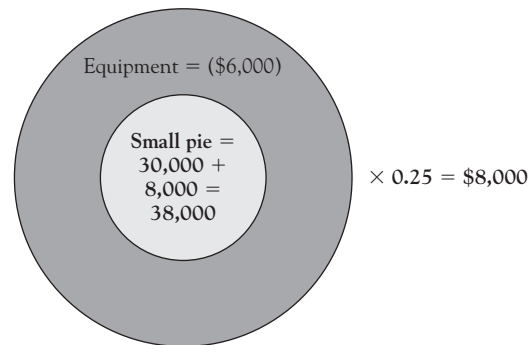
Illustration of Revaluation of Net Assets Approach (GAAP) Almost all of an entity's assets and liabilities have one or more generally accepted accounting principles for recognizing impairment losses or write-downs to fair value. Several examples of these GAAP are recognition of a valuation loss on inventory valued using the lower-of-cost-or-market method, impairment losses on goodwill, impairment losses on long-lived assets used in the business, and losses on financial assets such as investments. Thus, GAAP allows the recognition of decreases in the values of many assets. The process of admitting a new partner is a common time for evaluating the fair values of the partnership's net assets and comparing those values with the book values.

Assume that the reason Cha paid only \$8,000 for a 25 percent interest in the partnership is that equipment used in current production is recorded at a book value of \$14,000 but has a fair value of only \$8,000. The partners agree to recognize the impairment loss and write down the equipment to its fair value before the new partner's admission. The write-down is allocated to the original partners in the profit and loss ratio that existed during the period of the decline in the equipment's fair value: 60 percent to Alt and 40 percent to Blue. The write-down is recorded as follows:

(16)	Alt, Capital	3,600	
	Blue, Capital	2,400	
	Equipment		6,000

Recognize impairment loss on equipment.

Note that the partnership's total capital has now been reduced from \$30,000 to \$24,000 as a result of the \$6,000 write-down. The value of Cha's share of ABC Partnership's total resulting capital, *after the write-down*, is calculated as follows:



In this case, the revaluation actually reduces the size of the pie. Cha's capital account is credited for 25 percent of \$32,000 for \$8,000.

Note that because the "excess value" portion is really negative, the size of the pie is actually shrinking, not growing. The entry to record the admission of Cha as a partner in the ABC Partnership is

(17)	Cash	8,000	
	Cha, Capital		8,000
	Admission of Cha to partnership.		

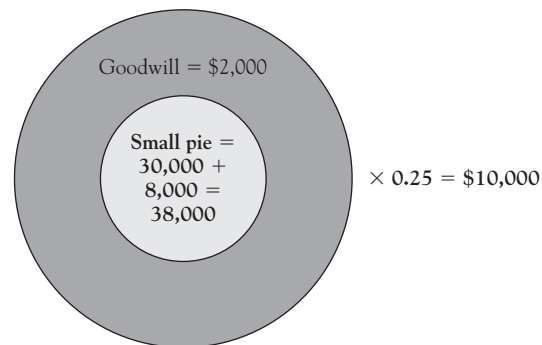
Cha's recorded capital credit is equal to her investment because the total partnership capital of \$32,000 (\$24,000 + \$8,000) now represents the partnership's fair value.

Illustration of Recording Goodwill for New Partner (Non-GAAP) The original partners may offer Cha a 25 percent capital interest in the ABC Partnership for an \$8,000 investment because she has essential business experience, skills, customer contacts, reputation, or other aspects of goodwill that she will bring into the partnership. The amount of goodwill the new partner brings in is usually determined through negotiations between the original partners and the prospective partner. For example, Alt, Blue, and Cha may agree that Cha's abilities will generate excess earnings for the resulting ABC Partnership. They agree that Cha should be given \$2,000 of goodwill recognition when she joins the partnership in recognition of her anticipated excess contribution to the partnership's future earnings. The negotiated goodwill is recognized and added to her tangible investment to determine the amount of capital credit.

Alternatively, the amount of goodwill the new partner brings in may be estimated from the amount of the total capital being retained by the original partners. In this case, they are retaining a 75 percent interest in the partnership and allowing the new partner a 25 percent capital interest. The dollar amount of the original partners' 75 percent interest is \$30,000. Cha's investment of \$8,000 plus goodwill makes up the remaining 25 percent. The amount of goodwill that Cha brought into the partnership is determined as follows:

<i>Step 1</i>	
75% of estimated total resulting capital	\$30,000
Estimated total resulting capital (\$30,000 ÷ 0.75)	<u>\$40,000</u>
<i>Step 2</i>	
Estimated total resulting capital	\$40,000
Total net assets not including goodwill (\$30,000 + \$8,000)	<u>(38,000)</u>
Estimated goodwill	<u>\$ 2,000</u>

Note that the goodwill estimate for the new partner is made using the information from the original partners' interests. In Case 2, the estimate of goodwill to the original partners was made using the information from the new partner's investment. The reason for this difference is that the best available information should be used for the goodwill estimates. If the new partner's goodwill is being estimated, it is not logical to use his or her tangible investment to estimate the total investment he or she made, including goodwill. This is circular reasoning that involves using a number to estimate itself. Furthermore, when goodwill is being assigned to the original partners, it is not logical to use their existing capital to estimate their goodwill. A useful way to remember how to estimate goodwill is to use the opposite partner's information for the estimate. Use the new partner to estimate goodwill to original partners; use them to estimate goodwill to the new partner. Cha's capital account balance will be 25 percent of the newly revalued partnership balance sheet, \$10,000.



The entry to record Cha's admission into the ABC Partnership is

(18)	Cash	8,000	
	Goodwill	2,000	
	Cha, Capital		10,000

Admission of Cha to partnership.

Note that the ABC Partnership's total resulting capital is now \$40,000 with Alt and Blue together having a 75 percent interest and Cha having a 25 percent interest.

Illustration of Bonus Method (GAAP) Cha's admission as a new partner with a 25 percent interest in the ABC Partnership for an investment of only \$8,000 may be accounted for by recognizing a bonus the original partners give Cha. The \$1,500 bonus is the difference between Cha's \$9,500 book value and her \$8,000 investment. The original partners' capital accounts are reduced by \$1,500 in their profit and loss ratio of 60 percent for Alt and 40 percent for Blue, and Cha's capital account is credited for \$9,500, as follows:

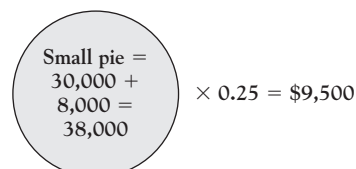
(19)	Cash	8,000	
	Alt, Capital	900	
	Blue, Capital	600	
	Cha, Capital		9,500

Admission of Cha to partnership.

Alt = $\$1,500 \times 0.60 = \900

Blue = $\$1,500 \times 0.40 = \600 .

Note that the amount of the capital credit assigned to the new partner is her share of the total resulting capital (the small pie) because the partners did not elect to revalue the balance sheet other than to record Cha's capital contribution.



The following schedule presents the key concepts for Case 3:

	Prior Capital	New Partner's Tangible Investment	New Partner's Proportion of Partnership's Book Value (25%)	Total Resulting Capital	New Partner's Share of Total Resulting Capital (25%)
Case 3					
New partner's investment less than proportionate book value	\$30,000	\$8,000	\$9,500		
1. Revalue assets by decreasing equipment by \$6,000				\$32,000	\$ 8,000
2. Recognize goodwill of \$2,000 for new partner				\$40,000	\$10,000
3. Bonus of \$1,500 to new partner				\$38,000	\$ 9,500

Summary and Comparison of Accounting for Investment of New Partner

See Figure 15–2 for the entries made in each of the three cases discussed. In addition, the capital balance of each of the three partners immediately after Cha's admission is presented to the right of the journal entries.

The following summarizes the alternative methods of accounting for the investment of a new partner:

Case 1: New partner's investment equals his or her proportion of the partnership's book value.

1. The new partner's capital credit equals his or her investment.
2. This case recognizes no goodwill or bonus.

Case 2: New partner's investment is more than his or her proportion of the partnership's book value.

1. The revaluation of an asset (or recognition of goodwill) increases the partnership's total resulting capital. The increase is allocated to the existing partners in their profit and loss ratio.
2. After recognition of the asset revaluation or unrecorded goodwill, the new partner's capital credit equals his or her investment and his or her percentage of the total resulting capital.
3. Under the bonus method, the partnership's total resulting capital is the sum of the existing partnership's capital plus the new partner's investment. The capital credit recorded for the new partner is less than the investment but equals his or her percentage of the resulting partnership capital.

Case 3: New partner's investment is less than his or her proportion of the partnership's book value.

1. Under the revaluation of assets approach, the write-down of the assets reduces the existing partners' capital in their profit and loss ratio. The new partner's capital is then credited for the amount of the investment. Moreover, the goodwill is assigned to the new partner, increasing the partnership's total resulting capital. The new partner's capital is credited for his or her percentage interest in the partnership's total resulting capital.
2. The bonus method results in a transfer of capital from the existing partners to the new partner. The new partnership's total resulting capital equals the prior capital plus the new partner's investment. The new partner's capital credit is more than the investment made but equals his or her percentage of the total resulting capital.

FIGURE15-2
Summary of
Accounting for
Investment of New
Partner: Journal
Entries and Capital
Balances after
Admission of New
Partner

Case 1: New partner's investment equals proportionate book value. Cha invests \$10,000 cash for 25 percent capital interest.

Cash	10,000
Cha, Capital	10,000

Alt	\$20,000
Blue	10,000
Cha	<u>10,000</u>
Total	<u>\$40,000</u>

Case 2: New partner's investment is more than proportionate book value. Cha invests \$11,000 cash for 25 percent capital interest.

(a) *Revalue net assets: (upward):*

Land	3,000
Alt, Capital	1,800
Blue, Capital	<u>1,200</u>

Alt	\$21,800
Blue	11,200
Cha	<u>11,000</u>

Cash	11,000
Cha, Capital	11,000

Total	<u>\$44,000</u>
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(b) *Recognize goodwill for original partners:*

Goodwill	3,000
Alt, Capital	1,800
Blue, Capital	<u>1,200</u>

Alt	\$21,800
Blue	11,200
Cha	<u>11,000</u>

Cash	11,000
Cha, Capital	11,000

Total	<u>\$44,000</u>
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(c) *Bonus to original partners:*

Cash	11,000
Alt, Capital	450
Blue, Capital	300
Cha, Capital	<u>10,250</u>

Alt	\$20,450
Blue	10,300
Cha	<u>10,250</u>
Total	<u>\$41,000</u>

Case 3: New partner's investment is less than proportionate book value. Cha invests \$8,000 cash for a 25 percent capital interest.

(a) *Revalue net assets: (downward)*

Alt, Capital	3,600
Blue, Capital	2,400
Equipment	<u>6,000</u>

Alt	\$16,400
Blue	7,600
Cha	<u>8,000</u>

Cash	8,000
Cha, Capital	8,000

Total	<u>\$32,000</u>
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(b) *Recognize goodwill for new partner:*

Cash	8,000
Goodwill	2,000
Cha, Capital	<u>10,000</u>

Alt	\$20,000
Blue	10,000
Cha	<u>10,000</u>

Total	<u>\$40,000</u>
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(c) *Bonus to new partner:*

Cash	8,000
Alt, Capital	900
Blue, Capital	600
Cha, Capital	<u>9,500</u>

Alt	\$19,100
Blue	9,400
Cha	<u>9,500</u>
Total	<u>\$38,000</u>



Determining a New Partner's Investment Cost

The previous sections have provided the amount of the new partner's contribution. In some instances, accountants are requested to determine the amount of cash investment by asking the new partner to contribute. The basic principles of partnership accounting provide the means to answer this question. For example, let's continue the basic example of partners Alt and Blue wishing to admit Cha as a new partner. The original partnership capital was \$30,000, and the partners wish to invite Cha into the partnership for a 25 percent interest.

Assume that the original partners, Alt and Blue, agree that the partnership's assets should be revalued up by \$3,000 to recognize the increase in value of the land the partnership holds. The question is how much Cha, the new partner, should be asked to invest for her 25 percent interest.

When determining the new partner's investment cost, it is important to note the partnership's total resulting capital and the percentage of ownership interest the existing partners retain. In this example, they retain a 75 percent interest in the resulting partnership, for which their 75 percent capital interest is \$33,000, the \$30,000 of existing capital plus the \$3,000 from the revaluation of the land, as follows:

75% of total resulting capital	\$33,000
	÷ 0.75
Total resulting capital (100%)	\$44,000
Less existing partners' capital	(33,000)
Cash contribution required of new partner	<u>\$11,000</u>

Note that this is simply another way to evaluate the admission process as discussed in the net asset revaluation illustration under Case 2.

In some cases, the bonus amount may be determined prior to determining the new partner's required cash contribution. For example, assume that Alt and Blue agree to give Cha a bonus of \$1,500 for joining the partnership. The following schedule determines the cash investment amount required of Cha, the new partner:

Prior capital of Alt and Blue	\$30,000
Less bonus given to Cha upon admission	(1,500)
Capital retained by Alt and Blue (75%)	<u>\$28,500</u>
Total resulting capital (\$28,500 ÷ 0.75)	\$38,000
Less original partners' capital	(28,500)
Capital credit required of new partner	\$ 9,500
Less bonus to new partner from original partners	(1,500)
Cash contribution required of new partner	<u>\$ 8,000</u>

This second example is another way to view the bonus-to-new-partner method under Case 3 as presented. The key is to determine the amount of capital that the existing partners will retain for their percentage share in the partnership's total resulting capital after admitting the new partner. The new partner's cash contribution can be computed simply by determining the amount of the capital credit that will be assigned to him or her and then recognizing any bonuses that will be used to align the capital balances.

Dissociation of a Partner from the Partnership

When a partner retires or withdraws from a partnership, that partner is dissociated from the partnership. In most cases, the partnership purchases the dissociated partner's interest

in the partnership for a buyout price. Section 701 of the UPA 1997 states that the buyout price is the estimated amount if (1) the partnership's assets were sold at a price equal to the higher of the liquidation value or the value based on a sale of the entire business as a going concern without the dissociated partner and (2) the partnership was wound up at that time with all partnership obligations settled. Note that goodwill may be included in the valuation. The partnership must pay interest to the dissociated partner from the date of dissociation to the date of payment. In cases of wrongful dissociation, the partnership may sue the partner for damages the wrongful dissociation causes the partnership.

In the case in which the partnership agrees to the dissociation and it is not wrongful, the accountant can aid in computing the buyout price. It is especially important to determine all existing liabilities on the dissociation date. The partnership agreement may include other procedures to use in the case of a partner dissociation, such as the specifics of valuation, the process of the acquisition of the dissociated partner's transferable value, and other aspects of the change in membership process.

Some partnerships have an audit performed when a change in partners is made. This audit establishes the existence of and the accuracy of the book values of the assets and liabilities. On occasion, accounting errors are found during an audit. Errors should be corrected and the partners' capital accounts adjusted based on the profit and loss ratio that existed in the period in which the errors were made. For example, if an audit disclosed that three years ago depreciation expense was charged for \$4,000 less than it should have been, the error is corrected retroactively, and the partners' capital accounts are charged with their respective shares of the adjustment based on their profit and loss ratio of three years ago.

Generally, the continuing partners buy out the retiring partner either by making a direct acquisition or by having the partnership acquire the retiring partner's interest. If the continuing partners directly acquire the retiring partner's interest, the only entry on the partnership's books is to record the reclassification of capital among the partners. If the partnership acquires the retiring partner's interest, the partnership must record the reduction of total partnership capital and the corresponding reduction of assets paid to the retiring partner. Computation of the buyout price when a partner dissociates from the partnership can take the form of three possible scenarios. These are discussed next.

1. Buyout Price Equal to Partner's Capital Credit

Assume Alt retires from the ABC Partnership when his capital account has a balance of \$55,000 after recording all increases in the partnership's net assets including income earned up to the date of the retirement. All partners agree to \$55,000 as the buyout price of Alt's partnership interest. The entry made by the ABC Partnership is

(20)	Alt, Capital	55,000	
	Cash		55,000
	Retirement of Alt.		

If the partnership is unable to pay the total of \$55,000 to Alt at the time of retirement, it must recognize a liability for the remaining portion.

2. Buyout Price Higher than Partner's Capital Credit

Assume Alt has a capital credit of \$55,000 and all the partners agree to a buyout price of \$65,000. Most partnerships would account for the \$10,000 payment above Alt's capital credit (\$65,000 paid – \$55,000) as a capital adjustment bonus to Alt from the capital accounts of the remaining partners. In this case, the \$10,000 would be allocated against the capital accounts of Blue and Cha in their profit ratio. Blue has a 30 percent interest, and Cha has a 25 percent interest in ABC Partnership's net income. The sum of their respective shares is 55 percent (30 percent + 25 percent), and their relative profit percentages, rounded to the nearest percentage, are 55 percent for Blue and 45 percent for Cha, computed as follows:

	Prior Profit Percentage	Remaining Profit Percentage
Alt	45	0
Blue	30	55 (30/55)
Cha	25	45 (25/55)
Total	100	100

The entry to record Alt's retirement is

(21)	Alt, Capital	55,000	
	Blue, Capital	5,500	
	Cha, Capital	4,500	
	Cash		65,000
	Retirement of Alt.		

The \$10,000 bonus paid to Alt is allocated to Blue and Cha in their respective profit ratios. Blue is charged for 55 percent, and Cha is charged for the remaining 45 percent.

Occasionally, a partnership uses the retirement of a partner to record unrecognized goodwill. In this case, the partnership may record the retiring partner's share only, or it may impute the entire amount of goodwill based on the retiring partner's profit percentage. If it imputes total goodwill, the remaining partners also receive their respective shares of the total goodwill recognized. Many accountants criticize recording goodwill on the retirement of a partner on the same theoretical grounds as they criticize recording unrecognized goodwill on the admission of a new partner. Nevertheless, partnership accounting sometimes uses all the recognition of goodwill at this event.

For example, if \$65,000 is paid to Alt and only his share of unrecognized goodwill is to be recorded, the partnership makes the following entries at the time of his retirement:

(22)	Goodwill	10,000	
	Alt, Capital		10,000
	Recognize Alt's share of goodwill.		
(23)	Alt, Capital	65,000	
	Cash		65,000
	Retirement of Alt.		

3. Buyout Price Less than Partner's Capital Credit

Sometimes, the buyout price is less than a partner's capital credit. This could result if liquidation values of net assets are less than their book values or because the dissociating partner wishes to leave the partnership badly enough to accept less than his or her current capital balance. For example, Alt agrees to accept \$50,000 as the buyout price for his partnership interest. The partnership should evaluate its net assets to determine whether any impairments or write-downs should be recognized. If no revaluations of the net assets are necessary, then the \$5,000 difference (\$50,000 cash paid less \$55,000 capital credit) is distributed as a capital adjustment to Blue and Cha in their respective profit and loss ratio.

(24)	Alt, Capital	55,000	
	Blue, Capital		2,750
	Cha, Capital.		2,250
	Cash		50,000
	Retirement of Alt.		

Summary of Key Concepts

Accounting for partnerships recognizes the unique aspects of this form of business organization. Most states have enacted the major provisions of the Uniform Partnership Act of 1997 (UPA 1997), which delineates the rights and responsibilities of the partners, both with third parties and among the partners, and the rights of third parties, such as creditors, with the partnership. A partnership agreement is very important because many sections of the UPA 1997 can be waived with a formal partnership agreement. The partnership also should file a Statement of Partnership Authority with the secretary of the state and the clerk of the county in which the partnership business takes place. The UPA 1997 includes sections stating that the partnership is an entity distinct from its partners, that partners are the partnership's agents, that partners are personally liable for the partnership obligations that exceed its assets, that partnership profits or losses are shared equally, and that a partner may dissociate, in which case that partner no longer may share in the partnership's management.

Partnerships use a wide variety of profit or loss distribution methods, and accountants must ensure that the partnership agreement is followed closely. Most partnerships continue in business when a partner dissociates (leaves the partnership) by purchasing that partner's interest at a buy-out price based on the partnership's value were it to wind up its business. Several accounting methods are used to account for changes in partnership membership. Some partnerships use a net asset revaluation approach, sometimes including goodwill recognition. The other major accounting approach used to account for changes in membership is the bonus method, which uses a reclassification of partner capital. Partnerships provide four financial statements: the income statement, the balance sheet, the statement of cash flows, and a statement of partners' capital that presents the changes in the partners' capital accounts during the period.

Key Terms

admission of a new partner, 764	interest on capital balances, 759	salary, 759
bonus, 759	new partner's proportion of the partnership's net book value, 769	statement of partners' capital, 763
bonus method, 765	partners' accounts, 757	Statement of Partnership Authority, 752
book value of a partnership, 766	partner's dissociation, 753	transferable interest, 753
buyout price, 764	preselected ratio, 758	Uniform Partnership Act of 1997
entity concept, 752	profit distribution plans, 758	(UPA 1997), 751
goodwill	revaluation method, 765	
recognition method, 765		

Appendix 15A Tax Aspects of a Partnership

The Internal Revenue Service views the partnership form of organization as a temporary aggregation of some of the individual partners' rights. The partnership is not a separate taxable entity. Therefore, the individual partners must report their share of the partnership income or loss on their personal tax returns, whether withdrawn or not. This sometimes creates cash flow problems for partners who leave their share of income in the partnership and permit the firm to use their share for growth. In such cases, the partners must pay income tax on income that was not distributed to them. However, this tax conduit feature also offers special tax features to the individual partners. For example, charitable contributions made by the partnership are reported on the partners' individual tax returns. Also, any tax-exempt income earned by the partnership is passed through to the individual partners.

This pass-through benefits individual partners when the business has an operating loss. The individual partners can recognize their shares of the partnership loss on their own tax returns, thereby offsetting other taxable income. If the business is incorporated, the loss does not pass through to the stockholders.

TAX BASIS OF ASSET INVESTMENTS

For capital investments, the accounting basis and the tax basis are computed differently. For tax purposes, a partnership must value the assets invested in it at the tax basis of the individual partner who invests the assets. For example, assume that partner A contributes a building to the AB

Partnership. The building originally cost \$6,000 and has been depreciated \$2,000, leaving a book value of \$4,000. The building has a market value of \$10,000. For tax purposes, the partnership records the building at \$4,000, partner A's adjusted basis.

This tax valuation differs from the amount that is recognized under generally accepted accounting principles. A basic GAAP concept is to value asset transfers between separate reporting entities at their respective fair market values. In this case, the partnership records the building at its \$10,000 fair value for accounting purposes. Most partnerships maintain their accounting records and financial statements using GAAP, and they use a separate adjusting schedule at the end of each period to report the results for tax purposes on Form 1065, the partnership tax information form.

In addition to asset transfers, a partnership also may assume the liabilities associated with an asset. For example, if the building was subject to a \$2,000 mortgage, which the AB Partnership assumed with the building, partner A benefits because the other partners have assumed a portion of the mortgage that A originally owed entirely.

A partner's tax basis in a partnership is the sum of the following:

The partner's tax basis of any assets contributed to the partnership.

Plus: The partner's share of other partners' liabilities assumed by the partnership.

Less: The amount of the partner's liabilities assumed by the other partners.

To illustrate, A contributes the building discussed, which has an adjusted tax basis of \$4,000 (\$6,000 cost less \$2,000 depreciation) and is subject to a mortgage of \$2,000. The building's market value is \$10,000. B contributes machinery that has a book value of \$15,000 and a market value of \$20,000 and is subject to a note payable of \$5,000. The partners agree to share equally in the liabilities assumed by the AB Partnership. The tax basis of each partner in the partnership is calculated as follows:

	Partner A	Partner B
Tax basis of assets contributed	\$4,000	\$15,000
Partner's share of other partner's liabilities assumed by partnership:		
Partner A: (1/2 of \$5,000)	2,500	
Partner B: (1/2 of \$2,000)		1,000
Partner's liabilities assumed by other partners:		
Partner A: (1/2 of \$2,000)	(1,000)	
Partner B: (1/2 of \$5,000)		(2,500)
Tax basis of partner's interest	<u>\$5,500</u>	<u>\$13,500</u>

Each partner's tax basis is used for tax recognition of gains or losses on subsequent disposals of the partner's investment in the partnership.

For GAAP purposes, each partner's investment is based on the fair value of the assets less liabilities assumed. Thus, in the preceding case, partner A's accounting basis is \$8,000 (\$10,000 market value of the building less \$2,000 mortgage), and partner B's accounting basis is \$15,000 (\$20,000 market value of the equipment less \$5,000 note payable). Any asset disposal gain or loss in the accounting financial statements is based on the valuations made using GAAP. A separate schedule of tax bases for each of the partners is typically maintained in case the information is required for a partner's individual tax return.

S CORPORATIONS AND LIMITED LIABILITY COMPANIES

An *S corporation* is a corporate entity that elects to be taxed in the same manner as a partnership with the shareholders including their share of corporate income or loss in their personal returns whether or not the income has been distributed as dividends. This eliminates the double taxation of corporate income: first, as taxable income to the corporation and, second, as taxable dividend income to the shareholder. The S corporation form provides the shareholders the liability limitation of an investment in a corporation. The Internal Revenue Service has certain qualifying criteria for S corporation status: (1) a maximum of 75 shareholders, all of whom must be either U.S. citizens or permanent resident aliens, is permitted, (2) only one class of stock may be issued, and (3) no more than 25 percent of the corporation's gross income can be derived from passive investment activities.

A *limited liability company* (LLC) is form of corporate entity governed by the laws of the state in which it is formed. The LLC provides liability protection to its investors as well as the pass-through taxation benefits of partnerships and S corporations. However, each state has its own distinct set of laws governing LLCs whereas the IRS has just one set of definitions for an S corporation.

Appendix 15B Joint Ventures

A *joint venture* usually is a business entity owned and operated by a small group of investors as a separate and specific business project organized for the mutual benefit of the ownership group. Many joint ventures are short-term associations of two or more parties to fulfill a specific project, such as the development of real estate, joint oil or gas drilling efforts, the financing of a joint production center, or the financing of a motion picture effort. Many international efforts to expand production or markets involve joint ventures either with foreign-based companies or with foreign governments. A recent phenomenon is the formation of research joint ventures in which two or more corporations agree to share the costs and eventual research accomplishments of a separate research laboratory. The venturers might not have equal ownership interests; a venturer's share could be as low as 5 or 10 percent or as high as 90 or 95 percent. Many joint ventures of only two venturers, called *50 percent-owned ventures*, divide the ownership share equally.

A joint venture may be organized as a corporation, partnership, or undivided interest. A corporate joint venture is usually formed for long-term projects such as developing and sharing of technical knowledge among a small group of companies. The incorporation of the joint venture formalizes the legal relationships between the venturers and limits each investor's liability to the amount of her or his investment in the venture. The venture's stock is not traded publicly, and the venturers usually have other business transactions between them. Accounting for a corporate joint venture is guided by **ASC 323** which requires that investors use the equity method to account for their investments in the common stock of corporate joint ventures.

When one corporation controls another, the controlled corporation is considered a subsidiary rather than a corporate joint venture even if it has a small number of other owners. A subsidiary should be consolidated by the controlling owner, and a noncontrolling interest recognized for the interests of other owners.

A partnership joint venture is accounted for as any other partnership. All facets of partnership accounting presented in the chapter apply to these partnerships, each of which has its own accounting records. Some joint ventures are accounted for on one of the venturer's books; however, this combined accounting does not fully reflect the fact that the joint venture is a separate reporting entity. Each partner, or venturer, maintains an investment account on its books for its share of the partnership venture capital. The investment in the partnership account is debited for the initial investment and for the investor's share of subsequent profits. Withdrawals and shares of losses are credited to the investment account; its balance should correspond to the balance in the partner's capital account shown on the joint venture partnership's statements.

ASC 323, states that intercompany profits should be eliminated and the investor-partners should record their shares of the venture's income or loss in the same manner as with the equity method. For financial reporting purposes, if one of the investor-venturers in fact controls the joint venture, she or he should consolidate the joint venture into its financial statements. If all investor-venturers maintain joint control, then the one-line equity method should be used to report the investment in the joint venture.

Accounting for unincorporated joint ventures that are undivided interests usually follows the accounting method used by partnerships. An *undivided interest* exists when each investor-venturer owns a proportionate share of each asset and is proportionately liable for its share of each liability. Some established industry practices, especially in oil and gas venture accounting, provide for a pro rata recognition of a venture's assets, liabilities, revenue, and expenses. For example, assume that both A Company and B Company are 50 percent investors in a joint venture, called JTV, for the purposes of oil exploration. The JTV venture has plant assets of \$500,000 and long-term liabilities of \$200,000. Therefore, both A Company and B Company have an investment of \$150,000 ($\$300,000 \times 0.50$).

Under the method, the balance sheets of both A and B companies report the investment as a \$150,000 investment in joint venture.

International Accounting Standard No. 31, “Interests in Joint Ventures” (IAS 31), specifies the reporting of joint ventures under international accounting financial reporting standards. **IAS 31** identifies three types of joint ventures: (1) *jointly controlled operations*, for which each venturer recognizes the assets that it controls and the liabilities and the expenses it incurs and its share of the joint venture’s income, (2) *jointly controlled assets*, for which each venturer recognizes its share of the jointly controlled assets, any liabilities it has incurred plus its share of any liabilities the joint venture incurred, and its share of the income together with its share of the expenses incurred from the joint venture’s operations plus any expenses that the individual venturer has incurred from its interest in the joint venture, and (3) *jointly controlled entities*, for which each venturer recognizes its interest in the joint venture using proportionate consolidation or the equity method.

Under the proportionate consolidation method, each venturer recognizes a pro rata share of the assets, liabilities, income, and expenses of the jointly controlled entity. This approach is illustrated in the JTV example. In this case, assets of \$250,000 ($\$500,000 \times 0.50$) and liabilities of \$100,000 ($\$200,000 \times 0.50$) are added to the present assets and liabilities of each investor-venturer. The proportionate share of the assets and liabilities should be added to similar items in the investor’s financial statements. The same pro rata method is also used for the joint venture’s revenue and expenses. A comparison of the equity method and the proportionate consolidation for venturer A Company is presented in Figure 15–3.

Joint ventures provide their investors flexibility as to management, operations, and the division of profits or losses. However, companies need to be aware of **ASC 810**. When an investor does not have a majority stock ownership, contractual or other agreements may specify the allocation of the entity’s profits or losses. **ASC 810** specifies that consolidation of a variable interest entity (VIE) is required if an investor will absorb a majority of its expected losses or receive a majority of the entity’s expected return. Therefore, an equity investor not having a controlling financial interest may be determined to be the primary beneficiary of the VIE and thus be required to fully consolidate that entity.

Real estate development is often conducted through joint ventures. Accounting for noncontrolling interests in real estate joint ventures is guided by **ASC 970**, which recommends the use of the equity method to account for noncontrolling investments in corporate or noncorporate real estate ventures.

A joint venture also makes footnote disclosures to present additional details about the its formation and operation, its methods of accounting, and a summary of its financial position and earnings.

Another form of business association is the *syndicate*, which is usually short term and has a defined single purpose, such as developing a financing proposal for a corporation. Syndicates are typically very informal; nevertheless, the legal relationships between the parties should be clearly specified before beginning the project.

FIGURE 15–3
Comparative Balance
Sheets for Reporting a
Joint Venture

	Balance Sheets of A Company		
	Before Joint Venture	Equity Method	Proportionate Consolidation
Current Assets	\$250	\$100	\$100
Property, Plant, & Equipment	400	400	650
Investment in Joint Venture	0	150	0
Total	<u>\$650</u>	<u>\$650</u>	<u>\$750</u>
Current Liabilities	\$100	\$100	\$100
Long-Term Debt	300	300	400
Stockholders’ Equity	250	250	250
Total	<u>\$650</u>	<u>\$650</u>	<u>\$750</u>

Questions

- LO 15-1** **Q15-1** Why is the partnership form of business organization sometimes preferred over the corporate or sole proprietorship forms?
- LO 15-1** **Q15-2** What is the Uniform Partnership Act of 1997 and what is its relevance to partnership accounting?
- LO 15-1** **Q15-3** What items are typically included in the partnership agreement?
- LO 15-1** **Q15-4** Define the following features of a partnership: (a) separate business entity, (b) agency relationship, and (c) partner's joint and several liability.
- LO 15-4** **Q15-5** Under what circumstances would a partner's capital account have a debit, or deficiency, balance? How is the deficiency usually eliminated?
- LO 15-5** **Q15-6** A partnership agreement specifies that profits will be shared in the ratio of 4:6:5. What percentage of profits will each partner receive? Allocate a profit of \$60,000 to each of the three partners.
- LO 15-5** **Q15-7** The Good-Nite partnership agreement includes a provision for profit distribution of interest on capital balances. Unfortunately, the provision does not state the specific capital balance to be used in computing the profit share. What choices of capital balances are available to the partners? What is the preferred capital balance to be used in an interest allocation? Why?
- LO 15-4** **Q15-8** Are salaries to partners a partnership expense? Why or why not?
- LO 15-6** **Q15-9** Does a partner leaving the partnership require the partnership to dissolve and wind up its business? Explain how the partnership may purchase the dissociated partner's interest in the partnership.
- LO 15-6** **Q15-10** What is the book value of a partnership? Does book value also represent its market value?
- LO 15-6** **Q15-11** Present the arguments for and against the bonus method of recognizing the admission of a new partner.
- LO 15-6** **Q15-12** In which cases of a new partner's admission does the credit to capital equal the new partners' investment? In which cases of a new partner's admission is his or her capital credit less than or more than the amount of the investment?
- LO 15-5** **Q15-13** Aabel, a partner in the ABC Partnership, receives a bonus of 15 percent of income. If income for the period is \$20,000, what is Aabel's bonus, assuming that it is computed as a percentage of income *before* the bonus? What is the bonus if it is computed as a percentage of income *after* deducting the bonus?
- LO 15-6** **Q15-14** Caine, a new partner in the ABC Partnership, has invested \$12,000 for a one-third interest in a partnership with capital of \$21,000 before Caine's admission. What is the ABC Partnership's implied fair value? If the partners agree to recognize goodwill for the difference between the book value and fair value, present the entries the ABC Partnership should make upon Caine's admission.
- Q15-15A** S. Horton contributes assets with a book value of \$5,000 to a partnership. The assets have a market value of \$10,000 and a remaining liability of \$2,000 that the partnership assumes. If the liability is shared equally with the other three partners, what is the basis of Horton's contribution for tax purposes? For GAAP purposes?
- Q15-16B** What is a joint venture? How are corporate joint ventures accounted for on the books of the investor companies?

Cases

LO 15-1, 15-5 **C15-1 Partnership Agreement**

Judgment

Nitty and Gritty are considering the formation of a partnership to operate a crafts and hobbies store. They have come to you to obtain information about the basic elements of a partnership agreement. These agreements usually specify an income and loss-sharing ratio. They also may

"A" indicates that the item relates to Appendix 15A, and "B" indicates that the item relates to Appendix 15B.

provide for additional income and loss-sharing features such as salaries, bonuses, interest allowances on invested capital.

Required

- Discuss why a partnership agreement may need features in addition to the income and loss-sharing ratio.
- Discuss the arguments in favor of recording salary and bonus allowances to partners as expenses included in computing net income.
- What are the arguments against recording salary and bonus allowances to partners as partnership expenses?
- Some partnership agreements provide for interest on invested capital in distributing income to the individual partners. List the additional provisions that should be included so the interest amounts can be computed.

LO 15-6

C15-2 Comparisons of Bonus, Goodwill, and Asset Revaluation Methods

Bill, George, and Anne are partners in the BGA Partnership. A difference of opinion exists among the partners as to how to account for Newt's admission as a new partner. The three present partners have the following positions:

Communication

Bill wants to use the bonus method.

George believes the goodwill method is best.

Anne wants to revalue the existing tangible assets.

You have been called in to advise the three partners.

Required

Prepare a memo discussing the three different methods of accounting for the admission of a new partner, including consideration of the effects on partnership capital in the year Newt is admitted and on the capital balances in future years.

LO 15-1

C15-3 Uniform Partnership Act Issues

(*Note:* Obtain a copy of the Uniform Partnership Act of 1997 [UPA 1997] for answering this case question. The UPA 1997 can be obtained from your university's general library, law library, or the Internet.)

Research

You are in a group that is considering forming a partnership to purchase a coffee shop located near your campus. The coffee shop offers freshly brewed coffee and rolls in the morning and soup and sandwiches the remainder of the day. During your preliminary discussions, several issues have emerged for which your group needs additional information.

Required

Research and provide a written summary for the following:

- Does every partner in fact have the right to serve as an agent of the partnership and bind the partnership by that individual partner's actions in carrying out the partnership business?
- If a new partner is admitted after the partnership operates for a time, what is the new partner's liability for partnership obligations arising before his or her admission? What is the new partner's liability for obligations of the partnership incurred after his or her admission?
- Should all partners be able to examine the accounting records (the partnership's books) at any time?
- What happens if the term of the partnership is set at one year and the partners decide to continue doing business? Is a new partnership agreement necessary at that time?
- What happens if an individual partner wishes to leave the partnership? Can that person just announce to the other partners that he or she no longer wishes to be in the partnership and will not be liable for any future partnership obligations? What are the rights of the other partners in this matter?
- What items do you believe should be in the partnership agreement prepared before actually agreeing to form the partnership?

LO 15-1

C15-4 Defining Partners' Authority*Understanding*

Adam, Bob, and Cathy are planning to form a partnership to create a business that will retail cell phones in a new shopping center just completed in their city. They have been able to reach agreement on many issues, but Cathy is still concerned that Adam might become a little irresponsible and use his position as a partner and the partnership's name in business transactions that Cathy would not approve for the partnership. Cathy feels that Adam has superb marketing skills that will benefit the business, but she wonders what he might do in regard to transactions with third parties on behalf of the partnership.

Required

Prepare a memo to Cathy discussing each partner's rights to engage in transactions on behalf of the partnership and how a partnership can restrict a partner's authority to engage in specific types of transactions.

LO 15-4, 15-5

C15-5 Preferences for Using GAAP for Partnership Accounting*Understanding*

You are providing accounting services for the JR Company partnership. The two partners, Jason and Richard, are thinking of adding a third partner to their business, and they have several questions regarding the use of GAAP for their partnership.

Required

Prepare a memo for the partners addressing each of their questions.

- Why are salaries to partners not shown on the partnership's income statement prepared using GAAP?
- Why should the partnership use GAAP to account for the admission of a new partner? Why is it not preferable for the partnership to recognize holding gains on its long-lived assets at the time of admitting the third partner? (The two partners argue that recognizing these gains now would allocate them to the partners who were growing the business prior to a new partner's admission.)
- Why should the partners and the partnership fully analyze all the partnership's liabilities to ensure that there are no unrecognized liabilities when a new partner is admitted? (The two partners feel this is an unnecessary cost because an unpaid supplier will simply send another bill in the future.)

Exercises

LO 15-3

E15-1 Multiple-Choice on Initial Investment [AICPA Adapted]

Select the correct answer for each of the following questions.

- On May 1, 20X1, Cathy and Mort formed a partnership and agreed to share profits and losses in the ratio of 3:7, respectively. Cathy contributed a parcel of land that cost her \$10,000. Mort contributed \$40,000 cash. The land was sold for \$18,000 immediately after the partnership's formation. What amount should be recorded in Cathy's capital account at the time the partnership is formed the partnership's?
 - \$18,000.
 - \$17,400.
 - \$15,000.
 - \$10,000.
- On July 1, 20X1, James and Short formed a partnership. James contributed cash. Short, previously a sole proprietor, contributed property other than cash, including realty subject to a mortgage, which the partnership assumed. Short's capital account on July 1, 20X1, should be recorded at
 - Short's book value of the property on July 1, 20X1.
 - Short's book value of the property less the mortgage payable on July 1, 20X1.
 - The property's fair value less the mortgage payable on July 1, 20X1.
 - The property's fair value on July 1, 20X1.

3. Two individuals who were previously sole proprietors form a partnership. Property other than cash that is part of the initial investment in the partnership is recorded for financial accounting purposes at the
- Proprietors' book values or the property's fair value on the date of the investment, whichever is higher.
 - Proprietors' book values or the property's fair value on the date of the investment, whichever is lower.
 - Proprietors' book values of the property on the date of the investment.
 - Property's fair value at the date of the investment.
4. Mutt and Jeff formed a partnership on April 1 and contributed the following assets:

	Mutt	Jeff
Cash	\$150,000	\$ 50,000
Land		310,000

The land was subject to a \$30,000 mortgage, which the partnership assumed. Under the partnership agreement, Mutt and Jeff share profit and loss in the ratio of one-third and two-thirds, respectively. Jeff's capital account at April 1 should be

- \$300,000.
 - \$330,000.
 - \$340,000.
 - \$360,000.
5. On July 1, Mabel and Pierre formed a partnership, agreeing to share profits and losses in the ratio of 4:6, respectively. Mabel contributed a parcel of land that cost her \$25,000. Pierre contributed \$50,000 cash. The land was sold for \$50,000 on July 1, four hours after formation of the partnership. How much should be recorded in Mabel's capital account on the partnership formation?
- \$10,000.
 - \$20,000.
 - \$25,000.
 - \$50,000.

LO 15-5

E15-2 Division of Income—Multiple Bases

The partnership agreement of Angela and Dawn has the following provisions:

- The partners are to earn 10 percent on the average capital.
- Angela and Dawn are to earn salaries of \$25,000 and \$15,000, respectively.
- Any remaining income or loss is to be divided between Angela and Dawn using a 70:30 ratio.

Angela's average capital is \$50,000 and Dawn's is \$30,000.

Required

Prepare an income distribution schedule assuming the income of the partnership is (a) \$80,000 and (b) \$20,000. If no partnership agreement exists, what does the UPA 1997 prescribe as the profit or loss distribution percentages?



LO 15-5

E15-3 Division of Income—Interest on Capital Balances

Left and Right are partners. Their capital accounts during 20X1 were as follows:

Left, Capital				Right, Capital			
8/23	6,000	1/1	30,000	3/5	9,000	1/1	50,000
		4/3	8,000			7/6	7,000
		10/31	6,000			10/7	5,000

Partnership net income is \$50,000 for the year. The partnership agreement provides for the division of income as follows:

1. Each partner is to be credited 8 percent interest on his or her average capital.
2. Any remaining income or loss is to be divided equally.

Required

Prepare an income distribution schedule.

LO 15-5

E15-4 Distribution of Partnership Income and Preparation of a Statement of Partners' Capital

The income statement for the Apple-Jack Partnership for the year ended December 31, 20X5, follows:



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APPLE-JACK PARTNERSHIP Income Statement For the Year Ended December 31, 20X5	
Net Sales	\$300,000
Cost of Goods Sold	(190,000)
Gross Margin	\$110,000
Operating Expenses	(30,000)
Net Income	<u>\$ 80,000</u>

Additional Information for 20X5

1. Apple began the year with a capital balance of \$40,800.
2. Jack began the year with a capital balance of \$112,000.
3. On April 1, Apple invested an additional \$15,000 into the partnership.
4. On August 1, Jack invested an additional \$20,000 into the partnership.
5. Throughout 20X5, each partner withdrew \$400 per week in anticipation of partnership net income. The partners agreed that these withdrawals are *not* to be included in the computation of average capital balances for purposes of income distributions.

Apple and Jack have agreed to distribute partnership net income according to the following plan:

	Apple	Jack
1. Interest on average capital balances	6%	6%
2. Bonus on net income before the bonus but after interest on average capital balances	10%	
3. Salaries	\$25,000	\$30,000
4. Residual (if positive)	70%	30%
Residual (if negative)	50%	50%

Required

- a. Prepare a schedule that discloses the distribution of partnership net income for 20X5. Show supporting computations in good form. Round to the nearest dollar.
- b. Prepare the statement of partners' capital at December 31, 20X5.
- c. How would your answer to part *a* change if all of the provisions of the income distribution plan were the same except that the salaries were \$30,000 to Apple and \$35,000 to Jack?

LO 15-1–15-6

E15-5 Matching Partnership Terms with Their Descriptions

Required

Match the descriptions on the left with the terms on the right. A term may be used once, more than once, or not at all.

Descriptions of Terms	Terms
1. Item that occurs when the new partner's investment exceeds the new partner's capital credit.	A. General partner
2. Partner who cannot actively participate in the management of the partnership.	B. Note payable to a partner
3. A allocation of partnership profits and losses when nothing is stated in the partnership agreement.	C. Recognition of neither bonus nor goodwill
4. Item that occurs when the new partner's investment equals the new partner's capital credit and no change occurs in the existing partners' capital balances.	D. Drawing account
5. Cost not deducted to determine the partnership's net income for the period.	E. Limited partner
6. Partner who actively participates in the partnership management and who is personally liable for the partnership's debts.	F. Bonus to existing partners
7. Item that occurs when the new partner's capital credit exceeds his or her investment and no change occurs in the existing partners' capital balances.	G. Interest on capital accounts
8. Account that increases when a partner takes assets out of the partnership in anticipation of partnership net income.	H. Partnership income or loss shared equally
9. Account that increases for the fair value of noncash assets invested by a partner.	I. New partner's goodwill recognized
10. Related-party transaction that must be disclosed in the notes to the financial statements.	J. Existing partners' goodwill recognized
11. Item that occurs when the new partner's investment equals his or her capital credit and an increase occurs in the existing partners' capital balances.	K. Partnership agreement
12. Item that occurs when the new partner's capital credit exceeds his or her investment and a decrease occurs in the existing partners' capital balances.	L. Bonus to new partner
13. Recognition of an intangible asset upon a new partner's admission to the partnership that results in increases in the existing partners' capital balances.	M. Capital account
14. Account closed to the capital account at year-end.	
15. Deduction of interest expense on this payable to determine the partnership's net income.	

LO 15-6

E15-6 Admission of a Partner

In the GMP partnership (to which Elan seeks admittance), the capital balances of Mary, Gene, and Pat, who share income in the ratio of 6:3:1, are

Mary	\$240,000
Gene	120,000
Pat	40,000

Required

- If no goodwill or bonus is recorded, how much must Elan invest for a one-third interest?
- Prepare journal entries for the admission of Elan if she invests \$80,000 for a 20 percent interest and goodwill is recorded.
- Prepare journal entries for the admission of Elan if she invests \$200,000 for a 20 percent interest. Total capital will be \$600,000; the partners use the bonus method.
- Elan is concerned that she may be held liable for the partnership liabilities existing on the day she is admitted to the GMP partnership. She found nothing in the partnership agreement on this item. What does the UPA 1997 state with regard to the liability of a new partner for partnership obligations incurred prior to admission?

LO 15-6

E15-7 Admission of a Partner

Pam and John are partners in PJ's partnership, having capital balances of \$120,000 and \$40,000, respectively, and share income in a ratio of 3:1. Gerry is to be admitted into the partnership with a 20 percent interest in the business.

Required

For each of the following independent situations, first record Gerry's admission into the partnership and then specify and briefly explain why the accounting method used in that situation is GAAP or non-GAAP.

- Gerry invests \$50,000, and goodwill is to be recorded.
- Gerry invests \$50,000. Total capital is to be \$210,000; the partners use the bonus method.
- Gerry purchases the 20 percent interest by directly paying Pam \$50,000. Gerry is assigned 20 percent interest in the partnership solely from Pam's capital account.
- Gerry invests \$35,000. Total capital is to be \$195,000; the partners use the bonus method.
- Gerry invests \$35,000, and goodwill is to be recorded.
- Gerry invests \$35,000. During the valuation process made as part of admitting the new partner, the partnership's inventory is determined to be overvalued by \$20,000 because of obsolescence. PJ's partnership uses the lower-of-cost-or-market value method for inventories.

LO 15-6

E15-8 Multiple-Choice Questions on the Admission of a Partner

Select the correct answer for each of the following questions.

(Note: The following balance sheet is for the partnership of Alex, Betty, and Claire in questions 1 and 2.)

Cash	\$ 20,000
Other Assets	180,000
	<u>\$200,000</u>
Liabilities	\$ 50,000
Alex, Capital (40%)	37,000
Betty, Capital (40%)	65,000
Claire, Capital (20%)	<u>48,000</u>
Total Liabilities & Capital	<u>\$200,000</u>

(Note: Figures shown parenthetically reflect agreed-upon profit and loss-sharing percentages.)

- If the assets are fairly valued on this balance sheet and the partnership wishes to admit Denise as a new one-sixth-interest partner without recording goodwill or bonus, Denise should contribute cash or other assets of
 - \$40,000.
 - \$36,000.
 - \$33,333.
 - \$30,000.
- If assets on the initial balance sheet are fairly valued, Alex and Betty give their consent, and Denise pays Claire \$51,000 for her interest, the revised capital balances of the partners would be
 - Alex, \$38,000; Betty, \$66,500; Denise, \$51,000.
 - Alex, \$38,500; Betty, \$66,500; Denise, \$48,000.
 - Alex, \$37,000; Betty, \$65,000; Denise, \$51,000.
 - Alex, \$37,000; Betty, \$65,000; Denise, \$48,000.
- On December 31, 20X4, Alan and Dave are partners with capital balances of \$80,000 and \$40,000, and they share profit and losses in the ratio of 2:1, respectively. On this date, Scott invests \$36,000 cash for a 20 percent interest in the capital and profit of the new partnership.

The partners agree that the implied partnership goodwill is to be recorded simultaneously with Scott's admission. The firm's total implied goodwill is

- a. \$4,800.
 - b. \$6,000.
 - c. \$24,000.
 - d. \$30,000.
4. Boris and Richard are partners who share profits and losses in the ratio of 6:4. On May 1, 20X9, their respective capital accounts were as follows:

Boris	\$60,000
Richard	50,000

On that date, Lisa was admitted as a partner with a one-third interest in capital and profits for an investment of \$40,000. The new partnership began with a total capital of \$150,000. Immediately after Lisa's admission, Boris's capital should be

- a. \$50,000.
 - b. \$54,000.
 - c. \$56,667.
 - d. \$60,000.
5. At December 31, Rod and Sheri are partners with capital balances of \$40,000 and \$20,000, and they share profits and losses in the ratio of 2:1, respectively. On this date, Pete invests \$17,000 in cash for a 20 percent interest in the new partnership's capital and profit. Assuming that the bonus method is used, how much should be credited to Pete's capital account on December 31?
- a. \$12,000.
 - b. \$15,000.
 - c. \$15,400.
 - d. \$17,000.
6. The capital accounts of the partnership of Ella, Nick, and Brandon follow with their respective profit and loss ratios:

Ella	\$139,000	(.500)
Nick	209,000	(.333)
Brandon	96,000	(.167)

Tony was admitted to the partnership when he purchased directly, for \$132,000, a proportionate interest from Ella and Nick in the partnership's net assets and profits. As a result, Tony acquired a 20 percent interest in the firm's net assets and profits. Assuming that implied goodwill is not to be recorded, what is the combined gain realized by Ella and Nick upon the sale of a portion of their partnership interests to Tony?

- a. \$0.
 - b. \$43,200.
 - c. \$62,400.
 - d. \$82,000.
7. Fred and Ralph are partners who share profits and losses in the ratio of 7:3, respectively. Their respective capital accounts are as follows:

Fred	\$35,000
Ralph	30,000

They agreed to admit Lute as a partner with a one-third interest in the capital and profits and losses upon an investment of \$25,000. The new partnership will begin with total capital of \$90,000. Immediately after Lute's admission, what are the capital balances of Fred, Ralph, and Lute, respectively?

- \$30,000, \$30,000, \$30,000.
 - \$31,500, \$28,500, \$30,000.
 - \$31,667, \$28,333, \$30,000.
 - \$35,000, \$30,000, \$25,000.
8. If A is the total capital of a partnership before the admission of a new partner, B is the total capital of the partnership after the new partner's investment, C is the amount of the new partner's investment, and D is the amount of capital credit to the new partner, then there is
- A bonus to the new partner if $B = A + C$ and $D < C$.
 - Goodwill to the old partners if $B > (A + C)$ and $D = C$.
 - Neither bonus nor goodwill if $B = A - C$ and $D > C$.
 - Goodwill to the new partner if $B > (A + C)$ and $D < C$.

LO 15-6

E15-9 Withdrawal of a Partner

In the LMK partnership, Luis's capital is \$40,000, Marty's is \$50,000, and Karl's is \$30,000. They share income in a 4:1:1 ratio, respectively. Karl is retiring from the partnership.

Required

Prepare journal entries to record Karl's withdrawal according to each of the following independent assumptions:

- Karl is paid \$38,000, and no goodwill is recorded.
- Karl is paid \$42,000, and only his share of the goodwill is recorded.
- Karl is paid \$35,000, and all implied goodwill is recorded.
- Prepare a one-paragraph note summarizing the guidance the UPA 1997 offers on computing the buyout price for a partner who is retiring from the partnership.



LO 15-6

E15-10 Retirement of a Partner

On January 1, 20X1, Eddy decides to retire from the partnership of Cobb, Davis, and Eddy. The partners share profits and losses in the ratio of 3:2:1, respectively. The following condensed balance sheets present the account balances immediately before and, for six independent cases, after Eddy's retirement.

Accounts	Balances prior to Eddy's Retirement	Balances after Eddy's Retirement					
		Case 1	Case 2	Case 3	Case 4	Case 5	Case 6
Assets:							
Cash	\$ 90,000	\$ 10,000	\$ 16,000	\$ 25,000	\$ 16,000	\$ 50,000	\$ 90,000
Other Assets	200,000	200,000	200,000	200,000	200,000	220,000	200,000
Goodwill	10,000	10,000	14,000	10,000	34,000	10,000	10,000
Total Assets	<u>\$300,000</u>	<u>\$220,000</u>	<u>\$230,000</u>	<u>\$235,000</u>	<u>\$250,000</u>	<u>\$280,000</u>	<u>\$300,000</u>
Liabilities & Capital:							
Liabilities	\$ 60,000	\$ 60,000	\$ 60,000	\$ 60,000	\$ 60,000	\$ 60,000	\$ 60,000
Cobb, Capital	80,000	74,000	80,000	83,000	92,000	110,000	80,000
Davis, Capital	90,000	86,000	90,000	92,000	98,000	110,000	160,000
Eddy, Capital	70,000	0	0	0	0	0	0
Total Liabilities & Capital	<u>\$300,000</u>	<u>\$220,000</u>	<u>\$230,000</u>	<u>\$235,000</u>	<u>\$250,000</u>	<u>\$280,000</u>	<u>\$300,000</u>

Required

Prepare the necessary journal entries to record Eddy's retirement from the partnership for each of the six independent cases.

Problems

LO 15-6

P15-11 Admission of a Partner

Debra and Merina sell electronic equipment and supplies through their partnership. They wish to expand their computer lines and decide to admit Wayne to the partnership. Debra's capital is \$200,000, Merina's capital is \$160,000, and they share income in a ratio of 3:2, respectively.

Required

Record Wayne's admission for each of the following independent situations:

- Wayne directly purchases half of Merina's investment in the partnership for \$90,000.
- Wayne invests the amount needed to give him a one-third interest in the partnership's capital if no goodwill or bonus is recorded.
- Wayne invests \$110,000 for a 25 percent interest. Goodwill is to be recorded.
- Debra and Merina agree that some of the inventory is obsolete. The inventory account is decreased before Wayne is admitted. Wayne invests \$100,000 for a 25 percent interest.
- Wayne directly purchases a 25 percent interest by paying Debra \$80,000 and Merina \$60,000. The land account is increased before Wayne is admitted.
- Wayne invests \$80,000 for a 20 percent interest in the total capital of \$440,000.
- Wayne invests \$100,000 for a 20 percent interest. Goodwill is to be recorded.

LO 15-5

P15-12 Division of Income

C. Eastwood, A. North, and M. West are manufacturers' representatives in the architecture business. Their capital accounts in the ENW partnership for 20X1 were as follows:

C. Eastwood, Capital				A. North, Capital				M. West, Capital			
9/1	8,000	1/1	30,000	3/1	9,000	1/1	40,000	8/1	12,000	1/1	50,000
		5/1	6,000			7/1	5,000			4/1	7,000
						9/1	4,000			6/1	3,000

Required

For each of the following independent income-sharing agreements, prepare an income distribution schedule.

- Salaries are \$15,000 to Eastwood, \$20,000 to North, and \$18,000 to West. Eastwood receives a bonus of 5 percent of net income after deducting his bonus. Interest is 10 percent of ending capital balances. Eastwood, North, and West divide any remainder in a 3:3:4 ratio, respectively. Net income was \$78,960.
- Interest is 10 percent of weighted-average capital balances. Salaries are \$24,000 to Eastwood, \$21,000 to North, and \$25,000 to West. North receives a bonus of 10 percent of net income after deducting the bonus and her salary. Any remainder is divided equally. Net income was \$68,080.
- West receives a bonus of 20 percent of net income after deducting the bonus and the salaries. Salaries are \$21,000 to Eastwood, \$18,000 to North, and \$15,000 to West. Interest is 10 percent of beginning capital balances. Eastwood, North, and West divide any remainder in an 8:7:5 ratio, respectively. Net income was \$92,940.

LO 15-6

P15-13 Determining a New Partner's Investment Cost

The following condensed balance sheet is presented for the partnership of Der, Egan, and Oprins, who share profits and losses in the ratio of 4:3:3, respectively.

Cash	\$ 40,000	Accounts Payable	\$150,000
Other Assets	710,000	Der, Capital	260,000
		Egan, Capital	180,000
		Oprins, Capital	160,000
Total Assets	<u>\$750,000</u>	Total Liabilities & Capital	<u>\$750,000</u>

Assume that the partnership decides to admit Snider as a new partner with a 25 percent interest.



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Required

For each of the following independent cases, determine the amount that Snider must contribute in cash or other assets.

- No goodwill or bonus is to be recorded.
- Goodwill of \$30,000 is to be recorded and allocated to the original partners.
- A bonus of \$24,000 is to be paid by Snider and allocated to the original partners.
- The original partners, Der, Egan, and Oprins, agree to give Snider \$10,000 of goodwill upon admission to the partnership.
- Other assets are revalued for an increase of \$20,000, and goodwill of \$40,000 is recognized and allocated to the original partners at the time of Snider's admission.
- The partners agree that total resulting capital should be \$820,000 and no goodwill should be recognized.
- Other assets are revalued down by \$20,000 and a bonus of \$40,000 is paid to Snider at the time of admission.

LO 15-5**P15-14 Division of Income**

Champion Play Company is a partnership that sells sporting goods. The partnership agreement provides for 10 percent interest on invested capital, salaries of \$24,000 to Luc and \$28,000 to Dennis, and a bonus for Luc. The 20X3 capital accounts were as follows:



Luc, Capital				Dennis, Capital			
8/1	15,000	1/1	50,000	7/1	10,000	1/1	70,000
		4/1	5,000			9/1	22,500

Required

For each of the following independent situations, prepare an income distribution schedule.

- Interest is based on weighted-average capital balances. The 5 percent bonus is calculated on net income after deducting the bonus. In 20X3, net income was \$64,260. Any remainder is divided between Luc and Dennis in a 3:2 ratio, respectively.
- Interest is based on ending capital balances after deducting salaries, which the partners normally withdraw during the year. The 8 percent bonus is calculated on net income after deducting the bonus and salaries. Net income was \$108,700. Any remainder is divided equally.
- Interest is based on beginning capital balances. The 12.5 percent bonus is calculated on net income after deducting the bonus. Net income was \$76,950. Any remainder is divided between Luc and Dennis in a 4:2 ratio, respectively.

LO 15-6**P15-15 Withdrawal of a Partner under Various Alternatives**

The partnership of Ace, Jack, and Spade has been in business for 25 years. On December 31, 20X5, Spade decided to retire. The partnership balance sheet reported the following capital balances for each partner at December 31, 20X5:

Ace, Capital	\$150,000
Jack, Capital	200,000
Spade, Capital	120,000

The partners allocate partnership income and loss in the ratio 20:30:50, respectively.

Required

Record Spade's withdrawal under each of the following independent situations.

- Jack acquired Spade's capital interest for \$150,000 in a personal transaction. Partnership assets were not revalued, and partnership goodwill was not recognized.
- Assume the same facts as in part *a* except that partnership goodwill applicable to the entire business was recognized by the partnership.

- c. Spade received \$180,000 of partnership cash upon retirement. Capital of the partnership after Spade's retirement was \$290,000.
- d. Spade received \$60,000 of cash and partnership land with a fair value of \$120,000. The carrying amount of the land on the partnership books was \$100,000. Capital of the partnership after Spade's retirement was \$310,000.
- e. Spade received \$150,000 of partnership cash upon retirement. The partnership recorded the portion of goodwill attributable to Spade.
- f. Assume the same facts as in part e except that partnership goodwill attributable to all partners was recorded.
- g. Because of limited cash in the partnership, Spade received land with a fair value of \$100,000 and a partnership note payable for \$50,000. The land's carrying amount on the partnership books was \$60,000. Capital of the partnership after Spade's retirement was \$360,000.

LO 15-5-15-6

P15-16 Multiple-Choice Questions—Initial Investments, Division of Income, Admission and Retirement of a Partner [AICPA Adapted]

Select the correct answer for each of the following questions.

1. When property other than cash is invested in a partnership, at what amount should the noncash property be credited to the contributing partner's capital account?
 - a. Contributing partner's tax basis.
 - b. Contributing partner's original cost.
 - c. Assessed valuation for property tax purposes.
 - d. Fair value at the date of contribution.
2. William and Martha drafted a partnership agreement that lists the following assets contributed at the partnership's formation:

	Contributed by	
	William	Martha
Cash	\$20,000	\$30,000
Inventory		15,000
Building		40,000
Furniture & Equipment	15,000	

The building is subject to a \$10,000 mortgage, which the partnership has assumed. The partnership agreement also specifies that profits and losses are to be distributed evenly. What amounts should be recorded as capital for William and Martha at the partnership's formation?

	William	Martha
a. \$35,000		\$85,000
b. \$35,000		\$75,000
c. \$55,000		\$55,000
d. \$60,000		\$60,000

3. Smith and Duncan are partners with capital balances of \$60,000 and \$20,000, respectively. Profits and losses are divided in the ratio of 60:40. Smith and Duncan decided to form a new partnership with Johnson, who invested land valued at \$15,000 for a 20 percent capital interest in the new partnership. Johnson's cost of the land was \$12,000. The partnership elected to use the bonus method to record Johnson's admission into the partnership. Johnson's capital account should be credited for
 - a. \$12,000.
 - b. \$15,000.
 - c. \$16,000.
 - d. \$19,000.

4. On April 30, 20X5, Apple, Blue, and Crown formed a partnership by combining their separate business proprietorships. Apple contributed \$50,000 cash. Blue contributed property with a \$36,000 carrying amount, a \$40,000 original cost, and \$80,000 fair value. The partnership accepted responsibility for the property's \$35,000 mortgage. Crown contributed equipment with a \$30,000 carrying amount, a \$75,000 original cost, and \$55,000 fair value. The partnership agreement specifies that profits and losses are to be shared equally but is silent regarding capital contributions. Which partner's capital account has the largest April 30, 20X5, balance?
- Apple.
 - Blue.
 - Crown.
 - All capital account balances are equal.

(Note: The following information is for questions 5 and 6.)

The Moon-Norbert Partnership was formed on January 2, 20X5. Under the partnership agreement, each partner has an equal initial capital balance accounted for under the goodwill method. Partnership net income or loss is allocated 60 percent to Moon and 40 percent to Norbert. To form the partnership, Moon originally contributed assets costing \$30,000 with a fair value of \$60,000 on January 2, 20X5, and Norbert contributed \$20,000 in cash. Partners' drawings during 20X5 totaled \$3,000 by Moon and \$9,000 by Norbert. Moon-Norbert's net income for 20X5 was \$25,000.

5. Norbert's initial capital balance in Moon-Norbert is
- \$20,000.
 - \$25,000.
 - \$40,000.
 - \$60,000.
6. Moon's share of Moon-Norbert's net income is
- \$15,000.
 - \$12,500.
 - \$12,000.
 - \$7,800.
7. In the Crowe-Dagwood partnership, Crowe and Dagwood had a capital ratio of 3:1 and a profit and loss ratio of 2:1. They used the bonus method to record Elman's admittance as a new partner. What ratio should be used to allocate to Crowe and Dagwood the excess of Elman's contribution over the amount credited to Elman's capital account?
- Crowe and Dagwood's new relative capital ratio.
 - Crowe and Dagwood's new relative profit and loss ratio.
 - Crowe and Dagwood's previous capital ratio.
 - Crowe and Dagwood's previous profit and loss ratio.
8. Blue and Green formed a partnership in 20X4. The partnership agreement provides for annual salary allowances of \$55,000 for Blue and \$45,000 for Green. The partners share profits equally and losses in a 60:40 ratio, respectively. The partnership had earnings of \$80,000 for 20X5 before any allowance to partners. What amount of these earnings should be credited to each partner's capital account?

	Blue	Green
a.	\$40,000	\$40,000
b.	\$43,000	\$37,000
c.	\$44,000	\$36,000
d.	\$45,000	\$35,000

9. When Jill retired from the partnership of Jill, Bill, and Hill, the final settlement of her interest exceeded her capital balance. Under the bonus method, the excess
- Was recorded as goodwill.
 - Was recorded as an expense.

- c. Reduced the capital balances of Bill and Hill.
- d. Had no effect on the capital balances of Bill and Hill.

LO 15-3–15-6

P15-17 Partnership Formation, Operation, and Changes in Ownership

The partnership of Jordan and O'Neal began business on January 1, 20X7. Each partner contributed the following assets (the noncash assets are stated at their fair values on January 1, 20X7):

	Jordan	O'Neal
Cash	\$ 60,000	\$ 50,000
Inventories	80,000	0
Land	0	130,000
Equipment	100,000	0

The land was subject to a \$50,000 mortgage, which the partnership assumed on January 1, 20X7. The equipment was subject to an installment note payable that had an unpaid principal amount of \$20,000 on January 1, 20X7. The partnership also assumed this note payable. Jordan and O'Neal agreed to share partnership income and losses in the following manner:

	Jordan	O'Neal
Interest on beginning capital balances	3%	3%
Salaries	\$12,000	\$12,000
Remainder	60%	40%

During 20X7, the following events occurred:

- Inventory was acquired at a cost of \$30,000. At December 31, 20X7, the partnership owed \$6,000 to its suppliers.
- Principal of \$5,000 was paid on the mortgage. Interest expense incurred on the mortgage was \$2,000, all of which was paid by December 31, 20X7.
- Principal of \$3,500 was paid on the installment note. Interest expense incurred on the installment note was \$2,000, all of which was paid by December 31, 20X7.
- Sales on account amounted to \$155,000. At December 31, 20X7, customers owed the partnership \$21,000.
- Selling and general expenses, excluding depreciation, amounted to \$34,000. At December 31, 20X7, the partnership owed \$6,200 of accrued expenses. Depreciation expense was \$6,000.
- Each partner withdrew \$200 each week in anticipation of partnership profits.
- The partnership's inventory at December 31, 20X7, was \$20,000.
- The partners allocated the net income for 20X7 and closed the accounts.

Additional Information

On January 1, 20X8, the partnership decided to admit Hill to the partnership. On that date, Hill invested \$99,800 of cash into the partnership for a 20 percent capital interest. Total partnership capital after Hill was admitted totaled \$450,000.

Required

- Prepare journal entries to record the formation of the partnership on January 1, 20X7, and to record the events that occurred during 20X7.
- Prepare the income statement for the Jordan-O'Neal Partnership for the year ended December 31, 20X7.
- Prepare a balance sheet for the Jordan-O'Neal Partnership at December 31, 20X7.
- Prepare the journal entry for the admission of Hill on January 1, 20X8.

P15-18A Initial Investments and Tax Bases [AICPA Adapted]

The DELS partnership was formed by combining individual accounting practices on May 10, 20X1. The initial investments were as follows:

	Current Value	Tax Basis
Delaney:		
Cash	\$ 8,000	\$ 8,000
Building	60,000	32,000
Mortgage payable, assumed by DELS	36,000	36,000
Engstrom:		
Cash	9,000	9,000
Office furniture	23,000	17,000
Note payable, assumed by DELS	10,000	10,000
Lahey:		
Cash	12,000	12,000
Computers and printers	18,000	21,000
Note payable, assumed by DELS	15,000	15,000
Simon:		
Cash	21,000	21,000
Library (books and periodicals)	7,000	5,000

Required

- Prepare the journal entry to record the initial investments using GAAP accounting.
- Calculate the tax basis of each partner's capital if Delaney, Engstrom, Lahey, and Simon agree to assume equal amounts for the payables.

LO 15-3–15-6

P15-19 Formation of a Partnership and Allocation of Profit and Loss

Haskins and Sells formed a partnership on January 2, 20X3. Each had been a sole proprietor before forming their partnership.

Part I

Each partner's contributions follow. The amounts under the cost column represent the amounts reported on the books of each sole proprietorship immediately before the formation of the partnership.

	Cost	Fair Value
Haskins:		
Cash	\$ 45,000	\$ 45,000
Inventories (FIFO)	48,000	49,000
Trade accounts receivable	40,000	40,000
Allowance for uncollectible accounts	(1,500)	(2,000)
Building	550,000	370,000
Accumulated depreciation	(200,000)	
Mortgage on building assumed by partnership	(175,000)	(175,000)
Sells:		
Cash	\$ 10,000	\$ 10,000
Trade accounts receivable	30,000	30,000
Allowance for uncollectible accounts	(2,000)	(2,500)
Inventories (FIFO)	15,000	13,500
Note receivable due in 6 months	50,000	50,000
Temporary investments	100,000	81,500
Customer lists	0	60,000

Required

Using the preceding information, prepare a classified balance sheet as of January 2, 20X3, for the Haskins and Sells partnership. Assume that \$25,000 of the mortgage is due in 20X3 and that the customer lists are accounted for as an intangible asset to be amortized over a five-year period.

Part II

During 20X3, the Haskins and Sells Partnership reported the following information:

Revenues	\$650,000
Cost of goods sold	320,000
Selling, general, and administrative expenses	70,000
Salaries paid to each partner (not included in selling, general, and administrative expenses):	
Haskins	90,000
Sells	70,000
Bonus paid to Haskins (not included in selling, general, and administrative expenses)	10% of net income
Withdrawals made during the year in addition to salaries:	
Haskins	10,000
Sells	5,000
Residual profit and loss-sharing ratio:	
Haskins	20%
Sells	80%

Required

- Prepare an income statement for the Haskins and Sells partnership for the year ended December 31, 20X3.
- Prepare a schedule that shows how to allocate the partnership net income for 20X3.
- What is the capital balance for each partner that will appear on the December 31, 20X3, balance sheet?
- Assume that the distribution of partnership net income remains the same (i.e., Haskins will continue to receive a 10 percent bonus and salaries will continue to be \$90,000 and \$70,000 to Haskins and Sells, respectively) and the residual profit and loss-sharing ratio will continue to be 20:80. What would partnership net income have to be for each partner to receive the same amount of income?