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PARTNERSHIPS: FORMATION, OPERATION, AND OWNERSHIP CHANGES

LEARNING OBJECTIVES

1. Describe the characteristics of a general partnership, a limited partnership, and a joint venture.
2. List some important items to be included in the partnership agreement.
3. Understand the differences between partnerships' and corporations' equity accounts in the balance sheet.
4. Explain the purpose of the partners' drawing accounts and capital accounts.
5. Prepare journal entries to form a partnership using the bonus and the goodwill methods.
6. Describe some common agreements used to allocate partnership net income or loss.
7. Explain why salary allowances and interest allowances are used in allocating partnership profits and losses.
8. Describe the methods used to record partnership changes when a new partner is admitted or when a partner withdraws from the partnership.
9. Describe the rationale behind the goodwill method in accounting for changes in partnership membership.

IN THE NEWS

"Sustainability can be a 2 + 2 = 5 (or even 50) game. To achieve outstanding triple bottom line performance, new types of economic, social, and environmental partnership are needed. Long-standing enemies must shift from mutual subversion to new forms of symbiosis. The resulting partnerships will help each partner perform traditional tasks more efficiently, while providing a platform from which to reach toward goals that none of the partners could hope to achieve on his own."[1]

The next two chapters deal exclusively with accounting and reporting problems associated with the partnership form of business organization. These chapters cover the complete life cycle of a partnership from its formation and operation to its liquidation. Partnerships are covered in this text because they are a common form of

[1] *Environmental Quality Management*, "Partnerships from Cannibals with Forks: The Triple Bottom Line of 21st-Century Business," by John Elkington, Autumn 1998, p. 37.

business organization. They are popular because they permit the pooling of limited resources, are easy to form (no special governmental approval is required), and may have certain tax advantages. Because partnerships are common, accountants are often called on to account for, and serve in, an advisory capacity to partnerships. Although many of the accounting concepts applicable to a sole proprietorship or a corporation are also applicable to partnerships, some aspects of partnership formation, operation, and liquidation require additional consideration. The unique aspects of accounting for a partnership are the focus of these chapters. Figure 15-1 presents a summary of statistics for partnerships in the United States from 2007 and 2008.

Accounting for a partnership is influenced by the agreement made among the partners and by the appropriate state statutes. Partnerships operate within the legal framework of the state in which they are organized and the statutes may vary from state to state. In order to illustrate statutory provisions, the Uniform Partnership Act (UPA) is integrated throughout the partnership chapters because it, or some modification thereof, is the partnership law that has been adopted by the majority of the states. An in-depth study of the legal aspects of partnerships is generally contained in the typical business law course.

PARTNERSHIP DEFINED

A partnership is defined by the UPA as "an association of two or more persons to carry on as co-owners a business for profit."[2] Persons in this definition include individuals, partnerships, corporations, and other associations. Not only are corporations sometimes partners, but also partnerships can be shareholders in a corporation.

EToys Inc. is betting that a lot of American parents want to buy Barbie, Arthur and other favorite playthings without visiting the mall, let alone chasing screaming children down toy store aisles. "We're benefiting from eToys' success and are happy to be their partner", says a Mattel spokesman. If the eToys' offering is completed as planned, it will mean big gains for the firm's top management and a small squad of venture capitalists. The company's biggest shareholders are various partnerships affiliated with Idealab!, a business incubator and venture-capital firm run by inventor Bill Gross.[3]

In some cases, it may be difficult to determine whether a partnership has been formed or whether an individual is a partner in a business arrangement. To determine the existence of a partnership, it may be helpful to look for the following three attributes: (1) there must be an agreement, either expressed or implied, between two or more persons; (2) the business must be operated for the purpose of making a profit; and (3) members of the firm must be co-owners of the business. Co-ownership involves the right of each partner to share in the profits of the business, to participate in the management of the business, and to hold an interest in properties conveyed to the partnership. These rights are shared equally unless agreed to otherwise in the partnership agreement.

[2] UPA, Section 6.

[3] *WSJ*, "EToys Plans to Join Web-Retailer Parade with Its Own IPO," by George Anders and Lisa Bannon, 4/6/99, p. B1.

FIGURE 15-1

Partnership Statistics, 2007–2008

	Number of Partnerships				*Number of Partners*			
	2007	*% of Industries*	*2008*	*% of Industries*	*2007*	*% of Industries*	*2008*	*% of Industries*
All industries	**3,096,334**		**3,146,007**		**18,515,696**		**19,300,249**	
Agriculture, forestry, fishing, and hunting	126,884	4.1%	119,323	3.8%	402,395	2.2%	425,776	2.2%
Mining	39,581	1.3%	35,047	1.1%	979,952	5.3%	875,620	4.5%
Utilities	3,991	0.1%	8,294	0.3%	97,169	0.5%	156,519	0.8%
Construction	208,538	6.7%	203,285	6.5%	554,232	3.0%	521,633	2.7%
Manufacturing	47,683	1.5%	45,859	1.5%	402,630	2.2%	430,090	2.2%
Wholesale trade	53,515	1.7%	61,746	2.0%	348,285	1.9%	348,124	1.8%
Retail trade	166,561	5.4%	175,275	5.6%	500,182	2.7%	524,096	2.7%
Transportation and warehousing	46,464	1.5%	50,246	1.6%	1,043,215	5.6%	1,274,881	6.6%
Information	34,206	1.1%	36,610	1.2%	158,926	0.9%	163,933	0.8%
Finance and insurance	308,307	10.0%	320,584	10.2%	4,431,223	23.9%	4,778,999	24.8%
Real estate and rental and leasing	1,488,966	48.1%	1,489,462	47.3%	6,792,082	36.7%	6,849,464	35.5%
Professional, scientific, and technical services	175,546	5.7%	190,784	6.1%	633,193	3.4%	683,710	3.5%
Management of companies (holding companies)	23,578	0.8%	23,346	0.7%	683,384	3.7%	734,539	3.8%
Administrative and support and waste management and remediation services	62,004	2.0%	66,286	2.1%	151,935	0.8%	157,792	0.8%
Educational services	11,605	0.4%	9,727	0.3%	29,618	0.2%	24,066	0.1%
Health care and social assistance	67,522	2.2%	68,538	2.2%	353,922	1.9%	434,840	2.3%
Arts, entertainment, and recreation	54,867	1.8%	66,576	2.1%	384,436	2.1%	349,029	1.8%
Accommodation and food services	106,954	3.5%	102,827	3.3%	381,100	2.1%	383,059	2.0%
Other services	68,949	2.2%	67,571	2.1%	186,552	1.0%	172,015	0.9%
Nature of business not allocable	613	0.0%	4,621	0.1%	1,265	0.0%	12,064	0.1%

Adapted from *Statistics of Income Bulletin*, Partnership Returns, Fall 2010, U.S. Internal Revenue Service.

REASONS FOR FORMING A PARTNERSHIP

The prospective owner(s) of a business should consider the various attributes of the different forms of business organizations before selecting the one that they believe best meets their organizational objectives and personal goals. A form suitable for one set of business objectives may not be appropriate for another. It is possible for a firm to start as a proprietorship and, as the business and personal environments change, to move to a partnership form, and ultimately, to incorporate.

One of the major advantages of a partnership is that it permits the pooling of capital and other resources without the complexities and formalities of a corporation. A partnership is easier and less costly to establish than a corporation and is generally not subject to as much governmental regulation. Furthermore, the partners may be able to operate with more flexibility because they are subject neither to the control of a board of directors nor to outside shareholders. There may also be certain tax advantages to a partnership, discussed later.

IN THE NEWS

Chip Bell, senior partner with Performance Research Associates in Dallas, compares partnering to dancing. He suggests six steps to great partnerships:

- ***Focus***, or prepare to partner. There should be a clear commitment to some purpose.
- ***Audition***, or pick great partners. Auditions are about discovery and disclosure. Be open for warning cues.
- ***Rehearse***, or get the partnership in shape. Work the plan, ignoring opposition or objections.
- ***Dance***, or keep the magic in motion. Great partnerships keep going and growing.
- ***Hurt***, or manage the pain. Great dances are rarely flawless, and the capacity to bend and continue in the face of adversity makes for resilience.
- ***Bow out***, or know when to call it curtains.[4]

CHARACTERISTICS OF A PARTNERSHIP

LO1 Characteristics of a general partnership.

Some partnership characteristics may make it more difficult for a partnership to raise capital than for a corporation. Partnerships are thus most common in comparatively small businesses, professional organizations, such as medical clinics or an accounting practice, and some limited projects undertaken to accomplish a single goal, such as an oil and gas exploration project or the purchase of a parcel of real estate for investment purposes. However, there is no limit to the size or number of partners in a firm. For example, in the large international CPA firms, the number of partners is in the thousands and revenue is in the millions of dollars.

One distinctive characteristic of a partnership is its advantageous federal income tax treatment. A partnership is treated as a "flow through" entity from a federal income tax perspective and as such, income is not subject to taxation at the partnership level. A partnership must file an information return with the IRS in which income or loss is allocated to the individual partners. A partner's respective share of the income or loss is then reported on his or her individual income tax return, whether distributed by the partnership or not.

[4] Adapted from *Dance Lessons: Six Steps to Great Partnerships in Business and Life*, by Chip Bell and Heather Shea (St. Paul, MN: Highbridge Company, 1998). Also see *Executive Excellence*, "Steps to Great Partnerships," by Chip Bell and Heather Shea, March 1999, pp. 5–6.

General Partnership

In a general partnership, each member is a general partner within the firm. That is, there is no "limited partner" in the organization. The following are characteristics of a general partnership.

Mutual Agency Every general partner is an agent of both the partnership and every other partner. Thus, a partner can bind the other partners to a contract if he or she is acting within the apparent scope of the business. Outside parties transacting with a partner can assume the partner has the power to bind the partnership unless they are informed otherwise. Outside parties should be aware, however, that for certain acts, such as the assignment of partnership property, unanimous consent of the partners is required.

Right to Dispose of a Partnership Interest A capital interest in a general partnership is a personal asset of the individual partner that can be sold or disposed of in any legal way. However, the UPA, recognizing the highly personal relationship of the partners, provides that a purchaser of another partner's interest does not have the right to participate in management unless he or she is accepted by all the partners. The new partner is entitled to the profit allocation acquired and, in the event of liquidation, to receive whatever assets the selling partner would have received had he or she continued in the partnership.

Unlimited Liability In a ***general partnership***, each partner is jointly and severally liable for the debts and obligations of the partnership. This means that in the case of liquidation, the creditors of the partnership, if not satisfied from assets of the partnership, can look to each partner's personal resources for recovery of unsatisfied claims. Jointly and severally means that a creditor can seek recovery from all the partners or can proceed against one or more of them separately.

Limited or Uncertain Life A general partnership may be dissolved for a number of reasons, including the death of a partner, the bankruptcy of an individual partner, the withdrawal of a partner from the partnership, or a judgment by a court that a partner is unsound of mind and incapable of performing his or her partnership duties.

The characteristics just discussed underline the importance of careful selection of the individuals to be associated in a general partnership. In particular, mutual agency and unlimited liability are distinctive features of a general partnership that could result in extensive personal liability resulting from the acts of other partners.

Recently, state laws have authorized the existence of a popular new form of general partnership known as a ***limited liability partnership (LLP)***. An LLP addresses the issue of unlimited liability by granting partners personal protection from partnership obligations arising from the actions of other partners. However, partners are still held personally liable for their own actions and those of others under their authority.

"Partnerships aren't for everyone. They require an investment of energy and demand vulnerability. And partnerships diminish the protection of anonymity. They are poor associations in which to hide. Partnership means working onstage, not backstage. Done well, partnerships work at amplifying disclosure and enhancing exposure."[5]

[5] *Executive Excellence*, "Steps to Great Partnerships," by Chip Bell and Heather Shea, March 1999, pp. 5–6.

Limited Partnership

LO1 Characteristics of a limited partnership.

In a ***limited partnership***, one or more of the partners are general partners and one or more are limited partners. While general partners manage the firm and are personally liable for obligations of the partnership, limited partners invest capital only and limit their liability for partnership obligations to the amount of their investment. In return, limited partners give up the right to participate in the management of the firm.

The limited partnership form of organization is selected when the general partners want to raise capital without giving up management control of the business. It is also an attractive form when the tax benefits associated with a partnership are desired, but the investors do not want to assume personal liability for the obligations of the partnership. For these reasons, the limited partnership form is often used for professional sports franchises and offerings of partnership interests made to the public for the purpose of carrying out a specific business plan, such as real estate ventures or oil and gas exploration projects.

IN THE NEWS

"Gene Phillips was at the helm when a now-defunct real estate partnership firm called Southmark sank into bankruptcy. His investors lost heavily. Phillips lived lavishly in Texas. . . . They say on Wall Street of limited partnerships: In the beginning, the limited partners have the money and the general partner has the experience. In the end the roles are reversed, especially if Gene Phillips is in the picture."[6]

Joint Ventures

LO1 Characteristics of a joint venture.

A ***joint venture*** is an arrangement entered into by two or more parties to accomplish a single or limited purpose for the mutual benefit of the members of the group, often to earn a profit. For example, a firm in one country may enter into an agreement with a firm of another country to pool their resources to construct an automobile manufacturing plant, or two or more firms may enter into an arrangement to develop a new product that requires complementary technological knowledge. Thus, the life of the joint venture is limited to that of the undertaking, which may be of short- or long-term duration.

The relationship between the parties in the arrangement is generally governed by a written agreement. A distinguishing characteristic of the agreement is that each joint venturer participates directly or indirectly in the overall management of the resources. Accordingly, major decisions require the consent of the ownership group.

Joint ventures are commonly organized as corporations or partnerships. If organized as a corporation, the investment in the joint venture generally must be accounted for using the equity method in accordance with the provisions of *Accounting Principles Board Opinion No. 18*.[7] As a corporation, a joint venture is governed by corporate law. If the arrangement is a partnership joint venture, interpretations of *Opinion No. 18* indicate that many of the provisions of that opinion are appropriate in accounting for the investment.[8] In general, partnership law applies to a partnership joint venture, but the authority of a joint venturer is limited to a

[6] *Forbes*, "The Old Double Dip," by Gretchen Morgenson, 7/7/97, pp. 54–56.

[7] *Opinion of the Accounting Principles Board No. 18*, "The Equity Method of Accounting for Investments in Common Stock" (New York: AICPA, 1971). [ASC 323]

[8] *Accounting Interpretations of APB Opinion No. 18* (New York: AICPA, 1972), par. 2. [ASC 323-30-15-3]

greater extent than that of a general partner. For example, as a general rule, one party to the arrangement is not an agent of the other parties.

PARTNERSHIP AGREEMENT

LO2 Important items in a partnership agreement.

A partnership is a voluntary association based on the contractual agreement between or among legally competent persons. The contract between the parties is called the ***partnership agreement, partnership contract,*** or ***articles of partnership.*** The partnership agreement generally contains provisions related to the nature of the business, operating policies, and the relations between the partners in operating and terminating the business. In the contract, the partners should clearly express their intention, and the document should cover all aspects of operating the partnership. If there are subsequent disputes and the partners are unable to reach a satisfactory agreement, it may be necessary to resort to litigation.

The partnership agreement should reflect fully the precise intentions of the parties and be as unambiguous as possible. The agreement should include the following important points:

1. The name of the firm and identity of the partners.
2. The nature, purpose, and scope of the business.
3. The effective date of organization.
4. The length of time the partnership is to operate.
5. Location of the place of business.
6. Provision for the allocation of profit and loss.
7. Provision for salaries and withdrawals of assets by partners.
8. The rights, duties, and obligations of each partner such as the amount of time each partner will spend on business activities, and whether each partner is a general or limited partner.
9. Authority of each partner in contract situations.
10. Procedures for admitting a new partner.
11. Provisions that specify how operations are to be conducted and how the various partners' interests are to be satisfied on the withdrawal or the death of a partner.
12. Procedures for the arbitration of disputes.
13. Fiscal period of the partnership.
14. Identification and valuation of initial asset investments and the specification of capital interest that each partner is to receive.
15. Situations that may cause the dissolution of the partnership and provisions for terminating or continuing the business.
16. Accounting practices to be followed, such as depreciation policies, the sequence of closing procedures, and whether the cash or accrual basis is to be used in measuring net income.
17. Whether or not an audit is to be performed.

Some of the items listed will be discussed in more detail in later sections.

The law does not specify the form of the agreement. Although it may be oral, it is a good business practice to have the agreement in writing for the protection of the individual partners. A written agreement tends to reduce the number of disagreements resulting from misunderstandings and "loss of memory."

Legally, the partners have a great deal of flexibility in drafting an agreement among themselves, but they must recognize that the UPA specifies certain rights of

and obligations to outside parties that may not be avoided by the individual partners. For example, as noted previously, the UPA (Section 15) imposes unlimited liability on each general partner for partnership debts and obligations. A provision in a partnership agreement that exempts a general partner from this obligation would be superseded by the provision in the UPA.

In drafting the agreement, the partners should seek both legal and accounting assistance to assure that their rights are protected and to help anticipate and avoid as many points of conflict as possible. If there are later disputes related to the relations among the partners, most provisions set out in the UPA control only if the partners have failed to make an express agreement, or if the partners are unable to reach a mutually satisfying agreement. For example, in the absence of an agreement concerning how to share profits, the UPA provides that profits are to be shared equally. Differences arising from ordinary matters may be decided by a majority vote of the partners [UPA, Section 18(H)].

The Greatest Show on Earth

William Cameron Coup organized a show in 1869 that staged simultaneous performances in two rings. He later formed a partnership with P.T. Barnum, and in 1871 they opened "The Greatest Show On Earth" in Brooklyn, N.Y. About ten years later, Barnum went into partnership with James Anthony Bailey, another American showman and one of the best organizers in the business, and with two other impresarios. Eventually, however, Barnum and Bailey became sole partners, with their circus giving simultaneous shows in three rings.[9]

Capital Interest versus Profit Interest

In preparing the partnership agreement, the partners must recognize that there is a distinction between a partner's capital interest and his or her interest in income and losses subsequently reported by the partnership. A partner's ***capital interest*** is a claim against the net assets of the partnership as shown by the balance in the partner's capital account; an ***interest in income and loss*** determines how the partner's capital interest will increase or decrease as a result of subsequent operations. The partners may agree that an individual partner is to receive a one-third capital interest in the partnership, but the same partner's interest in income and loss may be equal to, greater than, or less than one-third.

ACCOUNTING FOR A PARTNERSHIP

LO3 Partnerships' equity versus shareholders' equity.

For accounting purposes, a partnership is considered a separate economic and accounting entity. The assets, liabilities, and residual capital interest, as well as the transactions and events that affect the accounts of the partnership, are areas of interest that require a separate accounting to provide information to the partners and other interested parties. Separation of these activities from the personal transactions of the individual partners is necessary in order to evaluate the performance of the partnership. This does not mean that other forms of statements cannot be prepared for other purposes. For example, a general partner has unlimited liability to

[9] From *Funk and Wagnalls' New Encyclopedia*, Cambridge, MA: Funk and Wagnalls, Corp., 1996. ***Infopedia***, SoftKey Multimedia Inc., 1996.

the creditors of the partnership. Accordingly, the creditors may require information concerning the personal assets and debt position of individual partners, as well as the financial statements of the firm.

There is significantly more freedom in choosing a partnership accounting method than for other types of organizations, such as a corporation. While it is generally assumed that accounting for a partnership basically adheres to the same generally accepted accounting principles as accounting for a proprietorship or a corporation, it should be noted that small or specialized partnerships may utilize either cash basis or tax basis accounting as opposed to GAAP. Since partnerships are required to submit informational returns to the IRS that help determine individual partners' federal income tax, tax-based accounting may provide these partnerships with added convenience over GAAP-based accounting. While these varying methods are acceptable, this text will assume GAAP-based partnership accounting.

The primary difference in accounting for the different forms of organization is in the recording and reporting of capital transactions. A corporation's equity section reports the different sources of capital (for example, the issue of capital stock, additional paid-in capital from various sources, and retained earnings). Because each share of common stock has the same proportional interest in net income, dividends, voting rights, and assets in liquidation as any other share of the same class of stock, a separate capital account for each shareholder is not needed. However, in the case of a partnership, the capital interest in assets of each partner can vary. In addition, the partners' interest in net income or loss can vary and may not be proportional to their respective capital interests. As a result, the relationship of the partners' capital interest will change over time. To report the interest of each partner, a partnership's equity section normally consists of two accounts for each partner: one capital account and one drawing account.

LO4 Drawing and capital accounts.

Practice varies as to which of the two accounts is changed by capital transactions. Generally, investments and withdrawals of assets considered to be other than temporary are recorded in the capital account. The drawing account is typically debited to record withdrawals of assets in anticipation of profitable operations or payments of personal expenses of a partner from partnership assets. It is common practice to close the income summary account to either the drawing account or the capital account. The drawing account may be closed periodically to the capital account. The various sources of capital may thus be combined into one account. In this text, the income summary account and each partner's drawing account will be closed to the appropriate partners' capital accounts.

To illustrate the entries, assume that Ed Bell and Jane Peters operate a partnership in which they each originally contributed $25,000 cash. In the current year, income of $60,000 is to be allocated equally and each partner withdraws $1,000 per month or $12,000 a year. The entries follow:

At the beginning of the partnership:		
Cash	50,000	
Bell, Capital		25,000
Peters, Capital		25,000
To form the partnership.		
Each month to record withdrawals:		
Bell, Drawing	1,000	
Peters, Drawing	1,000	
Cash		2,000
To record monthly withdrawals.		

At the end of the period:		
Income Summary	60,000	
Bell, Capital		30,000
Peters, Capital		30,000
To close the income summary account.		
Bell, Capital	12,000	
Peters, Capital	12,000	
Bell, Drawing		12,000
Peters, Drawing		12,000
To close the partners' drawing accounts.		

Generally, the same accounting concepts are used to determine net income for proprietorships, partnerships, and corporations. There are, however, several differences. First, because a partnership is not subject to income tax, no income tax expense is reported in the income statement. Second, interest on capital investment and salaries to partners have traditionally been treated as allocations of net income, rather than as expenses of the business. This practice is considered appropriate under the proprietary theory view of the firm in which all transactions with the owners are viewed as capital transactions. In other words, no revenue or expense should be recognized in transactions with the partners. Also, since the partners are owners of the business, the interest and salaries may not represent objectively determined amounts.

In addition to the transactions discussed before that affect a partner's capital interest, an individual partner may also lend cash to the partnership that may be accounted for as a liability of the partnership. A partner may also borrow cash from the partnership with the intention of repaying the loan to the partnership. In contrast to capital transactions, such as the withdrawal of assets as part of a profit allocation, an advance to a partner is accounted for as a receivable of the partnership, provided that the receivable satisfies the normal tests of collectibility. Generally accepted accounting standards should also be followed in accounting for, and disclosing, receivables from officers or members of a firm.

Recording the Formation of a Partnership

Assets invested in the partnership, any debts assumed by the partnership, and the capital interest each partner is to receive should be specified in the partnership agreement. A listing of partnership assets is important, because creditors of the partnership must satisfy their claims from partnership assets before seeking recovery of unpaid claims from the personal assets of individual partners.

Assets invested in the partnership can be either cash or noncash assets, such as a patent, land, or equipment. Noncash assets invested in the partnership are properly recorded at fair values on the date of investment.[10] Liabilities assumed by the partnership should also be recorded at their fair values.

Once the partners agree as to the identification and valuation of assets being invested, liabilities being assumed by the partnership, and the capital interest that each partner is to receive, the assets, liabilities, and equities are recorded on the

[10] FASB ASC paragraph 845–10–30–1.

books of the partnership. To illustrate, assume that the following items are being invested to form WY Partnership:

	Agreed Fair Values	
	Investment by Wright	*Investment by Young*
Cash	$10,000	$10,000
Inventory	10,000	—
Land	—	20,000
Building	—	40,000
Equipment	20,000	—0—
Totals	40,000	70,000
Mortgage on building assumed by the partnership	—0—	20,000
Net assets invested	$40,000	$50,000

The journal entry to record the initial investment, assuming that Wright and Young agree that each partner is to receive a capital credit equal to the fair value of the net assets each partner invested, is as follows:

Cash	20,000	
Inventory	10,000	
Land	20,000	
Building	40,000	
Equipment	20,000	
Mortgage Payable		20,000
Wright, Capital		40,000
Young, Capital		50,000

LO5 Recording the formation of a partnership.

A problem results if the sum of the agreed net asset values does not equal the negotiated capital interest or if the agreement is unclear. For example, there are several possible interpretations of an agreement that each partner is to receive an equal capital interest. Two possible types of entries, the bonus method and the goodwill method, might be used to record the formation. Assuming the facts in the preceding paragraph, these entries are as follows:

	I Bonus Method		*II* Goodwill Method	
Cash	20,000		20,000	
Inventory	10,000		10,000	
Land	20,000		20,000	
Building	40,000		40,000	
Equipment	20,000		20,000	
Intangible Asset*	—		10,000	
Mortgage Payable		20,000		20,000
Wright, Capital		45,000		50,000
Young, Capital		45,000		50,000

* Generally referred to as partnership goodwill.

Under the ***bonus*** method, there is a capital interest transfer of $5,000 from Young to Wright to equalize the capital balances. Such an entry is made if Young recognizes that Wright is contributing something to the firm other than tangible assets, but the partners are reluctant to recognize an intangible asset, or a value for it cannot be determined objectively. Under the ***goodwill*** method, if equal capital interests are to be given to each partner, Wright's capital is increased by $10,000. This is accomplished by recognizing an intangible asset of $10,000 with a corresponding increase in the credit to the capital account of Wright. It is assumed that Wright is contributing something of value to the partnership that is intangible in nature, and which could not be

specifically identified. The value assigned to the intangible asset could have been more than $10,000. Young may also be contributing an intangible asset to the partnership in addition to the tangible assets identified and valued. Unless the intangible is specifically identifiable, such as a patent, it should probably ***not*** be recognized. It is difficult to justify the recognition of an unspecified intangible such as goodwill on the books of a ***new*** partnership that does not have an established earnings record.

Allocation of Net Income or Net Loss

The partners should include in the articles of partnership a provision indicating how income and losses are to be allocated. The profit and loss agreement determines how much each partner's interest in the firm increases or decreases as a result of operations. Often one of the major problems of accounting for a partnership is to determine the intent of the partners as indicated in the partnership agreement. The partners have much flexibility in the area. However, to avoid disagreement and potential litigation, the profit and loss agreement should be explicitly stated. In the absence of an agreement, courts have generally concluded that the intent of the parties was to allocate profits and losses equally. If a provision for profits, but not losses, is included in the agreement, the courts have generally concluded that losses should be allocated in the same ratio that profits are allocated. Therefore, the partnership agreement should state whether losses are to be allocated differently than profits.

The objective of the profit and loss agreement should be to reward the individual partners for their contributions of resources to the partnership. Some of the more common agreements are based on some combination of the following:

LO6 Allocating net income or loss.

1. A fixed ratio.
2. A ratio based on capital balances.
3. Interest on capital investment.
4. An allocation for time or managerial talent devoted to the partnership operation, either in the form of a fixed salary allocation or a bonus as a percentage of income.

Partnerships have a number of allocation possibilities and sometimes use several of the following strategies to allocate income or losses. Unless otherwise stated, income for the period is assumed to be $20,000 in the following examples.

Fixed Ratio One of the simplest agreements is for each partner to be allocated profit or loss each period on the basis of an equal percentage or some other specified ratio. For example, Adams and Brown may agree that profit and loss are to be allocated in the ratio 7:3. A profit of $20,000 would be allocated $14,000 to Adams and $6,000 to Brown. The entry to close the Income Summary account would take the following form:

Income Summary	20,000	
Adams, Capital		14,000
Brown, Capital		6,000

Note that the allocation determines the increase in each partner's interest in net assets resulting from operations. It has nothing to do with the withdrawals of assets by partners, which are recorded as debits to the capital or drawing accounts.

Unless stated otherwise, a loss of $20,000 would also be allocated using a 7:3 ratio. If this is not the intent of the partners, a separate loss agreement should be stipulated.

Capital Balances Assets invested in the partnership are important resources. The allocation of profits on the basis of the ratio of capital balances may result in an equitable allocation of profits when the operation of the partnership requires little of the partners' time, such as the operation of an apartment building in which there is a hired manager. To avoid conflicts, the capital ratio should be based upon the capital balance at a specific point in time, such as the amount of original investment, beginning-of-year balances, on average, or end-of-year balances. Allocations based on beginning and ending balances could be inequitable. For example, if the allocation ratio is based on ending balances, a partner could make a large capital investment at the end of the year. To avoid such abuse, partners may want to specify restrictions or use a weighted-average capital balance.

Assuming that the ratio is based on beginning capital balances and that Adams and Brown had balances of $60,000 and $40,000, respectively, the net income of $20,000 would be allocated as follows:

Capital Investment		*Net Income Allocation*
Adams	$ 60,000	($60,000/$100,000) × $20,000 = $12,000
Brown	40,000	($40,000/$100,000) × $20,000 = 8,000
	$100,000	$20,000

Net income allocation based on a weighted-average capital investment ratio is computed in Illustration 15-1. The weighted average is computed by multiplying the various capital balances that each partner maintained during the year by the fraction of the year that a particular capital balance was maintained. The $20,000 net income is allocated on the basis of the ratio of the weighted-average capital investment.

The allocation of a loss on the basis of the ratio of capital balances would mean that Adams, who has invested the most capital, would absorb the greatest amount of

ILLUSTRATION 15-1

Computation of Weighted-Average Capital Balances

Adams, Capital	(A) *Increase (Decrease) in Capital*	(B) *Cumulative Capital Balance*	(C) *Fraction of Year in Months*	(D) *Weighted Average (B) × (C)*
January 1 Beginning Balance		$60,000	3/12	$15,000
April 1 Added $30,000 Investment	$ 30,000	90,000	3/12	22,500
July 1 Withdrew $10,000	(10,000)	80,000	6/12	40,000
Weighted-Average Capital Balance				$77,500
Brown, Capital				
January 1 Beginning Balance		40,000	9/12	$30,000
October 1 Withdrew $10,000	$(10,000)	30,000	3/12	7,500
Weighted-Average Capital Balance				$37,500

Weighted-Average Investment		*Net Income Allocation*	
Adams	$ 77,500	($77,500/$115,000) × $20,000 =	$13,478
Brown	37,500	($37,500/$115,000) × $20,000 =	6,522
	$115,000		$20,000

the loss, which may be considered an unreasonable allocation. If this is the case, the partners may want to stipulate a different ratio for the allocation of losses.

Interest on Capital Investment Using the ratio of capital balances as the basis for allocation of profit assumes that invested capital is the most important resource of the partnership. However, in many profit-making organizations, other important resources should also be recognized. To accomplish this and still provide an equitable allocation, the partners may want to provide for interest on capital investment and allocate the remaining income on some other basis. Such a provision may also provide an incentive for additional capital to be invested, if necessary. The agreement should specify a minimum:

1. The interest rate,
2. The proper capital balance (beginning, ending, or average),
3. How remaining profits should be allocated, and
4. Whether or not interest should still be allocated in case of loss or in case profits are less than the agreed interest allocation.

LO7 Using interest allowances in allocating profits and losses.

Frequently, the interest allocation is based on weighted-average capital investment. To illustrate, assume the average investment in Illustration 15-1. Interest is then computed on this amount. Assuming a net income of $20,000, an 8% rate of interest, and that any remaining profit is to be divided equally, the profit (or loss, if negative) is allocated as follows:

Interest Allocation	*Adams*	*Brown*	*Total*
$77,500 × .08 =	$ 6,200		$ 6,200
37,500 × .08 =		$3,000	3,000
Total interest allocated	6,200	3,000	9,200
Remainder shared equally	5,400	5,400	10,800
Total to be allocated	$11,600	$8,400	$20,000

LO7 Using Salary allowance in allocating profits and losses.

Salary The partners may provide, as part of the profit and loss formula, a salary allowance in recognition of personal services rendered by a partner. The amount by which net income exceeds the salary allowances may then be divided by any ratio agreed upon by the partners. For example, if Adams devotes full time to the business activity and Brown spends a limited amount of time, the partnership agreement may specify that Adams is allowed a salary of $1,000 per month and that the remaining income is to be divided on the basis of the ratio of the beginning capital balances ($60,000 and $40,000, respectively). The allocation would be as follows:

	Adams	*Brown*	*Total*
Salary allowance	$12,000	$—0—	$12,000
Remainder			
($60,000/$100,000) × $8,000	4,800		
($40,000/$100,000) × $8,000		3,200 }	8,000
	$16,800	$3,200	$20,000

A salary agreement is considered a part of the profit and loss allocation formula and may be made independent of the agreement between the partners as to the right to withdraw cash or other assets from the partnership. The withdrawal of cash reduces the partner's capital interest (debit to the drawing account) but plays no

part in the allocation of net income. Since the term ***salary*** is normally understood to mean a cash payment for services received, it is important that the partners specify their intentions as to an allocation of profit or permission to withdraw assets.

Bonus Instead of basing the salary allocation on a fixed amount, the partners may provide for a bonus arrangement as a percentage of income or some other basis. Since a number of interpretations can result, the partners should explicitly state the basis to be used in calculating the bonus. Some possibilities based on net income are:

1. Net income before any allocation of income to partners (for example, before interest on capital, salaries to partners, and any bonus).
2. Net income after other income allocations, but before subtracting the bonus.
3. Net income after subtracting the bonus, but before subtracting the other allocations.
4. Net income after subtracting the bonus and other allocations from net income.

Calculation of the bonus in the first two alternatives is straightforward. To illustrate alternatives 3 and 4, assume that net income is $24,000, and a bonus of 20% is to be paid to Adams. Also, interest of $4,000 and $2,000 is to be allocated to Adams and Brown, respectively, and any remainder is to be allocated equally. The bonus and a proof of the calculation are as follows:

Alternative 3			*Alternative 4*		
Bonus	=	.2($24,000 − Bonus)	Bonus	=	.2($24,000 − $6,000 − Bonus)
Bonus	=	$4,800 − .2Bonus	Bonus	=	.2($18,000 − Bonus)
1.2 Bonus	=	$4,800	Bonus	=	$3,600 − .2Bonus
Bonus	=	$4,000	1.2 Bonus	=	$3,600
			Bonus	=	$3,000

Proof:

	Alternative 3	*Alternative 4*
Net income	$24,000	$24,000
Bonus	4,000	3,000
Interest		6,000
Income subject to bonus	$20,000	$15,000
	Bonus = .2($20,000)	Bonus = .2($15,000)
	Bonus = $4,000	Bonus = $3,000

Insufficient Income to Cover Allocation

In some cases, the partnership net income may be less than the interest and/or salary provided for in the partnership agreement. If the partners fail to provide for such an occurrence in the profit and loss formula, the established practice is to allocate the interest and/or salary as if sufficient income had been earned. The amount by which the salary and/or interest exceeds the net income is allocated to the individual partners in their agreed ratio for allocating residual income. For example, assume that Adams and Brown agree to divide profits as follows:

1. Salary: Adams, $4,000; Brown, $2,000.
2. Interest: 8% on average capital balances (see Illustration 15-1).
3. Remainder: To be divided equally.

A net income of $11,000 would be allocated as follows:

	Adams	*Brown*	*Total*
Salary	$ 4,000	$ 2,000	$ 6,000
Interest	6,200	3,000	9,200
	10,200	5,000	15,200
Excess allocation ($11,000 − $15,200)	(2,100)	(2,100)	(4,200)
Income allocation	$ 8,100	$ 2,900	$11,000

The entry to close the Income Summary account is:

Income Summary	11,000	
Adams, Capital		8,100
Brown, Capital		2,900

As will be shown in the next section, this procedure produces the same results as if each partner's salary and interest had been treated as an expense in the determination of the partnership net income or loss.

In the case of a loss of $20,000, the allocation would be as follows:

	Adams	*Brown*	*Total*
Salary	$ 4,000	$ 2,000	$ 6,000
Interest	6,200	3,000	9,200
	10,200	5,000	15,200
Excess allocation (−$20,000 − $15,200)	(17,600)	(17,600)	(35,200)
Loss allocation	$ (7,400)	$(12,600)	$(20,000)

To avoid such an allocation, the partners may elect to state an alternative allocation in the articles of partnership. Once again, this situation indicates the need for careful planning in drafting the partnership agreement.

TEST YOUR KNOWLEDGE

15.1

NOTE: Solutions to *Test Your Knowledge* questions are found at the end of each chapter before the end-of-chapter questions.

Multiple Choice

1. Bob and Tom form a partnership on January 1, 2008. Bob contributes $50,000, while Tom contributes $100,000 cash and a building worth $200,000. The building is subject to a mortgage of $40,000, which is assumed by the partnership. They agree to share profits and losses equally. Tom's capital account on January 1, 2008, should be:
   a. $300,000
   b. $280,000
   c. $155,000
   d. $260,000

SPECIAL PROBLEMS IN ALLOCATION OF INCOME AND LOSS

Salaries and Interest as an Expense

In the foregoing illustrations, salaries and interest were accounted for as an allocation of net income, rather than as an expense in the determination of net income. However, the partners may find the income statement more useful for evaluating

the operating performance of the partnership if either or both salary and interest allocations were treated as an expense in the determination of net income. If the salary levels and interest rates are reasonable for the resources provided, the income statement for the partnership may be more comparable to income statements of nonpartnership forms of organization. To illustrate, assume that the partnership reported net income of $11,000 before the interest and salaries of the partners. The partners are to be allocated salaries and interest as follows:

	Adams	*Brown*
Salary	$4,000	$2,000
Interest	6,200	3,000

The partners agree to allocate residual income and loss evenly. Journal entries to record the salaries and interest would be:

Salary Expense	6,000	
Adams, Capital		4,000
Brown, Capital		2,000
Interest Expense	9,200	
Adams, Capital		6,200
Brown, Capital		3,000

Net loss for the period after salaries and interest would be $4,200, computed as follows:

Net income before salaries and interest		$11,000
Less: Salary expense	$6,000	
Less: Interest expense	9,200	15,200
Net loss		$ 4,200

After the revenue and expense accounts are closed, Income Summary would have a debit balance of $4,200, which would be allocated evenly to the partners as agreed. The following entry would be recorded to close the income summary account:

Adams, Capital	2,100	
Brown, Capital	2,100	
Income Summary		4,200

Changes in the capital accounts are presented here:

Adams, Capital

From Income Summary	2,100	Salary entry	4,000
		Interest entry	6,200
		Net change in capital	8,100

Brown, Capital

From Income Summary	2,100	Salary entry	2,000
		Interest entry	3,000
		Net change in capital	2,900

This procedure results in the same change in the capital accounts as if the salaries and interest were considered an allocation of profit. (See the previous illustration where profits were insufficient to cover salary and interest allocations.) The method of reporting that is selected should be the one that provides the most useful information to the partners. Since the normal practice is to recognize salaries and interest as an allocation of profit, any such amounts treated as an expense should be adequately disclosed so the statement reader can properly evaluate the operating performance of the firm.

Adjustment of Income of Prior Years

Errors may occur in accounting for partnership operations, such as failure to accrue or defer expenses or revenue, errors in the inventory count or pricing, or errors in the calculation or amortization of fixed assets. Problems in the allocation of profit and loss can result if (1) errors are discovered that occurred in specific prior years, and (2) the partners have altered the profit and loss agreement since the period in which the error occurred. In a corporation, an error correction is accounted for as an adjustment to the beginning retained earnings balance. However, in a partnership the correction is allocated to the individual partners' capital accounts. The allocation should be based on the profit and loss agreement in effect during the period of the error.

Other allocation problems may arise, such as market changes in assets being held for investment purposes that occur before a change in the allocation formula, or an adjustment for bad debts that cannot be attributed to any specific period. There is no clear-cut answer to such problems. Litigation can be avoided by providing for the treatment of such potential problems in the partnership agreement.

FINANCIAL STATEMENT PRESENTATION

The income statement, balance sheet, and statement of cash flows for a partnership presented in conformity with GAAP are prepared in much the same manner as they are for a corporation. The following is a list of some of the differences in partnership reporting:

1. On the balance sheet or in a supplementary schedule, changes in partner's equity during the year should be disclosed.[11]
2. Partners' salary allowances are generally recognized as an allocation of net income, not as an expense in the determination of net income.
3. There is no income tax expense. The partners report their share of the partnership income or loss for the period on their individual income tax returns.
4. Interest paid to a partner on a loan balance is recognized as an expense. Interest allowance on capital investment is considered an allocation of profit.

A statement of changes in partners' capital is prepared to disclose changes in the interest of each partner during the year as shown in Illustration 15-2. For some

[11] This disclosure is usually not made when the number of partners is very large. For example, some accounting firms have thousands of partners.

ILLUSTRATION 15-2
AB Partnership
Statement of Partners' Capital
for the Year Ended December 31, 2004

	Adams	*Brown*	*Total*
Capital Balance, January 1	$ 60,000	$40,000	$100,000
Add: Additional Investment	30,000	—0—	30,000
Net Income Allocation	16,800	3,200	20,000
	106,800	43,200	150,000
Less: Withdrawals	10,000	10,000	20,000
Capital Balance, December 31	$ 96,800	$33,200	$130,000

external reporting purposes, such detail may not be considered necessary. The partnership capital, for example, may be reported as one amount, and the capital balance of each partner may be disclosed in a supplementary schedule or not disclosed at all.

CHANGES IN THE OWNERSHIP OF THE PARTNERSHIP

The UPA (Section 29) defines ***dissolution*** as "the change in the relation of the partners caused by any partner ceasing to be associated in the carrying on as distinguished from the winding up of the business." The partnership dissolution may be voluntary (for example, mutual agreement by the partners) or involuntary (for example, bankruptcy of an individual partner or the partnership itself). Although dissolution means the end of a specific relationship among the partners, it does not automatically result in the termination of business activity. For example, in some forms of dissolution, such as the bankruptcy of the partnership, the partnership operations are eventually terminated and the partnership ceases to exist. In other cases of dissolution the partnership may be dissolved, but the remaining partners may continue the normal operations of the partnership without any visible interruptions of the firm's operations.

In this chapter we consider the accounting problems associated with changes in the ownership of a continuing partnership. The changes that will be considered result from (1) admission of a new partner by the purchase of an interest directly from one or more current partners, which is frequently referred to as an assignment of a partnership interest, (2) admission of a new partner by investing assets in the partnership, and (3) withdrawal of a partner as a result of retirement or death. Unless precluded from doing so in the partnership agreement, generally a partner may insist on liquidation of the partnership in these forms of dissolutions. Because the going-concern value of the business is usually greater than its liquidation value, the partners may provide in the partnership agreement that such changes in the relations of the partners do not dissolve the partnership. Dissolution of the partnership in which operations are eventually terminated will be covered in the next chapter.

Valuation—A Central Issue

When there is a change in the membership of the partnership, the problem of assigning a fair value to the firm arises. For example, if a partner withdraws from the partnership and there are no express provisions in the partnership agreement for

determining the settlement, an equitable payment for his or her interest must be negotiated among the existing partners. Similarly, before admission, an incoming partner must negotiate with the existing partners an equitable purchase price for the interest he or she acquires. The settlement or purchase price is based on a number of factors, one of which is the fair values of the partnership assets. However, the fair values of the partnership assets are generally not reflected on the partnership books. In accordance with generally accepted accounting standards, partnership assets are recorded at cost, and subsequent increases in their market value are not recognized.

LO9 Rationale behind the goodwill method.

One approach is to first revalue assets and liabilities to their fair values and record any identifiable unrecorded assets and liabilities before recording the admission or withdrawal of a partner. In addition, the settlement price paid to a withdrawing partner or the purchase price paid by a new partner may be used to infer a value for the firm as a whole. Any difference between the value of the firm implied by the payment and the fair value of the net assets may be assigned to an intangible asset frequently referred to as partnership goodwill. An increase or decrease in net assets is allocated to the appropriate partners in their profit or loss ratio. Under this approach, the use of fair values provides an equitable measure of each partner's capital interest in the partnership. Furthermore, when a new partner is admitted, failure to recognize fair values will result in unrecorded value changes realized later being allocated in the profit- and loss-sharing ratio unless a separate provision is made. An unrecorded increase in value would benefit the new partner, whereas an unrecorded decrease would be a detriment. Revaluation of assets and liabilities is supported on the basis that, in dissolution, the old partnership is dissolved and a new entity is formed.

In practice, some accountants are reluctant to recognize a change in the value of an asset, even though there may be objective evidence that a specific asset is undervalued. They argue that recording an increase in fair value for external reporting purposes is not in accordance with generally accepted accounting practice and that economic substance should take precedence over legal form. That is, even though the partnership may be legally dissolved, the economic substance of some types of dissolution is that the business activity continues without interruption. Proponents of this method would retain the historical cost carrying value, and either prescribe in the agreement that unrecorded changes in value will not be shared with a new partner when realized, or will require a disproportionately high capital investment in relation to the new partner's income-sharing percentage. In this chapter, the revaluation of assets is shown as one of the approaches to recording changes in ownership because it is commonly advocated as an acceptable alternative and its use has some merit.

Methods of Recording Changes in the Membership of the Partnership

Two methods are frequently used to record changes in partnership membership:

LO8 Recording partnership changes.

1. *The bonus method.* When this method is used, the assets of the partnership are increased by the amount of the assets invested by the partner being admitted. Any difference between the assets invested and the credit to the new partner's capital account is adjusted to the capital accounts of the other partners involved in the negotiations. If a partner withdraws from a partnership, the partners may agree

to settle his or her capital interest by permitting the withdrawal of partnership assets. If the bonus method is used to record the withdrawal, the difference between the recorded value of the assets withdrawn and the debit to the withdrawing partner's capital account is adjusted to the capital accounts of the remaining partners.

2. *The goodwill method.* When this method is used, a new asset is recorded that is based on the difference between the value implied by the amount of consideration negotiated in the admission or withdrawal of a partner and the values reported in the partnership books.

Whether the bonus method or goodwill method is used, unrecorded changes in the value of existing assets and liabilities that are objectively determinable may be recorded before the change in membership is recorded.

As will be demonstrated, if certain limited conditions related to the profit and loss agreement are satisfied, the bonus and goodwill methods will produce the same result. If these conditions are met, the use of the bonus method precludes the problem of recording an intangible asset.

The bonus and goodwill methods are used for either ***admission of a new partner*** or the ***withdrawal of a partner***, described in the following sections A and B.

SECTION A: ADMISSION OF A NEW PARTNER

An individual may acquire an interest in a partnership: (1) by purchasing all or part of an interest directly from one or more existing partners (this transaction occurs outside the partnership and represents a transfer of assets between individuals), or (2) by being admitted as an additional partner on the investment of assets in the firm. Generally, the individual invests cash and/or other assets (for example, land, patent rights, equipment, marketable securities). A new partner could be admitted, however, by contributing a resource such as managerial talent. Because accountants ordinarily do not record such assets, unless the partners agree to transfer capital to the new partner's account, he or she will begin with a zero capital balance.

Assignment of an Interest by an Existing Partner

LO8 Methods to record partnership changes.

A partner is entitled to sell his or her interest in the firm, but no partner can be forced to accept a new member to the partnership. The UPA (Section 27) provides that the purchasing party acquire only the right to receive profits and assets in the event of liquidation to which the selling partner would otherwise be entitled. The purchaser does not acquire the right to participate in management unless all remaining partners agree to grant this right. The mere act of selling an interest does not dissolve the partnership, because the overall relation of the partners is not changed.

In the following illustrations, it is assumed that the partnership currently consists of two partners, Alan Adams and Bill Brown, with respective capital interests of $60,000 and $40,000. Adams and Brown share income and losses in the ratio of 6:4. Both partners agree to the admission of a new partner.

Acquisition of Interest by Payment to One Partner If an individual acquires an interest in a partnership by making payment directly to an existing partner, the interest acquired is recorded in a new capital account by transferring a corresponding

amount equal to the percentage interest acquired from the selling partner's capital account. For example, assume that Adams sold one-half of his interest in the firm to Carol Call for $36,000. The only entry necessary on the partnership books is to record the transfer of capital interest from the selling partner to the capital account established for the new partner. The entry is:

Adams, Capital (.50 × $60,000)	30,000	
Call, Capital		30,000

The following should be noted:

1. Since this is a personal transaction between the two individuals, the entry is the same regardless of the amount paid by Call directly to Adams.
2. Net assets and equities of the firm are not changed as a direct result of the transaction, since the sale was negotiated outside the partnership. However, as noted earlier, the partners may choose to revalue assets and liabilities.
3. The amount of capital transferred to Call is equal to Adams' recorded capital multiplied by the percentage interest in Adams' capital acquired by Call.
4. Call now has a capital interest of 30% ($30,000 of total interest of $100,000), but her profit interest does not have to equal this percentage.

A simplified balance sheet after the admission of Call would be as follows:

Net assets	$100,000	Adams, Capital	$ 30,000
		Brown, Capital	40,000
		Call, Capital	30,000
Total	$100,000	Total	$100,000

Acquisition of an Interest by Payment to More Than One Partner If Call had purchased a 30% interest from each partner for $36,000, the entry would be:

Adams, Capital (.30 × $ 60,000)	18,000	
Brown, Capital (.30 × $ 40,000)	12,000	
Call, Capital (.30 × $100,000)		30,000

The observations outlined before when the purchase was made from one partner apply in this case as well. Furthermore, this entry has no effect on how the cash payment made by Call is to be distributed to Adams and Brown outside the partnership. The amount and distribution of cash is a negotiated transaction between individuals and does not affect the partnership accounts unless the amount is used as a basis for the revaluation of the firm.

Goodwill Implied by the Purchase Price In the foregoing examples, the amount paid by Call to gain admission to the firm was ignored in recording the transfer of interest. This procedure is often referred to as the bonus method. Some argue that the payment of $36,000 for a $30,000 interest in the partnership indicates that the firm has assets that are unrecorded or undervalued. The assumption is that the negotiated purchase price took into consideration such factors as the fair values of the firm's assets, the present value of the firm's liabilities, and the valuation of the firm on the basis of future prospects. Thus, the payment can be used to approximate the value of the firm. If Call is willing to pay $36,000 for a 30% interest in the firm, then

ILLUSTRATION 15-3

Schedule of Account Balances

	Net Assets	+	*Goodwill*	=	*Capital Adams*	+	*Capital Brown*	+	*Capital Call*
Book Values	$100,000	+	$ —0—	=	$(60,000)	+	$(40,000)	+	$ —0—
Record Goodwill			20,000		(12,000)		(8,000)		—0—
	100,000	+	20,000	=	(72,000)	+	(48,000)	+	—0—
Transfer of Capital					21,600		14,400		(36,000)
Balance after Admission of Call	$100,000	+	$20,000	=	$(50,400)	+	$(33,600)	+	$(36,000)

*In this chapter, ( ) means that an account has a credit balance or a credit posted to an account.

the implied value of the partnership net assets is $120,000 ($36,000 ÷ .30). Net assets and capital should be increased by $20,000 from the recorded amounts of $100,000. Since this represents an unrecorded increase in the value of the firm's assets, the increase in assets of $20,000 is allocated to Adams and Brown in their profit-sharing ratio. To the extent that the excess cannot be assigned to specific identifiable recorded assets, the remaining amount is recorded as partnership goodwill. Assuming that the book values of assets and liabilities equal their fair values, the entries to record the increase in assets and admission of Call are as follows:

Goodwill	20,000	
Adams, Capital (.60 × $20,000)		12,000
Brown, Capital (.40 × $20,000)		8,000
Adams, Capital (.30 × $ 72,000)	21,600	
Brown, Capital (.30 × $ 48,000)	14,400	
Call, Capital (.30 × $120,000, also equal to cash paid)		36,000

This results in account balances as presented in Illustration 15-3.

Comparison of Bonus and Goodwill Methods In the illustration, Call is credited with a 30% interest in the firm under the bonus and the goodwill methods. To assist the partners in making a decision between the two methods, it may be helpful to demonstrate the effects of the two methods on their respective capital balances. If the firm were forced to liquidate, the goodwill would probably be of no value and, therefore, would represent a loss to the partnership.

The bonus and goodwill methods will yield the same result if two conditions related to the new profit and loss agreement are met. These are:

1. The new partner's profit-sharing percentage must be equal to his or her percentage interest in capital. In this illustration, Call received a capital interest of 30%. Her profit-sharing ratio must be 30%.
2. The old partner's profit-sharing ratio in the new partnership must be relatively the same as it was in the old partnership. Thus, if Call is to receive 30% of the profit in the new partnership, Adams and Brown must receive the remaining 70%. To be in the same relative ratio of 6:4, Adams must receive 42% (.6 ×.70) of profits, and Brown must receive 28% (.4 ×.70). The two methods are equivalent if, after recording goodwill impairment, the account balances are the same as they would be under the bonus method. The balances for each method are presented in Illustration 15-4.

ILLUSTRATION 15-4
Schedule of Account Balances

Goodwill Method	Net Assets	+ Goodwill	=	Capital Adams	+	Capital Brown	+	Capital Call
Balances after recording goodwill and admitting Call	$100,000	+ $ 20,000	=	$(50,400)	+	$(33,600)	+	$(36,000)
Impairment of goodwill		(20,000)						
$20,000 × .42				8,400				
20,000 × .28						5,600		
20,000 × .30								6,000
Totals	$100,000	+ $—0—	=	$(42,000)	+	$(28,000)	+	$(30,000)
Bonus Method								
Balances after recording admission of Call	$100,000	+ $—0—	=	$(42,000)	+	$(28,000)	+	$(30,000)

The two methods will also yield the same results if the bonus method is used and the unrecorded assets ($20,000) are ultimately realized and allocated to the partners in the ratio of 42:28:30.

Acquisition of an Interest by Investing Assets

An individual may obtain a partnership interest in capital and future income by investing something of value to the firm. If assets are invested, the admission is recorded by debiting the assets invested and adjusting the net capital interest in the firm by a corresponding amount. It is important that the assets invested be fairly valued. Any gain or loss recognized on sales subsequent to recording the admission will be allocated on the basis of the new profit and loss formula.

Three situations can exist when an individual invests assets in a firm:

1. Book value of the capital interest acquired is equal to the fair value of the assets invested.
2. Book value of the capital interest acquired is less than the fair value of the assets invested.
3. Book value of the capital interest acquired is greater than the fair value of the assets invested.

The book value of the capital interest acquired is computed as follows:

$$\left(\text{Capital balances of existing partners} + \text{Investment of new partner}\right) \times \text{Percentage interest acquired by new partner} = \text{Book value of capital interest acquired}$$

To illustrate the three situations, assume that Adams and Brown have capital interests of $40,000 and $30,000, respectively. Assume further that, unless stated otherwise, the book values of the recorded assets and liabilities of the firm equal their fair values. Profits are shared in the ratio of 6:4. Call is to be admitted to the partnership, after which the profit ratio is to be 4:4:2. For simplicity, we will assume in all cases that Call invests cash.

Case 1: Book Value Acquired Is Equal to Assets Invested Assume that Adams, Brown, and Call agree that Call is to invest $35,000 for a one-third capital interest in the partnership. The book value of Call's interest is equal to the assets invested and is computed as follows:

$$(\$70{,}000 + \$35{,}000) \times 1/3 = \$35{,}000$$

The entry to record the admission of Call is simply:

Cash	35,000	
Call, Capital		35,000

Adams' and Brown's capital accounts remain unchanged at $70,000, which represents the remaining two-thirds interest in the firm. Call's capital account properly reflects a one-third interest of $35,000. It should be noted that the ratio of the capital balance of 40:30:35 does not equal the agreed profit and loss ratio 4:4:2.

Case 2: Book Value Acquired Is Less Than Assets Invested Assume now that Call is to invest $50,000 for a one-third capital interest in the firm. Book value of the interest acquired is:

$$(\$70{,}000 + \$50{,}000) \times 1/3 = \$40{,}000$$

In this case, the amount invested exceeds the book value interest acquired by $10,000. There could be a number of explanations for Call's willingness to pay this $10,000 excess. It could be that, as a result of a profitable and favorable outlook for the firm's operations, Adams and Brown are in a strong bargaining position.

The accounting problem is to record the admission of Call in accordance with the negotiated intentions of the parties involved. Obviously, if Call's capital account is credited with $50,000, her interest would exceed one-third of the partnership's total capital. Either the bonus method or the goodwill method can be used to record the admission so that Call will end up with a one-third capital interest.

Bonus Method When the bonus method is used, the excess of the amount invested over the book value interest received is considered a bonus to the existing partners. In this example, Call invested $10,000 more than the capital interest received. The $10,000 bonus is allocated to the old partners on the basis of their profit and loss ratio, since this is an increase in partnership assets. The entry to admit Call is:

Cash	50,000	
Adams, Capital (.6 × $10,000)		6,000
Brown, Capital (.4 × $10,000)		4,000
Call, Capital ((1/3) × $120,000)		40,000

Adams and Brown now have capital balances of $46,000 and $34,000 for a total capital interest of $80,000, which is a two-thirds interest in total capital of $120,000. Call has the remaining one-third interest of $40,000.

The assets of the partnership may have been revalued before the admission of a new partner was recorded. The bonus method is frequently used when the parties do not want to record an intangible asset. Notice in the entry to record the admission that the assets are increased only by the amount invested. Any difference between the capital credit for Call and the cash invested is an adjustment to the capital accounts of Adams and Brown.

Goodwill Method Call may negotiate that she is to receive a capital credit equal to her investment. If Call is to receive a capital credit of $50,000 for a one-third interest, the total capital interest implied by this contract is $150,000. Adams and Brown must have the remaining two-thirds interest, or $100,000. Since their current balances of $70,000 represent their interest in the net assets, assets and capital appear to be understated by $30,000.[12] Assuming that the specific assets and liabilities are fairly valued, this understatement is recognized as goodwill attributable to the old partners and is allocated to Adams and Brown on the basis of their current profit and loss ratios. The journal entry is:

Goodwill	30,000	
Adams, Capital (.60 × $30,000)		18,000
Brown, Capital (.40 × $30,000)		12,000

The entry to record the admission of Call is:

Cash	50,000	
Call, Capital		50,000

Net Assets Undervalued Had the net assets not been fairly valued as assumed here, the excess payment by Call could mean that specific assets of the firm are undervalued, or that partnership liabilities are overstated. If so, the specific assets (whether tangible or identifiable intangible assets) and liabilities of the partnership could be adjusted instead of creating a goodwill account. However, the specific accounts should not be adjusted in the absence of objective evidence that there are unrecorded changes in value.

Case 3: Book Value Acquired Is Greater Than Assets Invested Assume that Call is to invest $20,000 for a one-third capital interest in the firm. Book value of the interest acquired is:

($70,000 + $20,000) = $90,000 × (1/3) = $30,000

In this case, the book value interest acquired exceeds the value of the assets invested by Call, which could imply that assets are overvalued ((1/3) (company value) = $20,000; or, company value = $60,000), or that for some reason, Adams and Brown are willing to grant Call a capital credit greater than the amount of assets she is investing. In some cases, for example, a partnership may be in need of operating capital and the partners may be willing to sacrifice their interest in existing assets to acquire the cash; or it could be that Call is bringing some particularly needed talent or reputation to the partnership.

In this case, as in Case 2, the admission could be recorded either by the bonus method or by the goodwill method. Under either method, Call will end up with a one-third interest in the net assets of the firm.

Bonus Method When the bonus method is used, assets are not increased above what the new partner is investing. If Call is to receive a $30,000 capital credit on investment of $20,000, then a bonus of $10,000 is being granted to Call. This bonus is

[12] An alternate way to calculate goodwill is: Net value of firm implied by contract of $150,000 minus $120,000 (capital balances of Adams and Brown plus Call's investment) equals goodwill of $30,000.

allocated to reduce Adams' and Brown's capital in their agreed profit and loss ratio. The following entry reflects the bonus to Call and a resulting one-third interest in the total capital of $90,000:

Cash	20,000	
Adams, Capital (.60 × $10,000)	6,000	
Brown, Capital (.40 × $10,000)	4,000	
Call, Capital		30,000

Adams and Brown now have capital balances of $34,000 and $26,000, respectively, for a total of $60,000, or a two-thirds interest.

Goodwill Method If Adams and Brown are unwilling to reduce their capital accounts on the admission of Call, then an alternative to the bonus method is to compute and record the goodwill implicit in the agreement. Since Adams' and Brown's capital interests are to remain unchanged, the old partners' capital balances are used as the base to compute the value of the firm. If their interest represents a two-thirds interest in the net assets of the new partnership, then a three-thirds interest in the firm is $105,000 (or $70,000 ÷ 2/3), of which Call is to receive a capital credit of $35,000 ((1/3) × $105,000). The $15,000 difference between the capital credit of $35,000 and Call's investment of $20,000 is goodwill. The entry to record the admission of Call is:

Cash	20,000	
Goodwill	15,000	
Call, Capital		35,000

The entry recognizes that the new partner is investing cash and is bringing an intangible asset to the partnership. The amount recorded is based on the value implied by the partners' agreement.

Net Assets Overvalued The payment of $20,000 by Call for a larger capital interest may provide evidence that the recorded value of the firm's net assets does not reflect fair values and that the use of the bonus method or the creation of a goodwill account is an effort to avoid a reduction in net assets. The $20,000 invested by Call for a one-third interest could be used to impute a value for the partnership's net assets after the admission of Call of only $60,000.[13] The journal entries to revalue the assets and admit Call are as follows:

Adams, Capital	18,000	
Brown, Capital	12,000	
Assets ($70,000 + $20,000 − $60,000)		30,000
Cash	20,000	
Call, Capital		20,000

Account balances that result from the admission of Call for the three alternatives discussed are given in Illustration 15-5. Subsequent events alone can indicate which method should have been used to record the admission. An examination of

[13] The implied value of $60,000 compared to the total *recorded* value of net assets of $90,000 ($40,000 + $30,000 + $20,000), including Call's investment, suggests that recorded assets are overvalued by $30,000.

ILLUSTRATION 15-5
Schedule of Account Balances

Debit	*Bonus Method*	*Goodwill Method*	*Overvalued Net Assets*
Net Assets	$90,000	$105,000	$60,000
Credits			
Adams, Capital	$34,000	$ 40,000	$22,000
Brown, Capital	26,000	30,000	18,000
Call, Capital	30,000	35,000	20,000
Totals	$90,000	$105,000	$60,000

one of a number of events that could result will emphasize the importance of the initial asset valuation. Assume that the bonus method was used to record the admission of Call and that the assets were overvalued and subsequently sold at a loss of $30,000. The agreed profit and loss ratio is 4:4:2. After this transaction, the partners' capital balances are as follows:

	Adams	*Brown*	*Call*
Balance after admission of Call	$(34,000)	$(26,000)	$(30,000)
Share of $30,000 loss	12,000	12,000	6,000
	$(22,000)	$(14,000)	$(24,000)

The selection of the bonus method as opposed to reducing overvalued assets results in a gain in Call's capital relative to Brown's. Additional comparisons of the three methods assuming various other subsequent events could be developed.

TEST YOUR KNOWLEDGE

15.2

NOTE: Solutions to *Test Your Knowledge* questions are found at the end of each chapter before the end-of-chapter questions.

Richard, Dave, and Luke have been operating a magazine stand for several years. They share profits and losses equally, and each has a $50,000 capital balance. They decided to admit a new partner, Craig. Craig is to receive a 25% interest in the partnership.

1. Determine the amount of cash that Craig must pay if the partners do not wish to recognize any goodwill or bonus.
2. Determine Craig's initial capital balance if he contributes $60,000 cash and the bonus method is applied.
3. Determine Craig's initial capital balance if he contributes $60,000 cash and the goodwill method is applied.

SECTION B: WITHDRAWAL OF A PARTNER

A partner cannot be prevented from withdrawing from a partnership by the other partners. Although some complex legal issues are involved, the partnership agreement may specify conditions for withdrawal and provisions for computing the settlement. If a settlement is not specifically provided for in the partnership agreement, Section 42 of the UPA states that "he or his legal representative. . . may have the value of this interest ascertained and shall receive as an ordinary creditor an amount equal to the value of this interest."

A buy/sell agreement can mandate that the exiting partner or heirs, in the case of death, sell his or her interest to the remaining owners, who are legally bound to buy the interest according to an agreed-upon method of valuation. It can also designate which partner becomes the buyer and which the seller if it comes to that end.[14]

If a partner withdraws in violation of the partnership agreement and without approval of the remaining partners, he is entitled only to his interest in the firm without consideration of goodwill. In such a case, the withdrawing partner is liable for damages sustained by the remaining parties for his breach of the partnership agreement. A partner who is forced to withdraw from a partnership is entitled to compensation for his full interest including goodwill.

LO8 Changes in partnership.

In the following examples, it is assumed that the partners mutually agree to the withdrawal such that: (1) the withdrawing partner may elect to sell his interest to an outside party; (2) the withdrawing partner may elect to sell his interest to one or more of the remaining partners; or (3) the partners may mutually agree to transfer partnership assets to the withdrawing partner for his interest in the firm. Case 1 has been discussed earlier and need not be reviewed again. The same considerations apply to Case 2, if negotiated outside the partnership. In Case 3 the partnership agreement may include requirements for determining the settlement price. In most cases the capital account does not reflect the current value of the partner's interest. To be equitable the fair values of the assets and liabilities need to be determined. It may be necessary to recognize unrecorded assets, correct the accounts for errors, or reflect changes in estimates such as the book value of depreciable assets. In the absence of a specific agreement, the partners may have to negotiate a settlement price at the date of withdrawal. Determination of an equitable value may be very difficult. The agreed settlement price may be equal to, greater than, or less than the book value interests of the withdrawing partner.

To illustrate the accounting for the withdrawal of a partner by transferring firm assets, assume a partnership consisting of three partners, Adams, Brown, and Call, with capital balances of $30,000, $40,000, $30,000, and a profit and loss ratio of 5:3:2. Any agreed asset and liability revaluations have already been recorded.

Bad things can happen if an outsider makes a bid for a piece of the company—the lead partner's share, say, but not everyone else's. You don't want to be forced to work alongside an incompetent heir or a crook. Solution: The buy/sell agreement dictates that an outsider cannot buy a majority interest without offering to buy out everyone else on the same terms. Alternatively, it might provide that the remaining partners have a right of first refusal on any shares being sold.[15]

Payment to a Retiring Partner

Payment in Excess of Book Value to a Withdrawing Partner Assume now that Adams is withdrawing from the partnership and the partners have mutually agreed that he is to receive payment of $40,000. The partners may agree to use the bonus method or the goodwill method to record the withdrawal.

[14] *Forbes*, "Planning for Divorce," by Leigh Gallagher, 3/22/99, pp. 94–95.

[15] *Forbes*, "Planning for Divorce," by Leigh Gallagher, 3/22/99, pp. 94–95.

Bonus Method If the bonus method is used, the remaining partners are charged with the amount of the payment that exceeds the book value of the retiring partner's capital balance. The amount of the bonus paid to the retiring partner is commonly allocated to the remaining partners on the basis of their relative profit and loss ratio (in this case the relative ratio of Brown to Call is 3:2). Support for this method is based on the cost principle. The bonus method may also be justified when the remaining partners are simply anxious to get rid of a partner for various reasons. Any recognition of goodwill is difficult to justify in the absence of an arm's-length transaction. The entry to record the withdrawal would be as follows:

Adams, Capital	30,000	
Brown, Capital	6,000	
Call, Capital	4,000	
Liability to Adams		40,000

RELATED CONCEPTS

The rationale for the bonus method is the *historical cost principle* and the absence of an arm's-length transaction. The rationale for the goodwill method is that formation of a new entity should be based on fair values.

Goodwill Method The goodwill method is used if (1) Brown and Call do not agree to a reduction in their capital balances; (2) the partners made specific provisions in the partnership agreement on how the withdrawal is to be recorded; or (3) the partners agree that an intangible asset should be recognized. If the partnership has been profitable, the firm as a whole may be worth more than the fair value of the net assets. Once again, the goodwill method is supported on the basis that a new entity is being formed and the accounts of the new entity should be based on fair values. One alternative is to calculate the implied goodwill from the price paid to the retiring partner. In our example, Adams receives a $10,000 excess payment over his capital balance. Since Adams' capital account is increased by 50% of any increase in assets, then a $10,000 excess payment implies a total goodwill of $20,000. The entries are:

Goodwill	20,000	
Adams, Capital		10,000
Brown, Capital		6,000
Call, Capital		4,000
Adams, Capital	40,000	
Liability to Adams		40,000

Some argue that, in accordance with the cost basis, only the goodwill of $10,000 that has been purchased should be recorded (called the partial goodwill method) and the entry should be:

Goodwill	10,000	
Adams, Capital		10,000
Adams, Capital	40,000	
Liability to Adams		40,000

Others would contend that the basis for recognizing goodwill should be "all or nothing at all."

It is probably difficult to justify recognition of any goodwill. If the goodwill is related to Adams, it will not exist if he withdraws. However, as discussed before, if the goodwill is based on past operations, the withdrawal may provide the objective evidence necessary to recognize it in the partnership accounts.

Payment of Less Than Book Value to a Withdrawing Partner A partner who is anxious to dispose of his or her interest in the partnership may agree to accept less than his or her book value interest in the partnership. The partner may do so for a number of reasons, such as (1) he or she may view the future of the company negatively,

(2) he or she may need operating capital for personal reasons, or (3) the business association may no longer be acceptable to the partner and, in his or her opinion, a forced liquidation of the firm might be detrimental to his or her interest. In such cases, use of the bonus method is justified, since the settlement may not be based on the economic value of the firm.

To illustrate, assume that Adams withdraws from the ABC Partnership and agrees to settle his $30,000 interest for $25,000. A bonus of $5,000 accrues to the remaining partners. The common practice is to allocate the bonus on the basis of their relative profit and loss ratio of 3:2. The entry would be:

Adams, Capital	30,000	
Brown, Capital		3,000
Call, Capital		2,000
Liability to Adams		25,000

A payment to Adams that is less than his capital interest may be an indication that assets are overvalued. Assets should be written down to fair values if it is determined that they are overvalued and that the settlement price is based on the net assets' fair value. In particular, if goodwill was previously recorded, an agreement to accept a payment that is less than the partner's book value interest may provide evidence that the intangible is overstated. Accordingly, the intangible should be reduced by the difference between the settlement price and the capital interest being retired. Assuming that assets are overvalued by $10,000, the sequence of entries becomes:

Adams, Capital	5,000	
Brown, Capital	3,000	
Call, Capital	2,000	
Asset		10,000
Adams, Capital	25,000	
Liability to Adams		25,000

Reducing the assets to fair value provides an equitable starting point for the new partnership formed by Brown and Call. As long as Brown and Call share profits in the same relative ratio, they will be indifferent as to the method used. However, it is more informative and conceptually preferred for the recorded asset values to reflect fair values if such values can be determined.

Death of a Partner

While historically under the UPA a partnership was dissolved by the death of a partner, recent changes now allow the partnership to continue operating by mandating a buyout of the deceased partner's interest.

Determining a partner's equity interest in the firm can result in disagreements between the surviving partners and the executor of the estate. To avoid litigation, the articles of partnership should contain procedures for determining a deceased partner's current equity in the partnership and the method of settlement. In the absence of specific provisions, the surviving partners and the executor of the estate must negotiate a settlement. To determine a partner's equity interest at the time of death, the assets and liabilities normally are adjusted to current values and the accounts are closed to determine the net income or loss earned since the end of the last fiscal period.

The partnership agreement may provide that the interest is to be settled by distributing partnership assets to the estate or the estate may receive payment by selling the interest to an outside party or to one or more of the surviving partners as individuals. Entries to record both types of settlements were presented in earlier sections of this chapter.

SUMMARY

1. *Describe the characteristics of a general partnership, a limited partnership, and a joint venture.* In a general partnership, the partners can bind the partnership into contracts, and the partnership interest is similar to a personal asset that can be sold. The primary difference between a general partnership and a limited partnership is that general partners are personally liable for the debts of the partnership, while a limited partner is only liable for the amount invested in the partnership. A joint venture occurs when two or more parties (agents) enter into an arrangement to pursue a specific purpose. When joint ventures are structured as partnerships, they follow the partnership laws. One exception is that one party cannot act (enter into a contract) on behalf of the joint venture without the consent of the other agents.

2. *List some important items to be included in the partnership agreement.* Important items to include in the partnership agreement are the name of the partnership, the identity of the partners, the effective date and the length of operations, the provision for allocating profits and losses, provisions for salaries and withdrawals, contracting authorities, procedures for admitting a new partner, and procedures for dissolution of the partnership.

3. *Understand the differences between partnerships' and corporations' equity accounts in the balance sheet.* In a corporation, amounts contributed by the owners (i.e., stockholders) are recorded in capital stock accounts. In addition, any income or loss earned by the corporation is reported in retained earnings. Dividends are considered a distribution of earnings and thus reduce retained earnings. In a partnership, amounts contributed by the owners (i.e., partners) are recorded in the partners' capital accounts. Any income or loss earned by the partnership is allocated to the partners' capital accounts. If a partner takes money out of the partnership, a drawing account is often used.

4. *Explain the purpose of the partners' drawing accounts and capital accounts.* In general, the partners' capital accounts are for permanent investments and should be updated periodically for withdrawals. Drawing accounts are often used in anticipation of earnings or to pay for personal expenses. Drawing accounts record withdrawals during the year and are closed to the partners' capital accounts at year-end.

5. *Prepare journal entries to form a partnership using the bonus and the goodwill methods.* A choice between the bonus and the goodwill methods for recording the formation of a partnership is needed if the amounts contributed by each partner do not agree with the amount of capital to be credited to each partner (for example, one partner contributes 40% of the assets but is to be given a 50% interest). For example, suppose that Bob and Ed enter into a partnership. Bob contributes $40 cash and Ed contributes $60. Yet each is to be given an equal interest. The journal entries under the bonus and goodwill methods are as follows:

Bonus Method		
Cash	$100	
Bob, Capital		$50
Ed, Capital		$50
Goodwill Method		
Cash	$100	
Intangible Asset	$ 20	
Bob, Capital		$60
Ed, Capital		$60

Under the bonus method, the total amount contributed is allocated to all partners in accordance with their agreed-upon capital share (equally in this illustration, resulting in a transfer of $10 from Ed to Bob). Under the goodwill method, Bob is assumed to be contributing an intangible asset to the firm. Since Ed contributed $60 and Bob only $40, an intangible asset of $20 is recorded to increase Bob's capital to $60.

6. *Describe some common agreements used to allocate partnership net income or loss.* Common agreements to allocate partnership net income or loss include using (1) fixed ratios, (2) a ratio based on the partners' capital balances, (3) an implicit interest rate based on the partners' capital accounts (such as 10% of the year-end capital balance), and (4) various amounts that represent salaries or bonuses. In addition, the agreement must specify how any excess or deficit after an original allocation is divided among the partners.

7. *Explain why salary allowances and interest allowances are used in allocating partnership profits and losses.* Interest allowances are often used as an incentive for capital to be invested and stay invested in the partnership. If a partner withdraws money from

the partnership, that partner will receive a lower amount of interest and thus a smaller allocation of total profits. If the partner contributes more funds, that partner will receive a higher allocation. Similarly, a salary allowance is a common method to reward partners providing services to the partnership for their efforts.

8. *Describe the methods used to record partnership changes when a new partner is admitted or when a partner withdraws from the partnership.* When a new partner is admitted, the new partner can purchase the interest from an existing partner or the new partner can contribute additional assets to the partnership. As when a partnership is formed, either the bonus or the goodwill method may be used if the amount contributed does not agree with the amount of capital to be credited to the new partner. Upon the withdrawal of a partner, the same procedures are applied. If the amount paid to the withdrawing partner is more or less than the partner's existing capital balance, either the bonus or the goodwill method can be used. In this case, the withdrawing partner's final capital balance must equal the amount paid. Under the bonus method, this is achieved by a transfer from (to) the remaining partners' capital accounts to (from) the withdrawing partner's capital balance. Under the goodwill method, the firm is revalued using the amount paid to the withdrawing partner. All partners' capital accounts are adjusted.

9. *Describe the rationale behind the goodwill method in accounting for changes in partnership membership.* Under the goodwill method of accounting for changes in partnership membership, the capital interest assigned to the new or withdrawing partner implies a certain value for the firm. Since records are maintained on historical cost, differences in net asset values are likely. In addition, significant intangible assets may have been created by the partnership over time. The goodwill method assumes that the assigned capital interest provides a basis for total firm valuation.

TEST YOUR KNOWLEDGE SOLUTIONS

15-1 1. d

15-2

1. (150,000 ÷ .75) = 200,000 less existing capital of 150,000 = $50,000 cash contribution.
2. (150,000 + 60,000) = 210,000 × 0.25 = $52,500 capital balance.
3. ($60,000 ÷ 0.25) = $240,000 total capital implied × 0.25 = $60,000 capital balance.

QUESTIONS

LO1 1. Describe the tax treatment of partnership income.

LO4 2. Distinguish between a partner's interest in capital and his interest in the partnership's income and losses. Also, make a general distinction between a partner's capital account and his drawing account.

LO1 3. Explain why a partnership is viewed in accounting as a "separate economic entity."

LO6 4. What are some of the methods commonly used in allocating income and losses to the partners?

LO7 5. Explain the distinction between the terms "withdrawals" and "salaries."

LO5 6. List some of the alternative methods of calculating a bonus that may appear in a partnership agreement.

LO8 7. What is meant by dissolution and what are its causes?

LO8 8. Discuss the methods used to record changes in partnership membership.

LO8 9. Differentiate between the admission of a new partner through assignment of an interest and through investment in the partnership.

LO8 10. Under what two conditions will the bonus and goodwill methods of recording the admission of a partner yield the same result?

LO8 11. Describe the circumstances where neither the goodwill nor the bonus method should be used to record the admission of a new partner.

LO8 12. How might a partner withdrawing in violation of the partnership agreement and without the consent of the other partners be treated? What about a partner who is forced to withdraw?

Business Ethics

Many companies with defined benefit plans are curtailing or eliminating the plans altogether. With a defined benefit plan, the company guarantees some set amount (or formula-determined payment) when the employee retires. Because most pension assets are invested in the stock market, whether a pension plan is fully funded often depends on the strength of the stock market. Because of this volatility, companies often find themselves unexpectedly in a position where they must either increase funding or disclose significant underfunding. Because of this, many companies simply reduce or eliminate the plan. Consider the pension plan of Golden Years Company (GYC). Historically, GYC has been a great company to work for, with strong employee benefits. GYC's pension liability is approximately $15 million. However, recently the company has been experiencing minor financial troubles in a decreasing stock market and, consequently, announced the termination of the pension plan in an effort to save costs. However, the pension plan was fully funded by $9 million (the fair value of assets exceeded the expected liability).

1. How does the firm reconcile the trade-off between financial performance and the responsibility to its employees?

EXERCISES

EXERCISE 15-1 Partnership Formation: Bonus and Goodwill Methods LO5

John, Jeff, and Jane decided to engage in a real estate venture as a partnership. John invested $100,000 cash and Jeff provided office equipment that is carried on his books at $82,000. The partners agree that the equipment has a fair value of $110,000. There is a $30,000 note payable remaining on the equipment to be assumed by the partnership. Although Jane has no physical assets to invest in the partnership, both John and Jeff believe that her experience as a real estate appraiser is a valuable skill needed by the partnership and is a basis for granting her a capital interest in the partnership.

Required:

Assuming that each partner is to receive an equal capital interest in the partnership,

A. Record the partnership formation under the bonus method.

B. Record the partnership formation under the goodwill method, and assume a total goodwill of $90,000.

C. Discuss the appropriateness of using either the bonus or goodwill methods to record the formation of the partnership.

EXERCISE 15-2 Partnership Transactions and Capital Statements LO5 LO6

Tom and Julie formed a management consulting partnership on January 1, 2008. The fair value of the net assets invested by each partner follows:

	Tom	*Julie*
Cash	$13,000	$12,000
Accounts receivable	8,000	6,000
Office supplies	2,000	800
Office equipment	30,000	—
Land	—	30,000
Accounts payable	2,000	5,000
Mortgage payable	—	18,800

During the year, Tom withdrew $15,000 and Julie withdrew $12,000 in anticipation of operating profits. Net profit for 2008 was $50,000, which is to be allocated based on the original net capital investment.

Required:

A. Prepare journal entries to:

(1) Record the initial investment in the partnership.

(2) Record the withdrawals.

(3) Close the Income Summary and Drawing accounts.

B. Prepare a statement of changes in partners' capital for the year ended December 31, 2008.

EXERCISE 15-3 **Allocation of Income or Loss** LO6

Jones, Silva, and Thompson form a partnership and agree to allocate income equally after recognition of 10% interest on beginning capital balances and monthly salary allowances of $2,000 to Jones and $1,500 to Thompson. Capital balances on January 1 were as follows:

Jones	$40,000
Silva	25,000
Thompson	30,000

Required:

Calculate the net income (loss) allocation to each partner under each of the following independent situations.

1. Net income for the year is $99,500.
2. Net income for the year is $38,300.
3. Net loss for the year is $15,100.

EXERCISE 15-4 **Allocation of Net Loss** LO6

Mary and Nancy invested $80,000 each to form a partnership. Mary has been authorized a salary of $20,000, while Nancy's salary is $25,000. Each partner is to receive 10% on the original capital investment. The profit and loss agreement stipulates that any remaining income or loss is to be divided equally. The partnership had a net loss of $20,000 this year.

Required:

Prepare the journal entry to record the allocation of the net loss for the year. Show supporting computations.

EXERCISE 15-5 **Bonus Agreement** LO6

On January 1, 2008, Tony and Jon formed T&J Personal Financial Planning with capital investments of $480,000 and $340,000, respectively. The partners wanted to draft a profit and loss agreement that would reward each individual for the resources invested in the partnership. Accordingly, the partnership agreement provides that profits are to be allocated as follows:

1. Annual salaries of $42,000 and $66,000 are granted to Tony and Jon, respectively.
2. In addition to the salary, Jon is entitled to a bonus of 10% of net income after salaries and bonus but before interest on capital investments is subtracted.
3. Each partner is to receive an interest credit of 8% on the original capital investment.
4. Remaining profits are to be allocated 40% to Tony and 60% to Jon.

On December 31, 2008, the partnership reported net income before salaries, interest, and bonus of $188,000.

Required:

Calculate the 2008 allocation of partnership profit.

EXERCISE 15-6 **Profit Distribution and Capital Statements** LO6

Hill, Jones, and Vose have been partners throughout 2008. Their average balances for the year and their balances at the end of the year before closing the nominal accounts are as follows:

Partner	*Average Balances*	*Balances 12/31/08*
Hill	$97,500	$70,000
Jones	27,300	21,800
Vose	14,250	11,700*

* Debit balance.

The income for 2008 is $108,000 before charging partners' salary allowances and before payment of interest on average balances at the agreed rate of 5% per annum. Annual salary allocations are $12,000 to Hill, $9,600 to Jones, and $8,800 to Vose. The balance of income is to be allocated at the rate of 60% to Hill, 10% to Jones, and 30% to Vose.

It is intended to distribute cash to the partners so that, after credits and allocations have been made as indicated in the preceding paragraph, the balances in the partners' accounts will be proportionate to their residual profit-sharing ratios. None of the partners is to invest additional cash, but they wish to distribute the lowest possible amount of cash.

Required:

Prepare a schedule of partners' accounts, showing balances at the end of 2008 before closing, the allocations of the net income for 2008, the cash distributed, and the closing balances.

(*AICPA adapted*)

EXERCISE 15-7 Partner Admission LO8

Phil Phoenix and Tim Tucson are partners in an electrical repair business. Their respective capital balances are $90,000 and $50,000, and they share profits and losses equally. Because the partners are confronted with personal financial problems, they decided to admit a new partner to the partnership. After an extensive interviewing process they elect to admit Don Dallas into the partnership.

Required:

Prepare the journal entry to record the admission of Don Dallas into the partnership under each of the following conditions:

1. Don acquires one-fourth of Phil's capital interest by paying $30,000 directly to him.
2. Don acquires one-fifth of each of Phil's and Tim's capital interests. Phil receives $25,000 and Tim receives $15,000 directly from Don.
3. Don acquires a one-fifth capital interest for a $60,000 cash investment in the partnership. Total capital after the admission is to be $200,000.
4. Don invests $40,000 for a one-fifth interest in partnership capital. Implicit goodwill is to be recorded.

EXERCISE 15-8 Adjusting Entries for Partner Admission LO8

Bill and Jane share profits and losses in a 70:30 ratio. Mike is to be admitted into a partnership upon the investment of $14,000 for a one-third capital interest. Account balances for Bill and Jane on June 30, 2008 just before the admission of Mike are as follows:

COMPREHENSIVE

	Debit	*Credit*
Cash	$ 6,000	
Accounts Receivable	9,000	
Notes Receivable	2,000	
Merchandise Inventory	12,000	
Prepaid Insurance	500	
Accounts Payable		$ 9,500
Bill, Capital		12,000
Jane, Capital		8,000
	$29,500	$29,500

It is agreed that for purposes of establishing the interests of the former partners, the following adjustments shall be made:

1. An allowance for doubtful accounts of 2% of the accounts receivable is to be established.
2. The merchandise inventory is to be valued at $10,000.
3. Accrued expenses of $600 are to be recognized.
4. Prepaid insurance is to be valued at $300.
5. The goodwill method is to be used to record the admission of Mike.

Required:

Prepare the entries to adjust the account balances in establishing the interests of Bill and Jane and to record the investment by Mike.

EXERCISE 15-9 Partner Admission LO8

Beth, Steph, and Linda have been operating a small gift shop for several years. After an extensive review of their past operating performance, the partners concluded that the business needed to expand in order to provide an adequate return to the partners. The following balance sheet is for the partnership prior to the admission of a new partner, Mary.

Cash	$160,000
Other Assets	640,000
	$800,000
Liabilities	$200,000
Beth, Capital (40%)	265,000
Steph, Capital (40%)	215,000
Linda, Capital (20%)	120,000
	$800,000

Figures shown parenthetically reflect agreed profit-and-loss sharing percentages.

Required:

Prepare the necessary journal entries to record the admission of Mary in each of the following independent situations. Some situations may be recorded in more than one way.

1. Mary is to invest sufficient cash to receive a one-sixth capital interest. The parties agree that the admission is to be recorded without recognizing goodwill or bonus.
2. Mary is to invest $160,000 for a one-fifth capital interest.
3. Mary is to invest $160,000 for a one-fourth capital interest.
4. Mary is to invest $160,000 for a 40% capital interest.

EXERCISE 15-10 Multiple Choice LO6 LO8

Select the best answer for each of the following.

1. Jon and Joe formed a partnership on July 1, 2008, and invested the following assets:

	Jon	*Joe*
Cash	$65,000	$125,000
Realty		250,000

The realty was subject to a mortgage of $25,000, which was assumed by the partnership. The partnership agreement provides that Jon and Joe will share profits and losses in the ratio of one-third and two-thirds, respectively. Joe's capital account at July 1, 2008, should be

(a) $375,000
(b) $366,667
(c) $285,000
(d) $350,000

Operating performance and other capital transactions were as follows.

		Capital Transactions					
		Dave		*Brian*		*Paul*	
Year-End	*Net Income (Loss)*	*Investment*	*Withdrawals*	*Investment*	*Withdrawals*	*Investment*	*Withdrawals*
12/31/08	$(5,400)	$15,000	$17,000	$15,000	$7,000	$6,000	$3,200
12/31/09	27,000	—0—	17,000	—0—	7,000	6,000	3,200
12/31/10	120,000	—0—	19,000	—0—	9,000	6,000	3,200

Required:

A. Prepare a schedule of changes in partners' capital accounts for each of the three years.

B. Prepare the journal entry to close the income summary account to the partners' capital accounts at the end of each year.

PROBLEM 15-3 Conversion from Cash to Accrual Basis LO8

The partnership of Cain, Gallo, and Hamm engaged you to adjust its accounting records and convert them uniformly to the accrual basis in anticipation of admitting Kerns as a new partner. Some accounts are on the accrual basis and some are on the cash basis. The partnership's books were closed at December 31, 2008, by the bookkeeper, who prepared the general ledger trial balance that appears as follows:

Cain, Gallo, and Hamm
General Ledger Trial Balance
December 31, 2008

	Debit	*Credit*
Cash	$ 15,000	
Accounts Receivable	40,000	
Inventory	30,000	
Land	9,000	
Buildings	50,000	
Allowance for Depreciation of Buildings		$ 6,000
Equipment	56,000	
Allowance for Depreciation of Equipment		6,000
Goodwill	5,000	
Accounts Payable		56,000
Allowance for Future Inventory Losses		8,000
Cain, Capital		37,000
Gallo, Capital		60,000
Hamm, Capital		32,000
Totals	$205,000	$205,000

Your inquiries disclose the following:

1. The partnership was organized on January 1, 2007. No provision was made in the partnership agreement for the allocation of partnership profits and losses. During 2007, profits were allocated equally among the partners. The partnership agreement was amended, effective January 1, 2008, to provide for the following profit and loss ratio: Cain, 40%; Gallo, 40%; and Hamm, 20%. The amended partnership agreement also stated that the accounting records were to be maintained on the accrual basis and that any adjustments necessary for 2007 should be allocated according to the 2007 profit allocation agreement.
2. The following amounts were not recorded as prepayments or accruals.

	December 31	
	2008	*2007*
Prepaid insurance	$700	$ 800
Advances from customers	900	1,500
Accrued interest expense	—	450

The advances from customers were recorded as sales in the year the cash was received.

3. In 2008, the partnership recorded a provision of $8,000 for anticipated declines in inventory prices. You convinced the partners that the provision was unnecessary and should be removed from the books.
4. The partnership charged equipment purchased for $4,400 on January 1, 2008, to expense. This equipment has an estimated life of 10 years and an estimated salvage value of $400. The partnership depreciates its capitalized equipment using the declining balance method at twice the straight-line depreciation rate.
5. The partners agreed to establish an allowance for doubtful accounts at 2% of current accounts receivable and 5% of past-due accounts. At December 31, 2007, the partnership had $54,000 of accounts receivable, of which only $4,000 was past due. At December 31, 2008, 20% of accounts receivable was past due, of which $4,000 represented sales made in 2007 and was considered collectible. The partnership had written off uncollectible accounts in the year the accounts became worthless as follows:

	Accounts Written Off In	
	2008	*2007*
2008 accounts	$ 800	—
2007 accounts	1,000	$250

6. Goodwill was recorded on the books in 2008 and credited to the partners' capital accounts in the profit and loss ratio in recognition of an increase in the value of the business resulting from improved sales volume. The partners agreed to write off the goodwill before admitting the new partner.

Required:

Prepare a worksheet showing the adjustments and the adjusted trial balance for the partnership on the accrual basis at December 31, 2008. All adjustments affecting income should be made directly to partners' capital accounts. Supporting computations should be in good form. (Do not prepare formal financial statements or formal journal entries.)

(*AICPA adapted*)

PROBLEM 15-4 Partner Admission LO8

Brown and Coss have been operating a tax accounting service as a partnership for five years. Their current capital balances are $92,000 and $88,000, respectively, and they share profits in a 60:40 ratio. Because of the growth in their tax business, they decide that they need a new partner. Moore is admitted to the partnership, after which the partners agree to share profits 40% to Brown, 35% to Coss, and 25% to Moore.

Required:

Prepare the necessary journal entries to admit Moore in each of the following independent conditions. If the information is such that both the bonus and goodwill methods are appropriate, record the admission using both methods.

1. Moore invests $90,000 in cash and receives a one-third capital interest.
2. Moore invests $120,000 cash for a 45% capital interest. Total capital after his admission is to be $300,000.
3. Moore agrees to invest $120,000 cash for a one-third capital interest, but will not accept a capital credit for less than his investment.
4. Moore invests $40,000 cash for a one-fourth capital interest. The partners agree that assets and the firm as a whole should not be revalued.
5. Moore invests $35,000 cash for a one-fifth capital interest. The partners agree that total capital after the admission of Moore should be $225,000.
6. Moore invests land in the partnership as a site for a new office building. The land, which originally cost Moore $90,000, now has a current market value of $150,000. Moore is admitted with a one-third capital interest.

7. Moore is admitted to the partnership by purchasing a 30% capital interest from each partner. A payment of $35,000 is made outside the partnership and is split between Brown and Coss.

PROBLEM 15-5 Adjusting Entries for Partner Admission LO8

The CAB Partnership, although operating profitably, has had a cash flow problem. Unable to meet its current commitments, the firm borrowed $34,000 from a bank giving a long-term note. During a recent meeting, the partners decided to obtain additional cash by admitting a new partner to the firm. They feel that the firm is an attractive investment, but that proper management of their liquid assets will be required. Meyers agrees to invest cash in the firm if her chief accountant can review the accounting records of the partnership.

The balance sheet for CAB Partnership as of December 31, 2008, is as follows:

Assets	
Cash	$ 8,000
Accounts Receivable	33,600
Inventory (at cost)	35,750
Land	27,000
Building (net of depreciation)	41,600
Equipment (net of depreciation)	27,250
Total	$173,200

Liabilities and Capital	
Accounts Payable	$ 32,450
Other Current Liabilities	6,750
Long-Term Note (8% due 2008)	34,000
Cox, Capital	37,500
Andrews, Capital	25,000
Bennet, Capital	37,500
Total	$173,200

The review of the accounts resulted in the accumulation of the following information:

1. Approximately 5% of the accounts receivable are uncollectible. The old partnership had been using the direct write-off method of accounting for bad debts.
2. Current replacement cost of the inventory is $41,250.
3. The market value of the land based on a current appraisal is $65,000.
4. The partners had been using an unreasonably long estimated life in establishing a depreciation policy for the building. On the basis of sound value (current replacement cost adjusted for use), the value of the building is $32,750.
5. There are unrecorded accrued liabilities of $3,275.

The partners agree to recognize the foregoing adjustments to the accounts. Cox, Andrews, and Bennet share profits 40:30:30. After the admission of Meyers, the new profit agreement is to be 30:20:30:20. Meyers is to receive a 25% capital interest in the partnership after she invests sufficient cash to increase the total capital interest to $150,000. Because of the uncertainty of the business, no goodwill is to be recognized before or after Meyers is admitted.

Required:

A. Prepare the necessary journal entries on the books of the old partnership to adjust the accounts.
B. Record the admission of Meyers.
C. Prepare a new balance sheet giving effect to the foregoing requirements.

PROBLEM 15-6 **Adjusting Entries for Partner Withdrawal** LO8

The December 31, 2008, balance sheet of the Datamation Partnership is shown below.

Datamation Partnership
Balance Sheet
December 31, 2008

Assets	
Cash	$ 80,000
Accounts Receivable	80,000
Inventory	62,000
Equipment	290,000
Total Assets	$512,000

Liabilities and Partners' Equity	
Accounts Payable	$ 60,000
Notes Payable to Dave, 8% dated September 1, 2008	22,000
Dave, Capital	220,000
Allen, Capital	110,000
Matt, Capital	100,000
Total Liabilities and Partners' Equity	$512,000

Dave, Allen, and Matt share profits and loses in the ratio of 50:30:20. The inventory on December 31 has a fair value of $68,000; accrued interest on the note payable to Dave is to be recognized as of December 31. The book values of all the other accounts are equal to their fair values. Allen withdrew from the partnership on December 31, 2008.

Required:

Prepare the journal entry or entries to record the withdrawal of Allen, given each of the following situations. Assume that the *bonus* method is used to account for the withdrawal.

1. Allen receives $36,624 cash and a $75,000 note from the partnership for his interest.
2. Matt purchases Allen's interest for $110,000.
3. The partnership gives Allen $35,000 cash and equipment with a book value and a fair value of $90,000 for his interest.
4. The partnership gives Allen $100,000 cash for his interest.
5. Allen sells one-fourth of his interest to Dave for $40,000 and three-fourths to Matt for $90,000.

PROBLEM 15-7 **Partner Withdrawal and New Profit-Loss Ratio** LO6 LO8

Neal, Palmer, and Ruppe are partners in a real estate company. Their respective capital balances and profit-sharing ratios are as follows:

As of December 31, 2008

Partners	*Capital Balance*	*Profit-Sharing Ratio*
Neal	$250,000	4
Palmer	150,000	3
Ruppe	100,000	3

Neal wishes to withdraw from the partnership on January 1, 2009, Palmer and Ruppe have agreed to pay Neal $300,000 from the partnership assets for his 50% capital interest. This