chapter 14

Partnerships: Formation and Operation

A reader of college accounting textbooks might well conclude that business activity is carried out exclusively by corporations. Because most large companies are legally incorporated, a vast majority of textbook references and illustrations concern corporate organizations. Contrary to the perception being relayed, partnerships (as well as sole proprietorships) make up a vital element of the business community. The Internal Revenue Service projects that by 2025, more than 4.7 million partnership income tax returns will be filed (as compared to over 7.5 million projected corporation income tax returns).[1]

The partnership form serves a wide range of business activities, from small local operations to worldwide enterprises. The following examples exist in the U.S. economy:

- Individual proprietors often join together to form a partnership as a way to reduce expenses, expand services, and add increased expertise. As will be discussed, partnerships also provide important tax benefits.
- A partnership is a common means by which friends and relatives can easily create and organize a business endeavor.
- Historically, doctors, lawyers, and other professionals have formed partnerships because of legal prohibitions against the incorporation of their practices. Although most states now permit alternative forms for such organizations, operating as a partnership or sole proprietorship is still necessary in many areas.

Over the years, some partnerships have grown to enormous sizes. Buckeye Partners, for example, primarily operates pipeline systems in the United States; in 2018, Buckeye had revenues of more than $4 billion. The professional services firm of PricewaterhouseCoopers, a partnership, recently reported revenues of more than $41 billion.[2] In 2018, Deloitte indicated operations in more than 150 countries,[3] and Ernst & Young reported having more than 260,000 employees around the world.[4]

[1] Internal Revenue Service, Publication 6292 (Rev. 8-2018), *Fiscal Year Return Projections for the United States: 2018–2025,* Washington D.C. 20224

[2] "Global Annual Review 2018," pwc.com.

[3] "Deloitte 2018 Global Impact Report," deloitte.com.

[4] "EY at a Glance," ey.com.

Learning Objectives

After studying this chapter, you should be able to:

LO 14-1 Explain the advantages and disadvantages of the partnership versus the corporate form of business.

LO 14-2 Describe the purpose of the articles of partnership and list specific items that should be included in this agreement.

LO 14-3 Prepare the journal entry to record the initial capital investment made by a partner.

LO 14-4 Use both the bonus method and the goodwill method to record a partner's capital investment.

LO 14-5 Demonstrate the impact that the allocation of partnership income has on the partners' individual capital balances.

LO 14-6 Allocate income to partners when interest and/or salary factors are included.

LO 14-7 Explain the meaning of partnership dissolution and understand that a dissolution will often have little or no effect on the operations of the partnership business.

LO 14-8 Prepare journal entries to record the acquisition by a new partner of either all or a portion of a current partner's interest.

LO 14-9 Prepare journal entries to record a new partner's admission by a contribution made directly to the partnership.

LO 14-10 Prepare journal entries to record the withdrawal of a current partner.

LO 14-1

Explain the advantages and disadvantages of the partnership versus the corporate form of business.

Partnerships—Advantages and Disadvantages

The popularity of partnerships derives from several advantages inherent to this type of organization. An analysis of these attributes explains why millions of enterprises in the United States are partnerships rather than corporations.

One of the most common motives is the ease of formation. Only an oral agreement is necessary to create a legally binding partnership. In contrast, depending on specific state laws, incorporation requires filing a formal application and completing various other forms and documents. Operators of small businesses may find the convenience and reduced cost involved in creating a partnership to be an especially appealing characteristic. Tax advantages also can be found in the partnership form of business. As articulated by the American Bar Association:

> The principal advantage of partnerships is the ability to make virtually any arrangements defining their relationship to each other that the partners desire. There is no necessity, as there is in a corporation, to have the ownership interest in capital and profits proportionate to the investment made; and losses can be allocated on a different basis from profits. It is also generally much easier to achieve a desirable format for control of the business in a partnership than in a corporation, since the control of a corporation, which is based on ownership of voting stock, is much more difficult to alter.
>
> Partnerships are taxed on a conduit or flow-through basis under subchapter K of the Internal Revenue Code. This means that the partnership itself does not pay any taxes. Instead the net income and various deductions and tax credits from the partnership are passed through to the partners based on their respective percentage interest in the profits and losses of the partnership, and the partners include the income and deductions in their individual tax returns.[5]

Thus, partnership revenue and expense items (as defined by the tax laws) must be assigned directly each year to the individual partners who pay the income taxes. Passing income balances through to the partners in this manner avoids double taxation of the profits that are earned by a business and then distributed to its owners. A corporation's income is taxed twice: when earned and again when conveyed as a dividend. A partnership's income is taxed only at the time that the business initially earns it.

For example, assume that a business earns $100. After paying any income taxes, the remainder is immediately conveyed to its owners. An income tax rate of 25 percent (combined federal and state) is assumed for corporations and individuals. The tax rate on corporate dividends is assumed to be 15 percent.[6] As the following table shows, if this business is a partnership rather than a corporation, the owners have $11.25 more expendable income, which is 11.25 percent of the business income. Although potentially significant in amount, this difference narrows as tax rates are lowered.

	Partnership	Corporation
Income before income taxes	$100.00	$100.00
Income taxes paid by business (25%)	–0–	(25.00)
Income distributed to owners	$100.00	$ 75.00
Income taxes paid by owners*	(25.00)	(11.25)
Expendable income	$ 75.00	$ 63.75

*25 percent assumed rate on ordinary income. 15 percent assumed rate on dividend income.

Historically, another tax advantage has long been associated with partnerships. Because income is taxable to the partners as the business earns it, any operating losses can be used to reduce their personal taxable income directly. In contrast, a corporation is viewed as legally

[5] American Bar Association, *Family Legal Guide,* 3rd ed. (New York: Random House Reference, 2004).

[6] Corporate dividends paid to shareholders are taxed either 0 percent, 15 percent, or 20 percent depending on their overall earnings level.

separate from its owners, so losses cannot be passed through to them. A corporation has the ability to carry forward indefinitely operating losses to decrease future taxable income (up to a maximum of 80 percent in any particular year). However, if a corporation is newly formed or has not been profitable, operating losses provide no immediate benefit to a corporation or its owners as losses do for a partnership.

The tax advantage of deducting partnership losses is limited, however. For tax purposes, ownership of a partnership is labeled as a passive activity unless the partner materially participates in the actual business activities. Passive activity losses thus serve only to offset other passive activity profits. In most cases, these partnership losses cannot be used to reduce earned income such as salaries. Thus, unless a taxpayer has significant passive activity income (from rents, for example), losses reported by a partnership create little or no tax advantage unless the partner materially participates in the actual business activity.

A more recent partnership tax advantage was created by the 2017 Tax Cuts and Jobs Act.[7] Eligible taxpayers, including those with partnership income, may be entitled to a deduction of up to 20 percent of qualified income from domestic "pass-through" businesses. Partnerships (along with other tax entities) must be considered a qualified trade or business for their owners to benefit from the 20 percent deduction. Even though many partnerships will be unable to qualify (e.g., health, law, accounting, financial services, etc.), others may qualify and thus entitle their partners to the 20 percent deduction for pass-through businesses.

The partnership form of business also has certain significant disadvantages. Perhaps the most severe problem is the unlimited liability that each partner automatically incurs. Partnership law specifies that any partner can be held personally liable for *all* debts of the business. The potential risk is especially significant when coupled with the concept of *mutual agency*. This legal term refers to the right that each partner has to incur liabilities in the name of the partnership. Consequently, partners acting within the normal scope of the business have the power to obligate the company for any amount. If the partnership fails to pay these debts, creditors can seek satisfactory remuneration from any partner that they choose.

Such legal concepts as unlimited liability and mutual agency describe partnership characteristics that have been defined and interpreted over a number of years. To provide consistent application across state lines in regard to these terms as well as many other legal aspects of a partnership, the Uniform Partnership Act (UPA) was created. This act, which was first proposed in 1914 (and revised in 1997), now has been adopted by all states in some form. It establishes uniform standards in such areas as the nature of a partnership, the relationship of the partners to outside parties, and the dissolution of the partnership. For example, Section 6 of the act provides the most common legal definition of a partnership: "an association of two or more persons to carry on a business as co-owners for profit."

Alternative Legal Forms

Because of the possible owner liability, partnerships often experience difficulty in attracting large amounts of capital. Potential partners frequently prefer to avoid the risk that is a basic characteristic of a partnership. However, the tax benefits of avoiding double taxation still provide a strong pull toward the partnership form. Hence, in recent years, a number of alternative types of organizations have been developed. The availability of these legal forms depends on state laws as well as applicable tax laws. In each case, however, the purpose is to limit the owners' personal liability while providing the tax benefits of a partnership.[8]

[7] *Tax Cuts and Jobs Act, Provision 11011 Section 199A—Qualified Business Income Deduction FAQs,* www.irs.gov.

[8] Many factors should be considered in choosing a specific legal form for an organization. The information shown here is merely an overview. For more information, consult a tax guide or a business law textbook. Also see Hopson and Hopson, "Making the Right Choice of Business Entity," *CPA Journal,* October 2014, pp. 42–47.

Subchapter S Corporation

A Subchapter S corporation (often referred to as an *S corporation*) is created as a corporation and, therefore, has all of the legal characteristics of that form.[9] According to U.S. tax laws, if the corporation meets certain regulations, it will be taxed in virtually the same way as a partnership. Thus, the Subchapter S corporation pays no income taxes, although any income (and losses) pass directly through to the taxable income of the individual owners. This form avoids double taxation, and the owners do not face unlimited liability. To qualify, the business can have only one class of stock and is limited to 100 stockholders. All owners must be individuals, estates, certain tax-exempt entities, or certain types of trusts. The most significant problem associated with this business form is that its growth potential is limited because of the restriction on the number and type of owners.

Limited Partnerships (LPs)

A *limited partnership* is a type of investment designed primarily for individuals who want the tax benefits of a partnership but who do not wish to work in a partnership or have unlimited liability. In such organizations, a number of limited partners invest money as owners but are not allowed to participate in the company's management. These partners can still incur a loss on their investment, but the amount is restricted to what has been contributed. To protect the creditors of a limited partnership, one or more general partners must be designated to assume responsibility for all obligations created in the name of the business.

Buckeye Partners, L.P., is an example of a limited partnership that trades on the New York Stock Exchange. Buckeye's December 31, 2018, balance sheet reported capital of $4.16 billion for its limited partners.

Many limited partnerships were originally formed as tax shelters to create immediate losses (to reduce the taxable income of the partners) with profits spread out into the future. As mentioned earlier, tax laws limit the deduction of passive activity losses, and this significantly reduced the formation of limited partnerships.

Limited Liability Partnerships (LLPs)

The *limited liability partnership* has most of the characteristics of a general partnership except that it significantly reduces the partners' liability. Partners may lose their investment in the business and are responsible for the contractual debts of the business. The advantage here is created in connection with any liability resulting from damages. In such cases, the partners are responsible for only their own acts or omissions plus the acts and omissions of individuals under their supervision.

As Section 306(c) of the Uniform Partnership Act notes,

> An obligation of a partnership incurred while the partnership is a limited liability partnership, whether arising in contract, tort, or otherwise, is solely the obligation of the partnership. A partner is not personally liable, directly or indirectly, by way of contribution or otherwise, for such an obligation solely by reason of being or so acting as a partner.

Thus, a partner in the Houston office of a public accounting firm would probably not be held liable for a poor audit performed by that firm's San Francisco office. Not surprisingly, limited liability partnerships have become very popular with professional service organizations that have multiple offices. For example, all of the four largest accounting firms are LLPs.

Limited Liability Companies (LLCs)

The limited liability company was first seen in the United States in 1977. By 1996, all 50 states had LLC statutes approved. Currently, it is estimated that two-thirds of all new companies in the United States are LLCs.[10] An LLC is classified as a partnership for tax purposes and court purposes. However, depending on state laws, the owners risk only their own investments. Thus, similar to a Subchapter S entity, the LLC provides liability protection for its owners and managers. In contrast to a Subchapter S corporation, the number of owners is not usually restricted, so growth may be easier to accomplish.

[9] Unless a corporation qualifies as a Subchapter S corporation or some other legal variation, it is referred to as a *Subchapter C corporation.* Therefore, a vast majority of all businesses are C corporations.

[10] "The History of LLCS," *IncNow,* January 18, 2018.

Partnership Accounting—Capital Accounts

Despite legal distinctions, questions should be raised as to the need for an entirely separate study of partnership accounting:

- Does an association of two or more persons require accounting procedures significantly different from those of a corporation?
- Does proper accounting depend on the legal form of an organization?

The answers to these questions are both yes and no. Accounting procedures are normally standardized for assets, liabilities, revenues, and expenses, regardless of the legal form of a business. *Partnership accounting, though, does exhibit unique aspects that warrant study, but they lie primarily in the handling of the partners' capital accounts.*

The stockholders' equity accounts of a corporation do not correspond directly with the capital balances found in a partnership's financial records. The various equity accounts reported by an incorporated enterprise display a greater range of information. This characteristic reflects the wide variety of equity transactions that can occur in a corporation as well as the influence of state and federal laws. Government regulation has had an enormous effect on the accounting for corporate equity transactions in that extensive disclosure is required to protect stockholders and other outside parties such as potential investors.

To provide adequate information and to meet legal requirements, corporate accounting must provide details about a variety of equity transactions and account balances. For example, the amount of a corporation's paid-in capital is shown separately from earned capital (retained earnings) and accumulated other comprehensive income; the par value of each class of stock is disclosed; treasury stock, stock options, stock dividends, and other capital transactions are reported based on prescribed accounting principles.

In contrast, partnerships provide only a limited equity disclosures primarily in the form of individual capital accounts that are accumulated for every partner or every class of partners. These balances measure each partner's or group's interest in the book value of the net assets of the business. Thus, the equity section of a partnership balance sheet is composed solely of capital accounts that can be affected by many different events: contributions from partners as well as distributions to them, earnings, and any other equity transactions.

However, partnership accounting does not differentiate between the various sources of ownership capital. Disclosing the composition of the partners' capital balances has not been judged necessary because partnerships have historically tended to be small with equity transactions that were rarely complex. Additionally, absentee ownership is not common, a factor that minimizes both the need for government regulation and outside interest in detailed information about the capital balances.

Articles of Partnership

LO 14-2

Describe the purpose of the articles of partnership and list specific items that should be included in this agreement.

Because the demand for information about capital balances is limited, accounting principles specific to partnerships are based primarily on traditional approaches that have evolved over the years rather than on official pronouncements. These procedures attempt to mirror the relationship between the partners and their business, especially as defined by the partnership agreement. This legal covenant, which may be either oral or written, is often referred to as the *articles of partnership* and forms the central governance for a partnership's operation. The financial arrangements spelled out in this contract establish guidelines for the various capital transactions. Therefore, the articles of partnership, rather than either laws or official rules, provide much of the underlying basis for partnership accounting.

Because the articles of partnership are a negotiated agreement that the partners create, an unlimited number of variations can be encountered in practice. Partners' rights and responsibilities frequently differ from business to business. Consequently, firms often hire accountants in an advisory capacity to participate in creating this document to ensure the equitable treatment of all parties. Although the articles of partnership may contain a number of provisions, an explicit understanding should always be reached in regards to the following:

- Name and address of each partner.
- Business location.
- Description of the nature of the business.

Discussion Question

WHAT KIND OF BUSINESS IS THIS?

After graduating from college, Shelley Williams held several different jobs but found that she did not enjoy working for other people. Finally, she and Yvonne Hargrove, her college roommate, decided to start a business of their own. They rented a small building and opened a florist shop selling cut flowers such as roses and chrysanthemums that they bought from a local greenhouse.

Williams and Hargrove agreed orally to share profits and losses equally, although they also decided to take no money from the operation for at least four months. No other arrangements were made, but the business did reasonably well, and after the first four months had passed, each began to draw out $500 in cash every week.

At year-end, they took their financial records to a local accountant so that they could get their income tax returns completed. He informed them that they had been operating as a partnership and that they should draw up formal articles of partnership agreement or consider incorporation or some other legal form of organization. They confessed that they had never really considered the issue and asked for his advice on the matter.

What advice should the accountant give to these clients?

- Rights and responsibilities of each partner.
- Initial contribution to be made by each partner and the method to be used for valuation.
- Specific method by which profits and losses are to be allocated.
- Periodic withdrawal of assets by each partner.
- Procedure for admitting new partners.
- Method for arbitrating partnership disputes.
- Life insurance provisions enabling remaining partners to acquire the interest of any deceased partner.
- Method for settling a partner's share in the business upon withdrawal, retirement, or death.

Accounting for Capital Contributions

LO 14-3

Prepare the journal entry to record the initial capital investment made by a partner.

Several types of capital transactions occur in a partnership: allocation of profits and losses, retirement of a current partner, admission of a new partner, and so on. The initial transaction, however, is the contribution the original partners make to begin the business. In the simplest situation, the partners invest only cash amounts. For example, assume that Carter and Green form a business to be operated as a partnership. Carter contributes $50,000 in cash, and Green invests $20,000. The initial journal entry to record the creation of this partnership follows:

Cash	70,000	
Carter, Capital		50,000
Green, Capital		20,000
To record cash contributed to start new partnership.		

The assumption that the partners invested only cash avoids complications in this first illustration. Often, though, one or more of the partners transfers noncash assets such as inventory, land, equipment, or a building to the business. Although partnerships record asset contributions at fair value, a case could be developed for initially valuing any contributed asset at the partner's current book value. According to the concept of unlimited liability (as well as present tax laws), a partnership does not exist as an entity apart from its owners. A logical extension of the idea is

that the investment of an asset is not a transaction occurring between two independent parties such as would warrant revaluation. This contention holds that the semblance of an arm's-length transaction is necessary to justify a change in the book value of any account.

Although retaining the recorded value for assets contributed to a partnership may seem reasonable, this method of valuation proves to be inequitable to any partner investing appreciated property. A $50,000 capital balance always results from a cash investment of that amount, but recording other assets depends entirely on the original book value.

For example, should a partner who contributes a building having a recorded value of $18,000 but a fair value of $50,000 be credited with only an $18,000 interest in the partnership? Because $50,000 in cash and $50,000 in appreciated property are equivalent contributions, a $32,000 difference in the partners' capital balances cannot be justified. To prevent such inequities, each item transferred to a partnership is initially recorded for external reporting purposes at current value.[11]

Requiring revaluation of contributed assets can, however, be advocated for reasons other than just the fair treatment of all partners. Despite some evidence to the contrary, a partnership can be viewed legitimately as an entity standing apart from its owners. As an example, a partnership maintains legal ownership of its assets and (depending on state law) can initiate lawsuits. For this reason, accounting practice traditionally has held that the contribution of assets (and liabilities) to a partnership is an exchange between two separately identifiable parties that should be recorded based on fair values.

Determining an appropriate valuation for each capital balance is more than just an accounting exercise. Over the life of a partnership, these figures serve in a number of important capacities:

1. The totals in the individual capital accounts often influence the assignment of profits and losses to the partners.
2. The capital account balance is usually one factor in determining the final distribution that will be received by a partner at the time of withdrawal or retirement.
3. Ending capital balances indicate the allocation to be made of any assets that remain following the liquidation of a partnership.

To demonstrate, assume that Carter invests $50,000 in cash to begin the previously discussed partnership and Green contributes the following assets:

	Book Value to Green	**Fair Value**
Inventory	$ 9,000	$10,000
Land	14,000	11,000
Building	32,000	46,000
Totals	$55,000	$67,000

As an added factor, Green's building is encumbered by a $23,600 mortgage that the partnership has agreed to assume.

Green's net investment is equal to $43,400 ($67,000 less $23,600). The following journal entry records the formation of the partnership created by these contributions:

Cash	50,000	
Inventory	10,000	
Land	11,000	
Building	46,000	
Mortgage Payable		23,600
Carter, Capital		50,000
Green, Capital		43,400
To record properties contributed to start partnership. Assets and liabilities are recorded at fair value.		

[11] For federal income tax purposes, the $18,000 book value is retained as the basis for this building, even after transfer to the partnership. Within the tax laws, no difference is seen between partners and their partnership, so no adjustment to fair value is warranted.

We should make one additional point before leaving this illustration. Although having contributed inventory, land, and a building, Green holds no further right to these individual assets; they now belong to the partnership. The $43,400 capital balance represents an ownership interest in the business as a whole but does not constitute a specific claim to any asset. Having transferred title to the partnership, Green has no more right to these assets than does Carter.

LO 14-4

Use both the bonus method and the goodwill method to record a partner's capital investment.

Intangible Contributions

In forming a partnership, the contributions made by one or more of the partners may go beyond assets and liabilities. A doctor, for example, can bring a particular line of expertise to a partnership, and a practicing dentist might have already developed an established patient list. These attributes, as well as many others, are frequently as valuable to a partnership as cash and fixed assets. *Hence, formal accounting recognition of such special contributions may be appropriately included as a provision of any partnership agreement.*

To illustrate, assume that James and Joyce plan to open an advertising agency, and they decide to organize the endeavor as a partnership. James contributes cash of $70,000, and Joyce invests only $10,000. Joyce, however, is an accomplished graphic artist, a skill that is considered especially valuable to this business. Therefore, in producing the articles of partnership, the partners agree to start the business with equal capital balances. Often such decisions result only after long, and sometimes heated, negotiations. Because the value assigned to an intangible contribution such as artistic talent is arbitrary at best, proper reporting depends on the partners' ability to arrive at an equitable arrangement.

In recording this agreement, James and Joyce have two options: (1) the bonus method and (2) the goodwill method. Each of these approaches achieves the desired result of establishing equal capital account balances. Recorded figures can vary significantly, however, depending on the procedure selected. Thus, the partners should reach an understanding prior to beginning business operations as to the method to be used. The accountant can help avoid conflicts by assisting the partners in evaluating the impact created by each of these alternatives.

The Bonus Method The bonus method assumes that a specialization such as Joyce's artistic abilities does *not* constitute a recordable partnership asset with a measurable cost. Hence, this approach recognizes only the assets that are physically transferred to the business (such as cash, patents, and inventory). Although these contributions determine total partnership capital, the establishment of specific capital balances is viewed as an independent process based solely on the partners' agreement. Because the initial equity figures result from negotiation, they do not need to correspond directly with the individual investments.

James and Joyce have contributed a total of $80,000 in identifiable assets to their partnership and have decided on equal capital balances. According to the bonus method, this agreement is fulfilled simply by splitting the $80,000 capital evenly between the two partners. The following entry records the formation of this partnership under this assumption:

Account	Debit	Credit
Cash	80,000	
James, Capital		40,000
Joyce, Capital		40,000
To record cash contributions with bonus to Joyce because of artistic abilities.		

Joyce received a *capital bonus* here of $30,000 (the $40,000 recorded capital balance in excess of the $10,000 cash contribution) from James in recognition of the artistic abilities she brought into the business.

The Goodwill Method The goodwill method is based on the assumption that an implied value can be calculated mathematically and recorded for any intangible contribution made by a partner. In the present illustration, Joyce invested $60,000 less cash than James but receives an equal amount of capital according to the partnership agreement. Proponents of the goodwill method argue that Joyce's artistic talent has an apparent value of $60,000, a figure that should be included as part of this partner's capital investment. If not recorded, Joyce's primary contribution to the business is ignored completely within the accounting records.

Cash	80,000	
Goodwill	60,000	
James, Capital		70,000
Joyce, Capital		70,000
To record cash contributions with goodwill attributed to Joyce in recognition of artistic abilities.		

Comparison of Methods Both approaches achieve the intent of the partnership agreement: to record equal capital balances despite a difference in the partners' cash contributions. The bonus method allocates the $80,000 invested capital according to the percentages designated by the partners, whereas the goodwill method capitalizes the implied value of Joyce's intangible contribution.

Although nothing prohibits the use of either technique, the recognition of goodwill poses definite theoretical problems. In previous discussions of both the equity method (Chapter 1) and business combinations (Chapter 2), goodwill was recognized but only as a result of an acquisition made by the reporting entity. Consequently, this asset had a historical cost in the traditional accounting sense. Partnership goodwill has no such cost; the business recognizes an asset even though no funds have been spent.

The partnership of James and Joyce, for example, is able to record $60,000 in goodwill without any expenditure. Furthermore, the value attributed to this asset is based solely on a negotiated agreement between the partners; the $60,000 balance has no objectively verifiable basis. Thus, although partnership goodwill is sometimes encountered in actual practice, this "asset" should be viewed with a strong degree of professional skepticism.

Additional Capital Contributions and Withdrawals

Subsequent to forming a partnership, the owners may choose to contribute additional capital amounts during the life of the business. These investments can be made to stimulate expansion or to assist the business in overcoming working capital shortages or other problems. Regardless of the reason, the contribution is again recorded as an increment in the partner's capital account based on fair value. For example, in the previous illustration, assume that James decides to invest another $5,000 cash in the partnership to help finance the purchase of new office furnishings. The partner's capital account balance is immediately increased by this amount to reflect the transfer to the partnership.[12]

In many instances, the articles of partnership allow withdrawals on a regular periodic basis as a reward for ownership or as compensation for work performed for the business. Often such distributions are recorded initially in a separate drawing account that is closed into the individual partner's capital account at year-end. Assume for illustration purposes that James and Joyce take out $1,200 and $1,500, respectively, from their business. The journal entry to record these payments is as follows:

James, Drawing	1,200	
Joyce, Drawing	1,500	
Cash		2,700
To record withdrawal of cash by partners.		

Larger amounts might also be withdrawn from a partnership on occasion. A partner may have a special need for money or just desire to reduce the basic investment that has been made in the business. Such transactions are usually sporadic occurrences and entail amounts significantly higher than the partner's periodic drawing. The articles of partnership may require prior approval by the other partners.

[12] The partners also may reverse this process by withdrawing assets from the business for their own personal use. To protect the interests of the other partners, the articles of partnership should clearly specify the amount and timing of such withdrawals.

Discussion Question

HOW WILL THE PROFITS BE SPLIT?

James J. Dewars has been the sole owner of a small CPA firm for the past 20 years. Now 52 years old, Dewars is concerned about the continuation of his practice after he retires. He would like to begin taking more time off now although he wants to remain active in the firm for at least another 8 to 10 years. He has worked hard over the decades to build up the practice so that he presently makes a profit of $180,000 annually.

Lewis Huffman has been working for Dewars for the past four years. He now earns a salary of $68,000 per year. He is a very dedicated employee who generally works 44 to 60 hours per week. In the past, Dewars has been in charge of the larger, more profitable audit clients whereas Huffman, with less experience, worked with the smaller clients. Both Dewars and Huffman do some tax work although that segment of the business has never been emphasized.

Sally Scriba has been employed for the past seven years with another CPA firm as a tax specialist. She has no auditing experience but has a great reputation in tax planning and preparation. She currently earns an annual salary of $80,000.

Dewars, Huffman, and Scriba are negotiating the creation of a new CPA firm as a partnership. Dewars plans to reduce his time in this firm although he will continue to work with many of the clients that he has served for the past two decades. Huffman will begin to take over some of the major audit jobs. Scriba will start to develop an extensive tax practice for the firm.

Because of the changes in the firm, the three potential partners anticipate earning a total net income in the first year of operations of between $130,000 and $260,000. Thereafter, they hope that profits will increase at the rate of 10 to 20 percent annually for the next five years or so.

How should this new partnership allocate its future net income among these partners?

LO 14-5

Demonstrate the impact that the allocation of partnership income has on the partners' individual capital balances.

Allocation of Income

At the end of each fiscal period, partnership revenues and expenses are closed out, accompanied by an allocation of the resulting net income or loss to the partners' capital accounts. Because a separate capital balance is maintained for each partner, a method must be devised for this assignment of annual income. Because of the importance of the process, the articles of partnership should always stipulate the procedure the partners established. If no arrangement has been specified, state partnership law normally holds that all partners receive an equal allocation of any income or loss earned by the business. If the partnership agreement specifies only the division of profits, then losses must be divided in the same manner as directed for profit allocation.

The profit allocation pattern can be important to the success of any organization because it can help emphasize and reward outstanding performance. Therefore, many partner compensation plans recognize contributions to revenue, growth, time spent with the firm, management skill development, or any other attribute the partnership deems important. Profit allocations plans can thus become complex in attempting to recognize and reward the various elements of each partner's contributions to the firm's success. Alternatively, partnerships can avoid all complications by assigning net income on an equal basis among all partners.

As an initial illustration, assume that Tinker, Evers, and Chance form a partnership by investing cash of $120,000, $90,000, and $75,000, respectively. The articles of partnership agreement specifies that Evers will be allotted 40 percent of all profits and losses because of previous business experience. Tinker and Chance are to divide the remaining 60 percent equally. This agreement also stipulates that each partner is allowed to withdraw $10,000 in cash annually from the business. The amount of this withdrawal does not directly depend on the method utilized for income allocation. *From an accounting perspective, the assignment of income and the setting of withdrawal limits are two separate decisions.*

At the end of the first year of operations, the partnership reports net income of $60,000. To reflect the changes made in the partners' capital balances, the closing process consists of the following two journal entries. The assumption is made here that each partner has taken the allowed amount of drawing during the year. In addition, for convenience, all revenues and expenses already have been closed into the Income Summary account.

Tinker, Capital	10,000	
Evers, Capital	10,000	
Chance, Capital	10,000	
Tinker, Drawing		10,000
Evers, Drawing		10,000
Chance, Drawing		10,000
To close out drawing accounts recording payments made to the three partners.		

Income Summary	60,000	
Tinker, Capital (30%)		18,000
Evers, Capital (40%)		24,000
Chance, Capital (30%)		18,000
To allocate net income based on provisions of partnership agreement.		

Statement of Partners' Capital

Because a partnership does not separately disclose a retained earnings balance, the statement of retained earnings usually reported by a corporation is replaced by a statement of partners' capital. The following financial statement is based on the data presented for the partnership of Tinker, Evers, and Chance. The changes made during the year in the individual capital accounts are outlined along with totals representing the partnership as a whole:

TINKER, EVERS, AND CHANCE
Statement of Partners' Capital
For Year Ending December 31, Year 1

	Tinker, Capital	Evers, Capital	Chance, Capital	Totals
Capital balances beginning of year	$120,000	$ 90,000	$75,000	$285,000
Allocation of net income	18,000	24,000	18,000	60,000
Drawings	(10,000)	(10,000)	(10,000)	(30,000)
Capital balances end of year	$128,000	$104,000	$83,000	$315,000

LO 14-6

Allocate income to partners when interest and/or salary factors are included.

Alternative Allocation Techniques—Example 1

Assigning net income based on a ratio may be simple, but this approach is not necessarily equitable to all partners. For example, assume that Tinker does not participate in the partnership's operations but is the contributor of the highest amount of capital. Evers and Chance both work full-time in the business, but Evers has considerably more experience in this line of work.

Under these circumstances, no single ratio is likely to reflect properly the various contributions made by each partner. Indeed, an unlimited number of alternative allocation plans could be devised in hopes of achieving fair treatment for all parties. For example, because of the different levels of capital investments, consideration should be given to including interest within the allocation process to reward the contributions. A compensation allowance is also a possibility, usually in an amount corresponding to the number of hours worked or the level of a partner's business expertise.

To demonstrate one possible option, assume that Tinker, Evers, and Chance begin their partnership based on the original facts except that they arrive at a more detailed method of allocating profits and losses. After considerable negotiation, an articles of partnership agreement

credits each partner annually for interest in an amount equal to 10 percent of that partner's beginning capital balance for the year. Evers and Chance also will be allotted $15,000 each as a compensation allowance in recognition of their participation in daily operations. Any remaining profit or loss will be split 3:4:3, with the largest share going to Evers because of the work experience that this partner brings to the business. As with any appropriate allocation, this pattern attempts to provide fair treatment for all three partners.

Under this arrangement, the $60,000 net income earned by the partnership in the first year of operation would be allocated as follows. The sequential alignment of the various provisions is irrelevant except that the ratio, which is used to assign the remaining profit or loss, must be calculated last.

Allocation of Partnership Net Income	**Tinker**	**Evers**	**Chance**	**Total**
Net Income				$ 60,000
Interest (10% of beginning capital)	$12,000	$9,000	$7,500	(28,500)
Net income remaining after interest				$ 31,500
Compensation allowance	–0–	15,000	15,000	(30,000)
Net income remaining after interest and compensation				$ 1,500
Remaining income distribution	450 (30%)	600 (40%)	450 (30%)	(1,500)
Net income allocation totals	$12,450	$24,600	$22,950	$ –0–

Importantly, the schedule computing the division of income must be completed prior to determining the final capital balances for the partners. For the Tinker, Evers, and Chance partnership, the allocations just calculated lead to the following year-end closing entry:

Income Summary	60,000	
Tinker, Capital		12,450
Evers, Capital		24,600
Chance, Capital		22,950
To allocate income for the year to the individual partners' capital accounts based on partnership agreement.		

Alternative Allocation Techniques—Example 2

As the preceding illustration indicates, the assignment process is no more than a series of mechanical steps reflecting the change in each partner's capital balance resulting from the provisions of the partnership agreement. The number of different allocation procedures that could be employed is limited solely by the partners' imagination. Although interest, compensation allowances, and various ratios are the predominant factors encountered in practice, other possibilities exist. Therefore, another approach to the allocation process is presented to further illustrate some of the variations that can be utilized. A two-person partnership is used here to simplify the computations.

Assume that Webber and Rice formed a partnership several years ago to operate a coffee shop. Webber contributed the initial capital, and Rice manages the business. With the assistance of their accountant, they wrote an articles of partnership agreement that contains the following provisions:

1. Each partner is allowed to draw $1,000 in cash from the business every month. Any withdrawal in excess of that figure will be accounted for as a direct reduction to the partner's capital balance.
2. Partnership profits and losses will be allocated each year according to the following plan:
    a. Each partner will earn 15 percent interest based on the monthly average capital balance for the year (calculated without regard for normal drawings or current income).

b. As a reward for operating the business, Rice is to receive credit for a bonus equal to 20 percent of the year's net income. However, no bonus is earned if the partnership reports a net loss.
c. The two partners will divide any remaining profit or loss equally.

Assume that Webber and Rice subsequently begin the current year with capital balances of $150,000 and $30,000, respectively. On April 1 of the current year, Webber invests an additional $8,000 cash in the business, and on July 1, Rice withdraws $6,000 in excess of the specified drawing allowance. Assume further that the partnership reports income of $30,000 for the current year.

Because the interest factor established in this allocation plan is based on a monthly average figure, the specific amount to be credited to each partner is determined by means of a preliminary calculation:

Webber—Interest Allocation

Beginning balance . . .	$150,000 × 3 months =	$ 450,000
Balance, April 1.	$158,000 × 9 months =	1,422,000
		1,872,000
		× 1/12
Monthly average capital balance		156,000
Interest rate.		× 15%
Interest credited to Webber		$ 23,400

Rice—Interest Allocation

Beginning balance . . .	$30,000 × 6 months =	$180,000
Balance, July 1	$24,000 × 6 months =	144,000
		324,000
		× 1/12
Monthly average capital balance		27,000
Interest rate.		× 15%
Interest credited to Rice		$ 4,050

Following this initial computation, the actual income assignment can proceed according to the provisions specified in the articles of partnership. The stipulations drawn by Webber and Rice must be followed exactly, even though the business's $30,000 profit for the current year is not sufficient to cover both the interest and the bonus. Income allocation is a mechanical process that should always be carried out as stated in the articles of partnership without regard to the specific level of income or loss.

Based on the plan that was created, Webber's capital increases by $21,675 during the current year, but Rice's account increases by only $8,325:

Allocation of Partnership Net Income	Weber	Rice	Total
Net Income			$ 30,000
Interest (above).	$23,400	$4,050	(27,450)
Net income remaining after interest.			$ 2,550
Bonus to Rice (20% × $30,000)	0	6,000	(6,000)
Net income (loss) remaining after interest and bonus			(3,450)
Remaining income (loss) distribution	(1,725) (50%)	(1,725) (50%)	$ 3,450
Net income allocation totals	$21,675	$8,325	$ -0-

As discussed earlier, the interest and bonus allocations sum to $33,450 and thus exceed the available net income of $30,000. The remaining overallocation of $3,450 is then treated as a loss in allocating the partnership's income to the individual partners.

LO 14-7

Explain the meaning of partnership dissolution and understand that a dissolution will often have little or no effect on the operations of the partnership business.

Accounting for Partnership Dissolution

Many partnerships limit capital transactions almost exclusively to contributions, drawings, and profit and loss allocations. Normally, though, over any extended period, changes in the members who make up a partnership occur. Employees may be promoted into the partnership or new owners brought in from outside the organization to add capital or expertise to the business. Current partners eventually retire, die, or simply elect to leave the partnership. Large operations may even experience such changes on a routine basis.

Regardless of the nature or the frequency of the event, any alteration in the specific individuals composing a partnership automatically leads to legal dissolution. In many instances, the breakup is merely a prerequisite to the formation of a new partnership. For example, if Abernethy and Chapman decide to allow Miller to become a partner in their business, the legally recognized partnership of Abernethy and Chapman has to be dissolved first. The business property as well as the right to future profits can then be conveyed to the newly formed partnership of Abernethy, Chapman, and Miller. The change is a legal one. Actual operations of the business would probably continue unimpeded by this alteration in ownership.

Conversely, should the partners so choose, dissolution can be a preliminary step in the termination and liquidation of the business. The death of a partner, lack of sufficient profits, or internal management differences can lead the partners to break up the partnership business. Under this circumstance, the partnership sells properties, pays debts, and distributes any remaining assets to the individual partners. Thus, in liquidations (which are analyzed in detail in the next chapter), both the partnership and the business cease to exist.

Dissolution—Admission of a New Partner

One of the most prevalent changes in the makeup of a partnership is the addition of a new partner. An employee may have worked for years to gain this opportunity, or a prospective partner might offer the new investment capital or business experience necessary for future business success. An individual can gain admittance to a partnership in one of two ways: (1) by purchasing an ownership interest from a current partner or (2) by contributing assets directly to the business.

In recording either type of transaction, the accountant has the option, once again, to retain the book value of all partnership assets and liabilities (as exemplified by the bonus method) or revalue these accounts to their present fair values (the goodwill method). The decision as to a theoretical preference between the bonus and goodwill methods hinges on one single question: *Should the dissolved partnership and the newly formed partnership be viewed as two separate reporting entities?*

If the new partnership is merely an extension of the old, no basis exists for restatement. The transfer of ownership is a change only in a legal sense and has no direct impact on business assets and liabilities. However, if the continuation of the business represents a legitimate transfer of property from one partnership to another, revaluation of all accounts and recognition of goodwill can be justified.

Because both approaches are encountered in practice, this textbook presents each. However, the concerns previously discussed in connection with partnership goodwill still exist: Recognition is not based on historical cost, and no objective verification of the capitalized amount can be made. One alternative revaluation approach that attempts to circumvent the problems involved with partnership goodwill has been devised. This hybrid method revalues all partnership assets and liabilities to fair value without making any corresponding recognition of goodwill.

LO 14-8

Prepare journal entries to record the acquisition by a new partner of either all or a portion of a current partner's interest.

Admission through Purchase of a Current Interest

As mentioned, one method of gaining admittance to a partnership is by the purchase of a current interest. One or more partners can choose to sell their portion of the business to an outside party. This type of transaction is most common in operations that rely primarily on monetary capital rather than on the business expertise of the partners.

In making a transfer of ownership, a partner can actually convey only three rights:

1. *The right of co-ownership in the business property.* This right justifies the partner's periodic drawings from the business as well as the distribution settlement paid at liquidation or at the time of a partner's withdrawal.

2. *The right to share in profits and losses as specified in the articles of partnership.*
3. *The right to participate in the management of the business.*

Unless restricted by the articles of partnership, every partner has the power to sell or assign the first two of these rights at any time. Their transfer poses no threat of financial harm to the remaining partners. In contrast, partnership law states that the right to participate in the management of the business can be conveyed only with the consent of all partners. This particular right is considered essential to the future earning power of the enterprise as well as the maintenance of business assets. Therefore, current partners are protected from the intrusion of parties who might be considered detrimental to the management of the company.

As an illustration, assume that Scott, Thompson, and York formed a partnership several years ago. Subsequently, York decides to leave the partnership and offers to sell his interest to Morgan. Although York may transfer the right of property ownership as well as the specified share of future profits and losses, the partnership does not automatically admit Morgan. York legally remains a partner until such time as both Scott and Thompson agree to allow Morgan to participate in the management of the business.

To demonstrate the accounting procedures applicable to the transfer of a partnership interest, assume that the following information is available relating to the partnership of Scott, Thompson, and York:

Partner	Capital Balance	Profit and Loss Ratio
Scott	$ 50,000	20%
Thompson	30,000	50
York	20,000	30
Total capital	$100,000	

As often happens, the relationship of the capital accounts to one another does not correspond with the partners' profit and loss ratio. Capital balances are historical cost figures. They result from contributions and withdrawals made throughout the life of the business as well as from the allocation of partnership income. Therefore, any correlation between a partner's recorded capital at a particular point in time and the profit and loss percentage would probably be coincidental. Scott, for example, has 50 percent of the current partnership capital ($50,000/$100,000) but is entitled to only a 20 percent allocation of income.

Instead of York selling his interest to Morgan, assume that each of these three partners elects to transfer a 20 percent interest to Morgan for a total payment of $30,000. According to the sales contract, *the money is to be paid directly to the owners.*

One approach to recording this transaction is that, because Morgan's purchase is carried out between the individual parties, the acquisition has no impact on partnership assets and liabilities. Because the business is not involved directly, the transfer of ownership requires a simple capital reclassification without any accompanying revaluation. This approach is similar to the bonus method; only a legal change in ownership is occurring so that revaluation of neither assets or liabilities nor goodwill is appropriate.

Book Value Method		
Scott, Capital (20% of capital balance)	10,000	
Thompson, Capital (20%)	6,000	
York, Capital (20%)	4,000	
Morgan, Capital (20% of total)		20,000
To reclassify capital to reflect Morgan's acquisition. Money is paid directly to partners.		

An alternative for recording Morgan's acquisition relies on a different perspective of the new partner's admission. Legally, the partnership of Scott, Thompson, and York is transferring all assets and liabilities to the partnership of Scott, Thompson, York, and Morgan.

Therefore, according to the logic underlying the goodwill method, a transaction is occurring between two separate reporting entities, an event that necessitates the complete revaluation of all assets and liabilities.

Because Morgan is paying $30,000 for a 20 percent interest in the partnership, the implied value of the business as a whole is $150,000 ($30,000/20%). However, the book value is only $100,000; thus, a $50,000 upward revaluation is indicated. This adjustment is reflected by restating specific partnership asset and liability accounts to fair value with any remaining balance recorded as goodwill.

Goodwill (Revaluation) Method		
Goodwill (or specific accounts)	50,000	
Scott, Capital (20% of goodwill)		10,000
Thompson, Capital (50%)		25,000
York, Capital (30%)		15,000
To recognize goodwill and revaluation of assets and liabilities based on value of business implied by Morgan's purchase price.		

Note that this entry credits the $50,000 revaluation to the original partners based on the profit and loss ratio rather than on capital percentages. Recognition of goodwill (or an increase in the book value of specific accounts) indicates that unrecorded gains have accrued to the business during previous years of operation. Therefore, the equitable treatment is to allocate this increment among the partners according to their profit and loss percentages. After the implied value of the partnership is established, the reclassification of ownership can be recorded based on the new capital balances as follows:

Scott, Capital (20% × new $60,000 capital balance)	12,000	
Thompson, Capital (20% × $55,000)	11,000	
York, Capital (20% × $35,000)	7,000	
Morgan, Capital (20% × $150,000 new total)		30,000
To reclassify capital to reflect Morgan's acquisition. Money is paid directly to partners.		

LO 14-9

Prepare journal entries to record a new partner's admission by a contribution made directly to the partnership.

Admission by a Contribution Made to the Partnership

Entrance into a partnership is not limited solely to the purchase of a current partner's interest. An outsider may be admitted to the ownership by contributing cash or other assets directly to the business rather than to the partners. For example, assume that King and Wilson maintain a partnership and presently report capital balances of $80,000 and $20,000, respectively. According to the articles of partnership, King is entitled to 60 percent of all profits and losses with the remaining 40 percent credited each year to Wilson. By agreement of the partners, Goldman is allowed to enter the partnership for a payment of $20,000 *with this money going into the business.* Based on negotiations that preceded the acquisition, all parties have agreed that Goldman receives an initial 10 percent interest in the net assets of the partnership.

Bonus Credited to Original Partners The bonus (or no revaluation) method maintains the same recorded value for all partnership assets and liabilities despite Goldman's admittance. The capital balance for this new partner is simply set at the appropriate 10 percent level based on the total net assets of the partnership after the payment is recorded. Because $20,000 is invested, total reported capital increases to $120,000. Thus, Goldman's 10 percent interest is computed as $12,000. *The $8,000 difference between the amount contributed and this allotted capital balance is viewed as a bonus.* Because Goldman is willing to accept a capital balance that is less than his investment, this bonus is attributed to the original partners (again based on their profit and loss ratio). As a result of the nature of the transaction, no need exists to recognize goodwill or revalue any of the assets or liabilities.

	Debit	Credit
Cash	20,000	
Goldman, Capital (10% of total capital)		12,000
King, Capital (60% of bonus)		4,800
Wilson, Capital (40% of bonus)		3,200
To record Goldman's entrance into partnership with $8,000 extra payment recorded as a bonus to the original partners.		

Goodwill Credited to Original Partners The goodwill method views Goldman's payment as evidence that the partnership as a whole possesses an actual value of $200,000 ($20,000/10%). Because—even with the new partner's investment—only $120,000 in net assets is reported, a valuation adjustment of $80,000 is implied.[13] Over the previous years, unrecorded gains have apparently accrued to the business. This $80,000 figure might reflect the need to revalue specific accounts such as inventory or equipment, although the entire amount, or some portion of it, may simply be recorded as goodwill.

	Debit	Credit
Goodwill (or specific accounts)	80,000	
King, Capital (60% of goodwill)		48,000
Wilson, Capital (40%)		32,000
To recognize goodwill based on Goldman's purchase price.		
Cash	20,000	
Goldman, Capital		20,000
To record Goldman's admission into partnership.		

Comparison of Bonus Method and Goodwill Method Completely different capital balances as well as asset and liability figures result from these two approaches. In both cases, however, the new partner is credited with the appropriate 10 percent of total partnership capital.

	Bonus Method	Goodwill Method
Assets less liabilities (as reported)	$100,000	$100,000
Goldman's contribution	20,000	20,000
Goodwill	–0–	80,000
Total	$120,000	$200,000
Goldman's capital	$ 12,000	$ 20,000

Because Goldman contributed an amount more than 10 percent of the partnership's resulting book value, this business is perceived as being worth more than the recorded accounts indicate. Therefore, the bonus in the first instance and the goodwill in the second were both assumed as accruing to the two original partners. Such a presumption is not unusual in an established business, especially if profitable operations have developed over a number of years.

Hybrid Method of Recording Admission of New Partner One other approach to Goldman's admission can be devised. Assume that the assets and liabilities of the King and Wilson partnership have a book value of $100,000, as stated earlier. Also assume that a piece of land held by the business is actually worth $30,000 more than its currently recorded book value. Thus, the identifiable assets of the partnership are worth $130,000. Goldman pays $20,000 for a 10 percent interest.

[13] In this example, because $20,000 is invested in the business, total capital to be used in the goodwill computation has increased to $120,000. If, as in the previous illustration, payment had been made directly to the partners, the original capital of $100,000 is retained in determining goodwill.

In this approach, the identifiable assets (such as land) are revalued, but no goodwill is recognized.

Land	30,000	
King, Capital (60% of revaluation)		18,000
Wilson, Capital (40%)		12,000
To record current fair value of land in preparation for admission of new partner.		

The admission of Goldman and the payment of $20,000 bring the total capital balance to $150,000. Because Goldman is acquiring a 10 percent interest, a capital balance of $15,000 is recorded. The extra $5,000 payment ($20,000 − $15,000) is attributed as a bonus to the original partners. In this way, asset revaluation and a capital bonus are both used to align the accounts.

Cash	20,000	
Goldman, Capital (10% of total capital)		15,000
King, Capital (60% of bonus)		3,000
Wilson, Capital (40% of bonus)		2,000
To record entrance of Goldman into partnership and bonus assigned to original partners.		

Bonus or Goodwill Credited to New Partner As previously discussed, Goldman also may be contributing some attribute other than tangible assets to this partnership. Therefore, the articles of partnership may be written to credit the new partner, rather than the original partners, with either a bonus or goodwill. Because of an excellent professional reputation, valuable business contacts, or myriad other possible factors, Goldman might be able to negotiate a beginning capital balance in excess of the $20,000 cash contribution. This same circumstance may also result if the business is desperate for new capital and is willing to offer favorable terms as an enticement to the potential partner.

To illustrate, assume that Goldman receives a 20 percent interest in the partnership (rather than the originally stated 10 percent) in exchange for the $20,000 cash investment. The specific rationale for the higher ownership percentage need not be identified.

The bonus method sets Goldman's initial capital at $24,000 (20 percent of the $120,000 book value). To achieve this balance, a capital bonus of $4,000 must be credited to Goldman and taken from the present partners:

Cash	20,000	
King, Capital (60% of bonus)	2,400	
Wilson, Capital (40% of bonus)	1,600	
Goldman, Capital		24,000
To record Goldman's entrance into partnership with reduced payment reported as a bonus from original partners.		

If goodwill rather than a bonus is attributed to the *entering partner,* a mathematical problem arises in determining the implicit value of the business as a whole. In the current illustration, Goldman paid $20,000 for a 20 percent interest. Therefore, the value of the company is calculated as only $100,000 ($20,000/20%), a figure that is less than the $120,000 in net assets reported after the new contribution. Negative goodwill appears to exist. One possibility is that individual partnership assets are overvalued and require reduction. As an alternative, the cash contribution might not be an accurate representation of the new partner's investment. Goldman could be bringing an intangible contribution (goodwill) to the business along with the $20,000. This additional amount must be determined algebraically:

$$\text{Goldman's capital} = 20\% \text{ of partnership capital}$$

Therefore:

$$\$20{,}000 + \text{Goodwill} = 0.20\ (\$100{,}000 + \$20{,}000 + \text{Goodwill})$$
$$\$20{,}000 + \text{Goodwill} = \$20{,}000 + \$4{,}000 + 0.20\ \text{Goodwill}$$
$$0.80\ \text{Goodwill} = \$4{,}000$$
$$\text{Goodwill} = \$5{,}000$$

If the partners determine that Goldman is, indeed, making an intangible contribution (a particular skill, for example, or a loyal clientele), Goldman should be credited with a $25,000 capital investment: $20,000 cash and $5,000 goodwill. When added to the original $100,000 in net assets reported by the partnership, this contribution raises the total capital for the business to $125,000. As the articles of partnership specified, Goldman's interest now represents a 20 percent share of the partnership ($25,000/$125,000).

Recognizing $5,000 in goodwill has established the proper relationship between the new partner and the partnership. Therefore, the following journal entry reflects this transaction:

	Debit	Credit
Cash	20,000	
Goodwill	5,000	
Goldman, Capital		25,000
To record Goldman's entrance into partnership with goodwill attributed to this new partner.		

LO 14-10

Prepare journal entries to record the withdrawal of a current partner.

Dissolution—Withdrawal of a Partner

Admission of a new partner is not the only method by which a partnership can undergo a change in composition. Over the life of the business, partners might leave the organization. Death or retirement can occur, or a partner may simply elect to withdraw from the partnership. The articles of partnership also can allow for the expulsion of a partner under certain conditions. Again, any change in membership legally dissolves the partnership, although its operations usually continue uninterrupted under the remaining partners' ownership.

Regardless of the reason for dissolution, some method of establishing an equitable settlement of the withdrawing partner's interest in the business is necessary. Often, the partner (or the partner's estate) may simply sell the interest to an outside party, with approval, or to one or more of the remaining partners. As an alternative, the business can distribute cash or other assets as a means of settling a partner's right of co-ownership. Consequently, many partnerships hold life insurance policies solely to provide adequate cash to liquidate a partner's interest upon death.

Whether death or some other reason caused the withdrawal, a final distribution will not necessarily equal the book value of the partner's capital account. A capital balance is only a recording of historical transactions and rarely represents the true value inherent in a business. Instead, payment is frequently based on the value of the partner's interest as ascertained by either negotiation or appraisal. Because a settlement determination can be derived in many ways, the articles of partnership should contain exact provisions regulating this procedure.

The withdrawal of an individual partner and the resulting distribution of partnership property can, as before, be accounted for by either the bonus (no revaluation) method or the goodwill (revaluation) method. Again, a hybrid option is also available.

As in earlier illustrations, if a bonus is recorded, the amount can be attributed to either of the parties involved: the withdrawing partner or the remaining partners. Conversely, any revaluation of partnership property (as well as the establishment of a goodwill balance) is allocated among all partners to recognize possible unrecorded gains. The hybrid approach restates assets and liabilities to fair value but does not record goodwill. This last alternative reflects the legal change in ownership but avoids the theoretical problems associated with partnership goodwill.

Accounting for the Withdrawal of a Partner

To demonstrate the various approaches that can be taken to account for a partner's withdrawal, assume that the partnership of Duncan, Smith, and Windsor has existed for a number of years. At the present time, the partners have the following capital balances as well as the indicated profit and loss percentages:

Partner	Capital Balance	Profit and Loss Ratio
Duncan	$ 70,000	50%
Smith	20,000	30
Windsor	10,000	20
Total capital	$100,000	

Windsor decides to withdraw from the partnership, but Duncan and Smith plan to continue operating the business. As per the original partnership agreement, a final settlement distribution for any withdrawing partner is computed based on the following specified provisions:

- An independent expert will appraise the business to determine its estimated fair value.
- Any individual who leaves the partnership will receive cash or other assets equal to that partner's current capital balance after including an appropriate share of any adjustment indicated by the previous valuation. The allocation of unrecorded gains and losses is based on the normal profit and loss ratio.

Following Windsor's decision to withdraw from the partnership, its property is immediately appraised. Total fair value is estimated at $180,000, a figure $80,000 in excess of book value. According to this valuation, land held by the partnership is currently worth $50,000 more than its original cost. In addition, $30,000 in goodwill is attributed to the partnership based on its value as a going concern. *Therefore, Windsor receives $26,000 on leaving the partnership: the original $10,000 capital balance plus a 20 percent share of this $80,000 increment.* The amount of payment is not in dispute, but the method of recording the withdrawal is.

Bonus Method Applied If the partnership used the bonus method to record this transaction, the extra $16,000 paid to Windsor is simply assigned as a decrease in the remaining partners' capital accounts. Historically, Duncan and Smith have been credited with 50 percent and 30 percent of all profits and losses, respectively. This same relative ratio is used now to allocate the reduction between these two remaining partners on a ⅝ and ⅜ basis:

Bonus Method		
Windsor, Capital (to remove account balance)	10,000	
Duncan, Capital (⅝ of excess distribution)	10,000	
Smith, Capital (⅜ of excess distribution)	6,000	
Cash		26,000
To record Windsor's withdrawal with $16,000 excess distribution taken from remaining partners.		

Goodwill Method Applied This same transaction can also be accounted for by means of the goodwill (or revaluation) approach. The appraisal indicates that land is undervalued on the partnership's records by $50,000 and that goodwill of $30,000 has apparently accrued to the business over the years. The first two of the following entries recognize these valuations. The adjustments properly equate Windsor's capital balance with the $26,000 cash amount to be distributed. Windsor's equity balance is merely removed in the final entry at the time of payment.

Land Revaluation		
Land	50,000	
Duncan, Capital (50%)		25,000
Smith, Capital (30%)		15,000
Windsor, Capital (20%)		10,000
To recognize land value as a preliminary step to Windsor's withdrawal.		
Goodwill Recognition		
Goodwill	30,000	
Duncan, Capital (50%)		15,000
Smith, Capital (30%)		9,000
Windsor, Capital (20%)		6,000
To recognize goodwill at the time of ownership change.		
Windsor, Capital (to remove account balance)	26,000	
Cash		26,000
To distribute cash to Windsor in settlement of partnership interest.		

After the land revaluation, Windsor's recorded capital balance increases to $20,000. The remaining unrecorded increase in partnership value is then assigned to the intangible asset goodwill. Goodwill represents an asset that captures the intangible increase in partnership value attributable to the past efforts of the individual partners.[14] Upon withdrawal, a partner is entitled to share in any unrecorded increase in partnership value based on his or her profit and loss ratio. The extra $6,000 paid to Windsor (beyond the $20,000 adjusted capital balance) thus is consistent with the $30,000 overall recognition of partnership goodwill: ($6,000 ÷ 20%) = $30,000.

The implied value of a partnership as a whole, however, cannot be determined directly from the amount distributed to a withdrawing partner. For example, paying Windsor $26,000 did not indicate that total capital should be $130,000 ($26,000 ÷ 20%). This computation is appropriate only when (1) a new partner is admitted or (2) the percentage of capital is the same as the profit and loss ratio. Here, an outside valuation of the business indicated that it was worth $80,000 more than book value. As a 20 percent owner, Windsor was entitled to $16,000 of that amount, raising the partner's capital account from $10,000 to $26,000, the amount of the final payment.

Hybrid Method Applied As indicated previously, a hybrid approach also can be adopted to record a partner's withdrawal. It also recognizes asset and liability revaluations but ignores goodwill. A bonus must then be recorded to reconcile the partner's adjusted capital balance with the final distribution.

The following journal entry, for example, does not record goodwill. However, the book value of the land is increased by $50,000 in recognition of present worth. This adjustment increases Windsor's capital balance to $20,000, a figure that is still less than the $26,000 distribution. The $6,000 difference is recorded as a bonus taken from the remaining two partners according to their relative profit and loss ratio.

Hybrid Method		
Land	50,000	
Duncan, Capital (50%)		25,000
Smith, Capital (30%)		15,000
Windsor, Capital (20%)		10,000
To adjust Land account to fair value as a preliminary step in Windsor's withdrawal.		

(continued)

[14] The value of many partnerships derives overwhelmingly from intangibles such as professional reputation and expertise. Because increases in intangible partnership value are difficult to quantify on an ongoing basis, they typically go unrecorded until a change in partnership ownership forces a reckoning.

(*continued*)

Windsor, Capital (to remove account balance)	20,000	
Duncan, Capital (⅝ of bonus)	3,750	
Smith, Capital (⅜ of bonus)	2,250	
Cash		26,000
To record final distribution to Windsor with $6,000 bonus taken from remaining partners.		

Summary

1. A partnership is defined as "an association of two or more persons to carry on a business as co-owners for profit." This form of business organization exists throughout the U.S. economy ranging in size from small, part-time operations to international enterprises. The partnership format is popular for many reasons, including the ease of creation and the avoidance of the double taxation that is inherent in corporate ownership. However, the unlimited liability incurred by each general partner normally restricts the growth potential of most partnerships. Thus, although the number of partnerships in the United States is large, the size of each tends to be small.
2. Over the years, a number of different types of organizations have been developed to take advantage of both the single taxation of partnerships and the limited liability afforded to corporate stockholders. Such legal forms include S corporations, limited partnerships, limited liability partnerships, and limited liability companies.
3. The unique elements of partnership accounting are found primarily in the capital accounts accumulated for each partner. The basis for recording these balances is the articles of partnership, a document that should be established as a prerequisite to the formation of any partnership. One of the principal provisions of this agreement is each partner's initial investment. Noncash contributions such as inventory or land are entered into the partnership's accounting records at fair value.
4. In forming a partnership, the partners' contributions need not be limited to tangible assets. A particular line of expertise possessed by a partner and an established clientele are attributes that can have a significant value to a partnership. Two methods of recording this type of investment are found in practice. The bonus method recognizes only identifiable assets. The capital accounts are then aligned to indicate the balances negotiated by the partners. According to the goodwill approach, all contributions (even those of a nebulous nature such as expertise) are valued and recorded, often as goodwill.
5. Another accounting issue to be resolved in forming a partnership is the allocation of annual net income. In closing out the revenue and expense accounts at the end of each period, some assignment must be made to the individual capital balances. Although an equal division can be used to allocate any profit or loss, partners frequently devise unique plans in an attempt to be equitable. Such factors as time worked, expertise, and invested capital should be considered in creating an allocation procedure.
6. Over time, changes occur in the makeup of a partnership because of death or retirement or because of the admission of new partners. Such changes dissolve the existing partnership, although the business frequently continues uninterrupted through a newly formed partnership. If, for example, a new partner is admitted by the acquisition of a present interest, the capital balances can simply be reclassified to reflect the change in ownership. As an alternative, the purchase price may be viewed as evidence of the underlying value of the organization as a whole. Based on this calculation, asset and liability balances are adjusted to fair value, and any residual goodwill is recognized.
7. Admission into an existing partnership also can be achieved by a direct capital contribution from the new partner. Because of the parties' negotiations, the amount invested will not always agree with the beginning capital balance attributed to the new partner. The bonus method resolves this conflict by simply reclassifying the various capital accounts to align the balances with specified totals and percentages. No revaluation is carried out under this approach. Conversely, according to the goodwill method, all asset and liability accounts are adjusted first to fair value. The price the new partner paid is used to compute an implied value for the partnership, and any excess over fair value is recorded as goodwill.
8. The composition of a partnership also can undergo changes because of the death or retirement of a partner. Individuals may decide to withdraw. Such changes legally dissolve the partnership, although business operations frequently continue under the remaining partners' ownership. In compensating the departing partner, the final asset distribution may differ from the ending capital balance. This disparity can, again, be accounted for by means of the bonus method, which adjusts the remaining capital accounts to absorb the bonus. The goodwill approach by which all assets and liabilities are restated to fair value with any goodwill being recognized also can be applied. Finally, a hybrid method revalues the assets and liabilities but ignores goodwill. Under this last approach, any amount paid to the departing partner in excess of the newly adjusted capital balance is accounted for by means of the bonus method.

Comprehensive Illustration

Problem

(*Estimated Time: 30 to 55 Minutes*) Heyman and Mullins begin a partnership on January 1, 2020. Heyman invests $40,000 cash and inventory costing $15,000 but with a current appraised value of only $12,000. Mullins contributes a building with a $40,000 book value and a $48,000 fair value. The partnership also accepts responsibility for a $10,000 note payable owed in connection with this building.

The partners agree to begin operations with equal capital balances. The articles of partnership also provide that at each year-end, profits and losses are allocated as follows:

1. For managing the business, Heyman is credited with a bonus of 10 percent of partnership income after subtracting the bonus. No bonus is accrued if the partnership records a loss.
2. Both partners are entitled to interest equal to 10 percent of the average monthly capital balance for the year without regard for the income or drawings of that year.
3. Any remaining profit or loss is divided 60 percent to Heyman and 40 percent to Mullins.
4. Each partner is allowed to withdraw $800 per month in cash from the business.

On October 1, 2020, Heyman invested an additional $12,000 cash in the business. For 2020, the partnership reported income of $33,000.

Lewis, an employee, is allowed to join the partnership on January 1, 2021. The new partner invests $66,000 directly into the business for a one-third interest in the partnership property. The revised partnership agreement still allows for both the bonus to Heyman and the 10 percent interest, but all remaining profits and losses are now split 40 percent each to Heyman and Lewis with the remaining 20 percent to Mullins. Lewis is also entitled to $800 per month in drawings.

Mullins chooses to withdraw from the partnership a few years later. After negotiations, all parties agree that Mullins should be paid a $90,000 settlement. The capital balances on that date were as follows:

Heyman, Capital	$88,000
Mullins, Capital	78,000
Lewis, Capital	72,000

Required:

a. Assuming that this partnership uses the bonus method exclusively, make all necessary journal entries. Entries for the monthly drawings of the partners are not required.

b. Assuming that this partnership uses the goodwill method exclusively, make all necessary journal entries. Again, entries for the monthly drawings are not required.

Solution

a. **Bonus Method**
2020

Jan. 1 All contributed property is recorded at fair value. Under the bonus method, total capital is then divided as specified between the partners.

Cash	40,000	
Inventory	12,000	
Building	48,000	
Note Payable		10,000
Heyman, Capital (50%)		45,000
Mullins, Capital (50%)		45,000
To record initial contributions to partnership along with equal capital balances.		

Oct. 1

Cash	12,000	
Heyman, Capital		12,000
To record additional investment by partner.		

Dec. 31 Both the bonus assigned to Heyman and the interest accrual must be computed as preliminary steps in the income allocation process. Because the bonus is based on income after subtracting the bonus, the amount must be calculated algebraically:

$$\text{Bonus} = 0.10\ (\$33{,}000 - \text{Bonus})$$
$$\text{Bonus} = \$3{,}300 - 0.10\ \text{Bonus}$$
$$1.10\ \text{Bonus} = \$3{,}300$$
$$\text{Bonus} = \$3{,}000$$

According to the articles of partnership, the interest allocation is based on a monthly average figure. Mullins's capital balance of $45,000 did not change during the year; therefore, $4,500 (10 percent) is the appropriate interest accrual for that partner. However, because of the October 1, 2020, contribution, Heyman's interest must be determined as follows:

Beginning balance	$45,000 × 9 months =	$405,000
New balance	$57,000 × 3 months =	171,000
		576,000
		× 1⁄12
Monthly average—capital balance		48,000
Interest rate		× 10%
Interest credited to Heyman.		$ 4,800

Following the bonus and interest computations, the $33,000 income earned by the business is allocated according to the previously specified arrangement:

	Heyman	Mullins	Totals
Net Income.			$ 33,000
Bonus to Heyman	3,000		(3,000)
Income remaining after bonus			$ 30,000
Interest on monthly average capital balance. . . .	4,800	4,500	(9,300)
Income remaining after bonus and interest			$ 20,700
Remaining income allocation	12,420 (60%)	8,280 (40%)	(20,700)
Net income allocation total	$20,220	$12,780	$ 0

The partnership's closing entries for the year would be recorded as follows:

Heyman, Capital	9,600	
Mullins, Capital.	9,600	
Heyman, Drawing		9,600
Mullins, Drawing		9,600
To close out $800 per month drawing accounts for the year.		
Income Summary	33,000	
Heyman, Capital		20,220
Mullins, Capital		12,780
To close out profit for year to capital accounts as computed above.		

At the end of this initial year of operation, the partners' capital accounts hold these balances:

	Heyman	Mullins	Totals
Beginning balance	$45,000	$45,000	$ 90,000
Additional investment.	12,000	–0–	12,000
Drawing.	(9,600)	(9,600)	(19,200)
Net income (above)	20,220	12,780	33,000
Total capital	$67,620	$48,180	$115,800

2021

Jan. 1 Lewis contributed $66,000 to the business for a one-third interest in the partnership property. Combined with the $115,800 balance previously computed, the partnership now has total capital of $181,800. Because no revaluation is recorded under the bonus approach, a one-third interest in the partnership equals $60,600 ($181,800 × ⅓). Lewis has invested $5,400 in excess of this amount, a balance viewed as a bonus accruing to the original partners:

Cash	66,000	
Lewis, Capital		60,600
Heyman, Capital (60% of bonus)		3,240
Mullins, Capital (40% of bonus)		2,160
To record Lewis's entrance into partnership with bonus to original partners.		

Several years later The final event in this illustration is Mullins's withdrawal from the partnership. Although this partner's capital balance reports only $78,000, the final distribution is set at $90,000. The extra $12,000 payment represents a bonus assigned to Mullins, an amount that decreases the capital of the remaining two partners. Because Heyman and Lewis have previously accrued equal 40 percent shares of all profits and losses, the reduction is split evenly between the two.

Mullins, Capital	78,000	
Heyman, Capital (½ of bonus payment)	6,000	
Lewis, Capital (½ of bonus payment)	6,000	
Cash		90,000
To record withdrawal of Mullins with a bonus from remaining partners.		

b. Goodwill Method

2020

Jan. 1 The fair value of Heyman's contribution is $52,000, whereas Mullins is investing only a net $38,000 (the value of the building less the accompanying debt). Because the capital accounts are initially to be equal, Mullins is presumed to be contributing goodwill of $14,000.

Cash	40,000	
Inventory	12,000	
Building	48,000	
Goodwill	14,000	
Note payable		10,000
Heyman, Capital		52,000
Mullins, Capital		52,000
Creation of partnership with goodwill attributed to Mullins.		

Oct. 1

Cash	12,000	
Heyman, Capital		12,000
To record additional contribution by partner.		

Dec. 31 Although Heyman's bonus is still $3,000 as derived in requirement (*a*), the interest accruals must be recalculated because the capital balances are different. Mullins's capital for the entire year was $52,000; thus, interest of $5,200 (10 percent) is appropriate. However, Heyman's balance changed during the year, so a monthly average must be determined as a basis for computing interest:

Beginning balance	$52,000 × 9 months =	$468,000
New balance	$64,000 × 3 months =	192,000
		660,000
		× 1⁄12
Monthly average—capital balance		55,000
Interest rate		× 10%
Interest credited to Heyman		$ 5,500

The $33,000 partnership income is allocated as follows:

	Heyman	Mullins	Totals
Net Income			$33,000
Bonus to Heyman	$ 3,000		(3,000)
Income remaining after bonus			$30,000
Interest on monthly average capital balance	5,500	5,200	(10,700)
Income remaining after bonus and interest			$19,300
Remaining income allocation	11,580 (60%)	7,720 (40%)	(19,300)
Net income allocation total	$20,080	$12,920	$ 0

The closing entries made under the goodwill approach would be as follows:

Heyman, Capital	9,600	
Mullins, Capital	9,600	
Heyman, Drawing		9,600
Mullins, Drawing		9,600
To close out drawing accounts for the year.		
Income Summary	33,000	
Heyman, Capital		20,080
Mullins, Capital		12,920
To assign profits per allocation schedule.		

After the closing process, the capital balances are composed of the following items:

	Heyman	Mullins	Totals
Beginning balance	$52,000	$52,000	$104,000
Additional investment	12,000	–0–	12,000
Drawing	(9,600)	(9,600)	(19,200)
Net income	20,080	12,920	33,000
Total capital	$74,480	$55,320	$129,800

2021

Jan. 1 Lewis's investment of $66,000 for a one-third interest in the partnership property implies that the business as a whole is worth $198,000 ($66,000 divided by ⅓). After adding Lewis's contribution to the present capital balance of $129,800, the business reports total net assets of only $195,800. Thus, a $2,200 increase in value ($198,000 − $195,800) is indicated and will be recognized at this time. Under the assumption that all partnership assets and liabilities are valued appropriately, this entire balance is attributed to goodwill.

Goodwill	2,200	
Heyman, Capital (60%)		1,320
Mullins, Capital (40%)		880
To recognize goodwill based on Lewis's acquisition price.		
Cash	66,000	
Lewis, Capital		66,000
To admit Lewis to the partnership.		

Several years later To conclude this illustration, Mullins's withdrawal must be recorded. This partner is to receive a distribution that is $12,000 more than the corresponding capital balance of $78,000. Because Mullins is entitled to a 20 percent share of profits and losses, the additional $12,000 payment indicates that the partnership as a whole is undervalued by $60,000 ($12,000/20%). Only in that circumstance would the extra payment to Mullins be justified. Therefore, once again, goodwill is recognized and is followed by the final distribution.

Goodwill	60,000	
Heyman, Capital (40%)		24,000
Mullins, Capital (20%)		12,000
Lewis, Capital (40%)		24,000
Recognition of goodwill based on withdrawal amount paid to Mullins.		
Mullins, Capital	90,000	
Cash		90,000
To distribute money to partner.		

Questions

1. What are the advantages of operating a business as a partnership rather than as a corporation? What are the disadvantages?
2. How does partnership accounting differ from corporate accounting?
3. What information do the capital accounts found in partnership accounting convey?
4. Describe the differences between a Subchapter S corporation and a Subchapter C corporation.
5. A company is being created, and the owners are trying to decide whether to form a general partnership, a limited liability partnership, or a limited liability company. What are the advantages and disadvantages of each of these legal forms?
6. What is an articles of partnership agreement, and what information should this document contain?
7. What valuation should be recorded for noncash assets transferred to a partnership by one of the partners?
8. If a partner is contributing attributes to a partnership such as an established clientele or a particular expertise, what two methods can be used to record the contribution? Describe each method.
9. What is the purpose of a drawing account in a partnership's financial records?
10. At what point in the accounting process does the allocation of partnership income become significant?
11. What provisions in a partnership agreement can be used to establish an equitable allocation of income among all partners?
12. If no agreement exists in a partnership as to the allocation of income, what method is appropriate?
13. What is a partnership dissolution? Does dissolution automatically necessitate the cessation of business and the liquidation of partnership assets?
14. By what methods can a new partner gain admittance into a partnership?
15. When a partner sells an ownership interest in a partnership, what rights are conveyed to the new owner?
16. A new partner enters a partnership, and goodwill is calculated and credited to the original partners. How is the specific amount of goodwill assigned to these partners?
17. Under what circumstance might goodwill be allocated to a new partner entering a partnership?
18. When a partner withdraws from a partnership, why is the final distribution often based on the appraised value of the business rather than on the book value of the capital account balance?

Problems

LO 14-1

1. Which of the following is *not* a reason for the popularity of partnerships as a legal form for businesses?
   a. Partnerships may be formed merely by an oral agreement.
   b. Partnerships can more easily generate significant amounts of capital.
   c. Partnerships avoid the double taxation of income that is found in corporations.
   d. In some cases, losses may be used to offset gains for tax purposes.

LO 14-1

2. How does partnership accounting differ from corporate accounting?
   a. The matching principle is not considered appropriate for partnership accounting.
   b. Revenues are recognized at a different time by a partnership than is appropriate for a corporation.
   c. Individual capital accounts replace the contributed capital and retained earnings balances found in corporate accounting.
   d. Partnerships report all assets at fair value as of the latest balance sheet date.

LO 14-2

3. Which of the following best describes the articles of partnership agreement?
   a. The purpose of the partnership and partners' rights and responsibilities are required elements of the articles of partnership.
   b. The articles of partnership are a legal covenant and must be expressed in writing to be valid.
   c. The articles of partnership are an agreement that limits partners' liability to partnership assets.
   d. The articles of partnership are a legal covenant that may be expressed orally or in writing, and form the central governance for a partnership's operations.

LO 14-9

4. Pat, Jean Lou, and Diane are partners with capital balances of $50,000, $30,000, and $20,000, respectively. These three partners share profits and losses equally. For an investment of $50,000 cash (paid to the business), MaryAnn will be admitted as a partner with a one-fourth interest in capital and profits. Based on this information, which of the following best justifies the amount of MaryAnn's investment?
   a. MaryAnn will receive a bonus from the other partners upon her admission to the partnership.
   b. Assets of the partnership were overvalued immediately prior to MaryAnn's investment.
   c. The book value of the partnership's net assets was less than the fair value immediately prior to MaryAnn's investment.
   d. MaryAnn is apparently bringing goodwill into the partnership, and her capital account will be credited for the appropriate amount.

LO 14-10

5. A partnership has the following capital balances with partners' profit and loss percentages indicated parenthetically:

Henry (50%)	$135,000
Thomas (30%)	85,000
Catherine (20%)	80,000

   Anne is going to invest $125,000 into the business to acquire a 40 percent ownership interest. Goodwill is to be recorded. What will be Anne's beginning capital balance?
   a. $125,000
   b. $170,000
   c. $200,000
   d. $245,000

LO 14-8

6. A partnership has the following capital balances with partners' profit and loss percentages indicated parenthetically:

Burks (35%)	$280,000
Donovan (40%)	300,000
Watkins (25%)	170,000

   Ranzilla agrees to pay a total of $245,000 directly to these three partners to acquire a 25 percent ownership interest from each. The partnership will record goodwill based on the new partner's payment. What is Donovan's capital balance after the transaction?
   a. $225,000
   b. $294,000
   c. $392,000
   d. $398,000

LO 14-9

7. The capital balance for Maxwell is $110,000 and for Russell is $40,000. These two partners share profits and losses 70 percent (Maxwell) and 30 percent (Russell). Evan invests $50,000 in cash into the partnership for a 30 percent ownership. The bonus method will be used. What is Russell's capital balance after Evan's investment?
   a. $35,000
   b. $37,000
   c. $40,000
   d. $43,000

LO 14-9

8. Patrick has a capital balance of $120,000 in a local partnership, and Caitlin has a $90,000 balance. These two partners share profits and losses by a ratio of 60 percent to Patrick and 40 percent to Caitlin. Camille invests $60,000 in cash in the partnership for a 20 percent ownership. The goodwill method will be used. What is Caitlin's capital balance after this new investment?
   a. $99,600
   b. $102,000
   c. $112,000
   d. $126,000

LO 14-9

9. The capital balance for Messalina is $210,000 and for Romulus is $140,000. These two partners share profits and losses 60 percent (Messalina) and 40 percent (Romulus). Claudius invests $100,000 in cash in the partnership for a 20 percent ownership. The bonus method will be used. What are the capital balances for Messalina, Romulus, and Claudius after this investment is recorded?
   a. $216,000, $144,000, $90,000
   b. $218,000, $142,000, $88,000
   c. $222,000, $148,000, $80,000
   d. $240,000, $160,000, $100,000

LO 14-6

10. A partnership begins its first year with the following capital balances:

Alexander, Capital	$ 90,000
Bertrand, Capital	100,000
Coloma, Capital	160,000

The articles of partnership stipulate that profits and losses be assigned in the following manner:

- Each partner is allocated interest equal to 5 percent of the beginning capital balance.
- Bertrand is allocated compensation of $45,000 per year.
- Any remaining profits and losses are allocated on a 3:3:4 basis, respectively.
- Each partner is allowed to withdraw up to $25,000 cash per year.

Assuming that the net income is $115,000 and that each partner withdraws the maximum amount allowed, what is the balance in Coloma's capital account at the end of the year?
   a. $143,000
   b. $135,000
   c. $168,000
   d. $164,000

LO 14-4, 14-5, 14-6

11. A partnership begins its first year of operations with the following capital balances:

Winston, Capital	$110,000
Durham, Capital	80,000
Salem, Capital	110,000

According to the articles of partnership, all profits will be assigned as follows:

- Winston will be awarded an annual salary of $20,000 with $10,000 assigned to Salem.
- The partners will be attributed interest equal to 10 percent of the capital balance as of the first day of the year.
- The remainder will be assigned on a 5:2:3 basis, respectively.
- Each partner is allowed to withdraw up to $10,000 per year.

The net loss for the first year of operations is $20,000, and net income for the subsequent year is $40,000. Each partner withdraws the maximum amount from the business each period. What is the balance in Winston's capital account at the end of the second year?
   a. $102,600
   b. $104,400
   c. $108,600
   d. $109,200

LO 14-10

12. A partnership has the following capital balances:

Allen, Capital	$60,000
Burns, Capital	30,000
Costello, Capital	90,000

Profits and losses are split as follows: Allen (20 percent), Burns (30 percent), and Costello (50 percent). Costello wants to leave the partnership and is paid $100,000 from the business based on provisions in the articles of partnership. If the partnership uses the bonus method, what is the balance of Burns's capital account after Costello withdraws?
   a. $24,000
   b. $27,000
   c. $33,000
   d. $36,000

Problems 13 and 14 are *independent* problems based on the following scenario:

At year-end, the Circle City partnership has the following capital balances:

Manning, Capital	$130,000
Gonzalez, Capital	110,000
Clark, Capital	80,000
Freeney, Capital	70,000

Profits and losses are split on a 3:3:2:2 basis, respectively. Clark decides to leave the partnership and is paid $90,000 from the business based on the original contractual agreement.

LO 14-10

13. The payment made to Clark beyond his capital account was for Clark's share of previously unrecognized goodwill. After recognizing partnership goodwill, what is Manning's capital balance after Clark withdraws?
    a. $133,000
    b. $137,500
    c. $140,000
    d. $145,000

LO 14-10

14. If instead the partnership uses the bonus method, what is the balance of Manning's capital account after Clark withdraws?
    a. $100,000
    b. $126,250
    c. $130,000
    d. $133,750

Problems 15 and 16 are *independent* problems based on the following capital account balances and profit and loss percentages (indicated parenthetically):

William (40%)	$ 220,000
Jennings (40%)	160,000
Bryan (20%)	110,000

LO 14-8

15. Darrow invests $270,000 in cash for a 30 percent ownership interest. The money goes to the original partners. Goodwill is to be recorded. How much goodwill should be recognized, and what is Darrow's beginning capital balance?
    a. $410,000 and $270,000
    b. $140,000 and $270,000
    c. $140,000 and $189,000
    d. $410,000 and $189,000

LO 14-9

16. Darrow invests $250,000 in cash for a 30 percent ownership interest. The money goes to the business. No goodwill or other revaluation is to be recorded. After the transaction, what is Jennings's capital balance?
    a. $160,000
    b. $168,000
    c. $170,200
    d. $171,200

LO 14-9

17. Lear is to become a partner in the WS partnership by paying $80,000 in cash to the business. At present, the capital balance for Hamlet is $70,000 and for MacBeth is $40,000. Hamlet and MacBeth share profits on a 7:3 basis. Lear is acquiring 40 percent of the new partnership.
    a. If the goodwill method is applied, what will the three capital balances be following the payment by Lear?
    b. If the bonus method is applied, what will the three capital balances be following the payment by Lear?

LO 14-9

18. The Distance Plus partnership has the following capital balances at the beginning of the current year along with respective profit and loss percentages:

Tiger (50%)	$85,000
Phil (30%)	60,000
Ernie (20%)	55,000

Each of the following questions should be viewed independently.

a. If Sergio invests $100,000 in cash in the business for a 25 percent interest, what journal entry is recorded? Assume that the bonus method is used.

b. If Sergio invests $60,000 in cash in the business for a 25 percent interest, what journal entry is recorded? Assume that the bonus method is used.

c. If Sergio invests $72,000 in cash in the business for a 25 percent interest, what journal entry is recorded? Assume that the goodwill method is used.

LO 14-9

19. A partnership has the following account balances: Cash, $50,000; Other Assets, $600,000; Liabilities, $240,000; Nixon, Capital (50 percent of profits and losses), $200,000; Hoover, Capital (20 percent), $120,000; and Polk, Capital (30 percent), $90,000. Each of the following questions should be viewed as an independent situation:

a. Grant invests $80,000 in the partnership for an 18 percent capital interest. Goodwill is to be recognized. What are the capital accounts thereafter?

b. Grant invests $100,000 in the partnership to get a 20 percent capital balance. Goodwill is not to be recorded. What are the capital accounts thereafter?

LO 14-5, 14-6, 14-9

20. The Prince-Robbins partnership has the following capital account balances on January 1, 2021:

Prince, Capital	$70,000
Robbins, Capital	60,000

Prince is allocated 80 percent of all profits and losses with the remaining 20 percent assigned to Robbins after interest of 10 percent is given to each partner based on beginning capital balances.

On January 2, 2021, Jeffrey invests $37,000 cash for a 20 percent interest in the partnership. This transaction is recorded by the goodwill method. After this transaction, 10 percent interest is still to go to each partner. Profits and losses will then be split as follows: Prince (50 percent), Robbins (30 percent), and Jeffrey (20 percent). In 2021, the partnership reports a net income of $15,000.

a. Prepare the journal entry to record Jeffrey's entrance into the partnership on January 2, 2021.

b. Prepare a schedule showing how the 2021 net income allocation to the partners should be determined.

LO 14-6

21. The partnership agreement of Jones, King, and Lane provides for the annual allocation of the business's profit or loss in the following sequence:

- Jones, the managing partner, receives a bonus equal to 20 percent of the business's profit.
- Each partner receives 15 percent interest on average capital investment.
- Any residual profit or loss is divided equally.

The average capital investments for 2021 were as follows:

Jones.	$100,000
King	200,000
Lane.	300,000

The partnership earned $90,000 net income for 2021. Prepare a schedule showing how the 2021 net income should be allocated to the partners.

LO 14-4, 14-5, 14-6

22. Purkerson, Smith, and Traynor have operated a bookstore for a number of years as a partnership. At the beginning of 2021, capital balances were as follows:

Purkerson	$60,000
Smith	40,000
Traynor	20,000

Due to a cash shortage, Purkerson invests an additional $8,000 in the business on April 1, 2021.

Each partner is allowed to withdraw $1,000 cash each month.

The partners have used the same method of allocating profits and losses since the business's inception:

- Each partner is given the following compensation allowance for work done in the business: Purkerson, $18,000; Smith, $25,000; and Traynor, $8,000.
- Each partner is credited with interest equal to 10 percent of the average monthly capital balance for the year without regard for normal drawings.
- Any remaining profit or loss is allocated 4:2:4 to Purkerson, Smith, and Traynor, respectively. The net income for 2021 is $23,600. Each partner withdraws the allotted amount each month.

Prepare a schedule showing calculations for the partners' 2021 ending capital balances.

LO 14-4, 14-5, 14-6

23. On January 1, 2020, the dental partnership of Angela, Diaz, and Krause was formed when the partners contributed $30,000, $58,000, and $60,000, respectively. Over the next three years, the business reported net income and (loss) as follows:

2020	$ 70,000
2021	42,000
2022	(25,000)

During this period, each partner withdrew cash of $15,000 per year. Krause invested an additional $5,000 in cash on February 9, 2021.

At the time that the partnership was created, the three partners agreed to allocate all profits and losses according to a specified plan written as follows:

- Each partner is entitled to interest computed at the rate of 10 percent per year based on the individual capital balances at the beginning of that year.
- Because of prior work experience, Angela is entitled to an annual salary allowance of $12,000 per year, and Diaz is entitled to an annual salary allowance of $9,000 per year.
- Any remaining profit will be split as follows: Angela, 20 percent; Diaz, 40 percent; and Krause, 40 percent. If a net loss remains after the initial allocations to the partners, the balance will be allocated: Angela, 30 percent; Diaz, 50 percent; and Krause, 20 percent.

Prepare a schedule that determines the ending capital balance for each partner as of the end of each of these three years.

LO 14-10

24. The E.N.D. partnership has the following capital balances as of the end of the current year:

Pineda	$230,000
Adams	190,000
Fergie	160,000
Gomez	140,000
Total capital	$720,000

Answer each of the following *independent* questions:

a. Assume that the partners share profits and losses 3:3:2:2, respectively. Fergie retires and is paid $190,000 based on the terms of the original partnership agreement. If the goodwill method is used, what is the capital balance of the remaining three partners?

b. Assume that the partners share profits and losses 4:3:2:1, respectively. Pineda retires and is paid $280,000 based on the terms of the original partnership agreement. If the bonus method is used, what is the capital balance of the remaining three partners?

LO 14-10

25. The partnership of Matteson, Richton, and O'Toole has existed for a number of years. At the present time, the partners have the following capital balances and profit and loss sharing percentages:

Partner	Capital Balance	Profit and Loss Percentage
Matteson	$ 90,000	30%
Richton	150,000	50
O'Toole	100,000	20

O'Toole elects to withdraw from the partnership, leaving Matteson and Richton to operate the business. Following the original partnership agreement, when a partner withdraws, the partnership and all of its individual assets are to be reassessed to current fair values by an independent appraiser. The withdrawing partner will receive cash or other assets equal to that partner's current capital balance after including an appropriate share of any adjustment indicated by the appraisal. Gains and losses indicated by the appraisal are allocated using the regular profit and loss percentages.

An independent appraiser is hired and estimates that the partnership as a whole is worth $600,000. Regarding the individual assets, the appraiser finds that a building with a book value of $180,000 has a fair value of $220,000. The book values for all other identifiable assets and liabilities are the same as their appraised fair values.

Accordingly, the partnership agrees to pay O'Toole $120,000 upon withdrawal. Matteson and Richton, however, do not wish to record any goodwill in connection with the change in ownership.

Prepare the journal entry to record O'Toole's withdrawal from the partnership.

LO 14-2, 14-4, 14-6, 14-9

26. In the early part of 2021, the partners of Hugh, Jacobs, and Thomas sought assistance from a local accountant. They had begun a new business in 2020 but had never used an accountant's services.

    Hugh and Jacobs began the partnership by contributing $150,000 and $100,000 in cash, respectively. Hugh was to work occasionally at the business, and Jacobs was to be employed full-time. They decided that year-end profits and losses should be assigned as follows:

    - Each partner was to be allocated 10 percent interest computed on the beginning capital balances for the period.
    - A compensation allowance of $5,000 was to go to Hugh with a $25,000 amount assigned to Jacobs.
    - Any remaining income would be split on a 4:6 basis to Hugh and Jacobs, respectively.

    In 2020, revenues totaled $175,000, and expenses were $146,000 (not including the partners' compensation allowance). Hugh withdrew cash of $9,000 during the year, and Jacobs took out $14,000. In addition, the business paid $7,500 for repairs made to Hugh's home and charged it to repair expense.

    On January 1, 2021, the partnership sold a 15 percent interest to Thomas for $64,000 cash. This money was contributed to the business with the bonus method used for accounting purposes.

    Answer the following questions:

    a. Why was the original profit and loss allocation, as just outlined, designed by the partners?

    b. Why did the drawings for 2020 not agree with the compensation allowances provided for in the partnership agreement?

    c. What journal entries should the partnership have recorded on December 31, 2020?

    d. What journal entry should the partnership have recorded on January 1, 2021?

LO 14-3, 14-9, 14-10

27. The following is the current balance sheet for a local partnership of doctors:

Cash and current assets	$ 30,000	Liabilities	$ 40,000
Land	180,000	A, Capital	20,000
Building and equipment (net)	100,000	B, Capital	40,000
		C, Capital	90,000
		D, Capital	120,000
Totals	$310,000	Totals	$310,000

The following questions represent *independent* situations:

a. E is going to invest enough money in this partnership to receive a 25 percent interest. No goodwill or bonus is to be recorded. How much should E invest?

b. E contributes $36,000 in cash to the business to receive a 10 percent interest in the partnership. Goodwill is to be recorded. Profits and losses have previously been split according to the following percentages: A, 30 percent; B, 10 percent; C, 40 percent; and D, 20 percent. After E makes this investment, what are the individual capital balances?

c. E contributes $42,000 in cash to the business to receive a 20 percent interest in the partnership. Goodwill is to be recorded. The four original partners share all profits and losses equally. After E makes this investment, what are the individual capital balances?

d. E contributes $55,000 in cash to the business to receive a 20 percent interest in the partnership. No goodwill or other asset revaluation is to be recorded. Profits and losses have previously been split according to the following percentages: A, 10 percent; B, 30 percent; C, 20 percent; and D, 40 percent. After E makes this investment, what are the individual capital balances?

e. C retires from the partnership and, as per the original partnership agreement, is to receive cash equal to 125 percent of her final capital balance. No goodwill or other asset revaluation is to be recognized. All partners share profits and losses equally. After the withdrawal, what are the individual capital balances of the remaining partners?

LO 14-5, 14-6, 14-9

28. Gorman and Morton form a partnership on May 1, 2019. Gorman contributes cash of $50,000; Morton conveys title to the following properties to the partnership:

	Book Value	Fair Value
Equipment	$15,000	$28,000
Licensing agreements	35,000	36,000

The partners agree to start their partnership with equal capital balances. No goodwill is to be recognized.

According to the articles of partnership written by the partners, profits and losses are allocated based on the following formula:

- Gorman receives a compensation allowance of $1,000 per month.
- All remaining profits and losses are split 40:60 between Gorman and Morton, respectively.
- Each partner can make annual cash drawings of $25,000 beginning in 2020.

Net income of $11,000 is earned by the business during 2019.

Steele is invited to join the partnership on January 1, 2020. Because of her business reputation and financial expertise, she is given a 40 percent interest for $54,000 cash. The bonus approach is used to record this investment, made directly to the business. The articles of partnership are amended to give Steele a $2,000 compensation allowance per month and an annual cash drawing of $20,000. Remaining profits are now allocated:

Gorman	12%
Morton.	48
Steele	40

All drawings are taken by the partners during 2020. At year-end, the partnership reports net income of $86,000.

On January 1, 2021, Frank (previously a partnership employee) is admitted into the partnership. Each partner transfers 10 percent to Frank, who makes the following payments directly to the partners:

Gorman	$5,216
Morton.	4,724
Steele	9,560

Once again, the articles of partnership must be amended to allow for the entrance of the new partner. This change entitles Frank to a compensation allowance of $800 per month and an annual drawing of $14,000. Profits and losses are now assigned as follows:

Gorman	13.5%
Morton.	40.5
Steele	36.0
Frank	10.0

For the year of 2021, the partnership earned a profit of $40,000, and each partner withdrew the allowed amount of cash.

Prepare schedules that determine the capital balances for the individual partners as of the end of each year 2019 through 2021.

LO 14-4, 14-5, 14-6, 14-9

29. Kimble, Sykes, and Gerard open an accounting practice on January 1, 2019, in Chicago, Illinois, to be operated as a partnership. Kimble and Sykes will serve as the senior partners because of their years of experience. To establish the business, Kimble, Sykes, and Gerard contribute cash and other properties valued at $208,000, $180,000, and $92,000, respectively. An articles of partnership agreement is drawn up stipulating the following:

- Personal drawings are allowed annually up to an amount equal to 10 percent of the partner's beginning capital balance for the year.
- Profits and losses are allocated according to the following plan:
  1. Each partner receives an annual salary allowance of $55 per billable hours worked.
  2. Interest is credited to the partners' capital accounts at the rate of 12 percent of the beginning capital balance for the year.
  3. Kimble and Sykes are eligible for an annual bonus of 10 percent of net income after subtracting the bonus, salary allowance, and interest. The agreement also states that there will be no bonus if there is a net loss or if salary and interest result in a negative remainder of net income to be distributed.
  4. Any remaining partnership profit or loss is to be divided evenly among all partners.

On January 1, 2020, the partners admit Nichols to the partnership. Nichols contributes cash directly to the business in an amount equal to a 25 percent interest in the book value of the partnership property subsequent to this contribution. The partnership profit and loss sharing agreement is not altered upon Nichols' entrance into the firm; the general provisions continue to be applicable.

The billable hours for the partners during the first three years of operation follow:

	2019	2020	2021
Kimble	1,700	1,800	1,880
Sykes	1,440	1,500	1,620
Gerard	1,300	1,380	1,310
Nichols	–0–	1,560	1,550

The partnership reports net income (loss) for 2019 through 2021 as follows:

2019	$282,000
2020	(12,400)
2021	477,000

Each partner withdraws the maximum allowable amount each year.

a. Prepare schedules that allocate each year's net income to the partners (to the nearest dollar).

b. Prepare in appropriate form a statement of partners' capital for the year ending December 31, 2021.

LO 14-8, 14-9, 14-10

30. A partnership of attorneys in the St. Louis, Missouri, area has the following balance sheet accounts as of January 1, 2021:

Assets	$320,000	Liabilities	$120,000
		Athos, capital	80,000
		Porthos, capital	70,000
		Aramis, capital	50,000

According to the articles of partnership, Athos is to receive an allocation of 50 percent of all partnership profits and losses, while Porthos receives 30 percent, and Aramis, 20 percent. The book value of each asset and liability should be considered an accurate representation of fair value.

For each of the following *independent* situations, prepare the journal entry or entries to be recorded by the partnership. (Round to nearest dollar.)

a. Porthos, with permission of the other partners, decides to sell half of his partnership interest to D'Artagnan for $50,000 in cash. No asset revaluation or goodwill is to be recorded by the partnership.

b. All three of the present partners agree to sell 10 percent of each partnership interest to D'Artagnan for a total cash payment of $25,000. Each partner receives a negotiated portion of this amount. Goodwill is recorded as a result of the transaction.

c. D'Artagnan is allowed to become a partner with a 10 percent ownership interest by contributing $30,000 in cash directly into the business. The bonus method is used to record this admission.

d. Use the same facts as in requirement (*c*) except that the entrance into the partnership is recorded by the goodwill method.

e. D'Artagnan is allowed to become a partner with a 10 percent ownership interest by contributing $12,222 in cash directly to the business. The goodwill method is used to record this transaction.

f. Aramis decides to retire and leave the partnership. An independent appraisal of the business and its assets indicates a current fair value of $280,000. Goodwill is to be recorded. Aramis will then be given the exact amount of cash that will close out his capital account.

LO 14-2, 14-3, 14-5, 14-6, 14-8, 14-10

31. Steve Reese is a well-known interior designer in Fort Worth, Texas. He wants to start his own business and convinces Rob O'Donnell, a local merchant, to contribute the capital to form a partnership. On January 1, 2019, O'Donnell invests a building worth $52,000 and equipment valued at $16,000 as well as $12,000 in cash. Although Reese makes no tangible contribution to the partnership, he will operate the business and be an equal partner in the beginning capital balances.

To entice O'Donnell to join this partnership, Reese draws up the following profit and loss agreement:

- O'Donnell will be credited annually with interest equal to 20 percent of the beginning capital balance for the year.
- O'Donnell will also have added to his capital account 15 percent of partnership income each year (without regard for the preceding interest figure) or $4,000, whichever is larger. All remaining income is credited to Reese.
- Neither partner is allowed to withdraw funds from the partnership during 2019. Thereafter, each can draw $5,000 annually or 20 percent of the beginning capital balance for the year, whichever is larger.

The partnership reported a net loss of $10,000 during the first year of its operation. On January 1, 2020, Terri Dunn becomes a third partner in this business by contributing $15,000 cash to the partnership. Dunn receives a 20 percent share of the business's capital. The profit and loss agreement is altered as follows:

- O'Donnell is still entitled to (1) interest on his beginning capital balance as well as (2) the share of partnership income just specified.
- Any remaining profit or loss will be split on a 6:4 basis between Reese and Dunn, respectively.

Partnership income for 2020 is reported as $44,000. Each partner withdraws the full amount that is allowed.

On January 1, 2021, Dunn becomes ill and sells her interest in the partnership (with the consent of the other two partners) to Judy Postner. Postner pays $46,000 directly to Dunn. Net income for 2021 is $61,000 with the partners again taking their full drawing allowance.

On January 1, 2022, Postner withdraws from the business for personal reasons. The articles of partnership state that any partner may leave the partnership at any time and is entitled to receive cash in an amount equal to the recorded capital balance at that time plus 10 percent.

a. Prepare journal entries to record the preceding transactions on the assumption that the bonus (or no revaluation) method is used. Drawings need not be recorded, although the balances should be included in the closing entries.

b. Prepare journal entries to record the previous transactions on the assumption that the goodwill (or revaluation) method is used. Drawings need not be recorded, although the balances should be included in the closing entries.

(Round all amounts to the nearest dollar.)

Develop Your Skills

RESEARCH CASE

Go to the Buckeye Partners, L.P., website where forms filed with the SEC are available through the Investor Center. Find Buckeye's recent annual financial statements in their 10–K report for the partnership.

Required

Review Buckeye's financial statements as well as the accompanying notes. List and briefly discuss information included for this partnership that would typically not appear in financial statements produced for a corporation.

ANALYSIS CASE

Erin Carson, Megyn Delaney, and Caitlin Erikson form a partnership as a first step in creating a business. Carson invests most of the capital but does not plan to be actively involved in the day-to-day operations. Delaney has had some experience and is expected to do a majority of the daily work. Erikson has been in this line of business for some time and has many connections. Therefore, she will devote a majority of her time to getting new clients.

Required

Write a memo to these three partners suggesting at least two different ways in which the profits of the partnership can be allocated each year in order to be fair to all parties.

COMMUNICATION CASE 1

Kelly Fernandez and Michael Webster have decided to create a business. They have financing available and have a well-developed business plan. However, they have not yet decided which type of legal business structure would be best for them.

Required

Write a report for these two individuals outlining the types of situations in which the corporate form of legal structure would be the best choice.

COMMUNICATION CASE 2

Use the information in Communication Case 1.

Required

Write a report for these two individuals outlining the types of situations in which the partnership form of legal structure would be the best choice.

EXCEL CASE

The Ace and Deuce partnership has been created to operate a law firm. The partners are attempting to devise a fair system to allocate profits and losses. Ace plans to work more billable hours each year than Deuce. However, Deuce has more experience and can charge a higher hourly rate. Ace expects to invest more money in the business than Deuce.

Required

Build a spreadsheet that can be used to allocate profits and losses to these two partners each year. The spreadsheet should be constructed so that the following variables can be entered:

Net income for the year.
Number of billable hours for each partner.
Hourly rate for each partner.
Capital investment by each partner.
Interest rate on capital investment.
Profit and loss ratio.

Use this spreadsheet to determine the allocation if partnership net income for the current year is $200,000, the number of billable hours is 2,000 for Ace and 1,500 for Deuce, the hourly rate for Ace is $20 and for Deuce is $30, and investment by Ace is $80,000 and by Deuce is $50,000. Interest on capital will be accrued each year at 10 percent of the beginning balance. Any remaining income amount will be split 50–50.

Use the spreadsheet a second time but make these changes: Deuce reports 1,700 billable hours, Ace invests $100,000, and interest will be recognized at a 12 percent annual rate. How do these three changes impact the allocation of the $200,000?