Partnerships

Dr. V. David Raja
Assistant Professor in commerce,
St. Xavier’s College (Autonomous),
Palayamkottai.

Characteristics of a Partnership

- It is an association of two or more persons who co-own a business for a profit.
- A partnership combines:
  - capital
  - talent
  - experience

Characteristics of a Partnership

- written agreement
- limited life
- mutual agency
- unlimited liability
- co-ownership of property
- non-taxpaying entity
- partnership accounting

Types of Partnerships

- There are two basic types of partnerships.

1. General partnerships
2. Limited partnerships

- S corporations are taxed in the same way that a partnership is taxed.

Objective 2

Account for the Partners' Investments in a Partnership.

The Partnership Start-up Example

- David Cohen and Krysta Lugo formed a partnership on June 1, 20xx, to sell advanced technological devices.
- David's contributions are cash of $300,000 and equipment costing $40,000 which has a book value of $27,000 and a current market value of $30,000.
- What is the journal entry?

Journal Entry 1

June 1, 20xx		
Cash	300,000	
Equipment	30,000	
David, Capital		330,000
To record David's investment in the partnership		

Example Continues...

- Krysta's contributions are cash of $10,000 and a building costing $290,000 which has a book value of $245,000 and a current market value of $400,000.
- What is the journal entry?

Journal Entry 2

June 1, 20xx		
Cash	10,000	
Building	400,000	
Krysta, Capital		410,000
To record Krysta's investment in the partnersh		

The Partnership Start-up

David and Krysta
Balance Sheet
June 1, 20xx

Assets		*Capital*	
Cash	$310,000	Krysta, Capital	$410,000
Building	400,000	David, Capital	330,000
Equipment	30,000	Total capital	
Total assets	$740,000	balances	$740,000

Objective 3

Allocate Profits and Losses to the Partners

Fraction Allocation Example

- David and Krysta agreed to split profits and losses as follows:
- 60% to David and 40% to Krysta
- How do we allocate $180,000 net income for the year?
- $180,000 × 60% = $108,000 to David
- $180,000 × 40% = $ 72,000 to Krysta

Fraction Allocation Example

- Assume that they incurred a $40,000 loss for the year (60% David, 40% Krysta).

December 31, 20xx		
David, Capital	24,000	
Krysta, Capital	16,000	
Income Summary		40,000
To allocate net loss to partners		

Capital Contributions Example

Krysta, Capital	$410,000
David, Capital	330,000
Total	$740,000

The partnership earned a profit of $120,000 for the year.

Capital Contributions Example

Krysta: $410,000 ÷ $740,000 × $120,000 = $66,486 (Krysta’s share)

David: $330,000 ÷ $740,000 × $120,000 = $53,514 (David’s share)

Capital and Service Example

- Net income is $120,000.
- The first $40,000 is allocated based on capital contribution.
- The next $60,000 is allocated $40,000 to David and $20,000 to Krysta based on service.
- Any remaining amount is to be allocated equally.

Capital and Service Example

	David	Krysta	Total
Total net income:			$120,000
First ***$40,000*** allocation:			
330 ÷ 740 × $40,000	$17,838		
410 ÷ 740 × $40,000		$22,162	40,000
Net income remaining			80,000
Next ***$60,000*** allocation:	40,000	20,000	60,000
Net income remaining			20,000
Next ***$20,000*** allocation:	10,000	10,000	20,000
Net income remaining			-0-
Total income allocated	$67,838	$52,162	$120,000

Salaries and Interest Example

- Net income is $194,00.
- Salaries are paid in the amount of $40,000 to David and $30,000 to Krysta.
- Interest of 10% is paid on the beginning capital balances.
- Any remainder is split evenly.

Salaries and Interest Example

	David	Krysta	Total
Total net income:			$194,000
First ***$70,000*** salaries:	$40,000	$30,000	70,000
Net income remaining			124,000
Net interest allocation:			
$330,000 × 10%	33,000		
$410,000 × 10%		41,000	74,000
Net income remaining			50,000
Next ***$50,000*** allocation:	25,000	25,000	50,000
Net income remaining			-0-
Total income allocated	$98,000	$96,000	$194,000

Salaries and Interest Example

- Assume that the business earned $140,000.
- How is this amount allocated based on the previous allocation formula?

Salaries	$ 70,000
Interest	74,000
Total	$144,000

$140,000 – $144,000 = ($4,000)

Salaries and Interest Example

	David	Krysta	Total
Total net income:			$140,000
First ***$70,000*** salaries:	$40,000	$30,000	70,000
Net income remaining			70,000
Net interest allocation:			
$330,000 × 10%	33,000		
$410,000 × 10%		41,000	74,000
Net income remaining			(4,000)
Next (***$4,000)*** allocation:	(2,000)	(2,000)	(4,000)
Net income remaining			-0-
Total income allocated	$71,000	$69,000	$194,000

Partner Drawings

- Cash withdrawals by partners represent a reduction of capital much as a dividend is a distribution of corporate equity.
- Debit Drawing and credit Cash.
- At period end, drawing accounts are closed to partners' capital accounts.
- Credit Drawing and debit each partner's Capital.

Objective 4

Account for the Admission of a New Partner

Purchase a Partner’s Interest

- Debit old partner’s Capital and credit new partner’s Capital.
- The price paid by the new partner to the old partner is not reflected on the partnership books.

Invest in the Partnership

- A new partner contributes assets to the partnership in exchange for a share of the business.
- The new partner's investment does not necessarily purchase an equivalent profit-sharing interest.
- To gain admission, a new partner may be willing to pay a bonus to existing partners.

Invest in the Partnership Example

- Krysta Lugo and David Cohen admit Cesar Jones as a partner for a capital contribution of $445,000.
- Jones will receive 1/3 interest in the partnership and will share profits and losses equally.
- David's capital was $330,000 and Krysta's was $410,000.

Invest in the Partnership Example

Partners' capital before admitting new partner	$ 740,000
Cesar's investment	445,000
Capital after admitting Cesar	$1,185,000

Cesar's capital (1/3 × $1,185,000) = $ 395,000

Bonus $445,000 – $ 395,000 = $50,000

Invest in the Partnership Example

Cash	445,000	
Cesar, Capital		395,000
David, Capital		25,000
Krysta, Capital		25,000
To admit Cesar as a partner with 1/3 interest		

Assume that Cesar was admitted
to a 1/3 interest for $100,000.

Bonus to New Partners

Partners' capital before admitting new partner	$740,000
Cesar's investment	100,000
Capital after admitting Cesar	$840,000

Cesar's capital (1/3 × $840,000) = $280,000

Bonus to Cesar = $180,000

Objective 5

Account for a Partner's Withdrawal from the Firm

Withdrawal of a Partner

Balance Sheet
June 30, 20xx

Cash	$ 39,000	***Total liabilities***	$ 98,000
Inventory	54,000	Parker, capital	50,000
Land	45,000	Lopez, capital	30,000
Building (net)	60,000	Isaac, capital	20,000
Total assets	$198,000	***Total***	$198,000

Withdrawal of a Partner

- Suppose that Mark Isaac is retiring in midyear from the partnership of Lopez, Parker, and Isaac.
- An independent appraiser revalues the inventory at $48,000 (down from $54,000), and the land at $81,000 (up from $45,000).

Withdrawal of a Partner

- The partnership agreement has allocated one-fourth of the profits to T. Lopez, one-half to K. Parker, and one-fourth to Mark Isaac.
- How do we record the revaluation of the inventory and the land?

Withdrawal of a Partner

June 30		
Lopez, Capital	1,500	
Parker, Capital	3,000	
Isaac, Capital	1,500	
Inventory		6,000

To revalue the inventory and allocate the loss to the partners

Withdrawal of a Partner

June 30		
Land	36,000	
Lopez, Capital		9,000
Parker, Capital		18,000
Isaac, Capital		9,000

To revalue the land and allocate the gain to the partners

Withdrawal of a Partner

Balance Sheet (after reevaluation)
June 30, 20xx

Cash	$ 39,000	***Total liabilities***	$ 98,000
Inventory	48,000	Parker, capital	65,000
Land	81,000	Lopez, capital	37,500
Building (net)	60,000	Isaac, capital	27,500
Total assets	$228,000	***Total***	$228,000

Withdrawal of a Partner

Withdrawal at book value

June 30		
Isaac, Capital	27,500	
Cash		27,500

To record withdrawal of M. Isaac from the business

Withdrawal of a Partner

- Assume that Isaac is eager to leave the business and agrees to receive $18,500 for his equity.
- The remaining partners share the $9,000 difference which is a bonus to them.
- Lopez and Parker agree that Parker will earn two-thirds of partnership profits and losses and Lopez one-third.

Withdrawal of a Partner

Isaac, Capital	27,500	
Cash		18,500
Lopez, Capital		3,000
Parker, Capital		6,000

To record withdrawal of M. Isaac from the business

Withdrawal of a Partner

- Death of a partner also dissolves the partnership.
- Debit the partner’s Capital account and credit the payable to the estate.
- The excess or deficiency paid to the withdrawing partner is allocated to the remaining partners in accordance with their profit sharing ratio.

Objective 6

Account for the Liquidation of a Partnership

Liquidation

Balance Sheet (after adjusting and closing)

Cash	$ 10,000	***Total liabilities***	$ 30,000
		Jane, capital	40,000
Land	60,000	Elaine, capital	20,000
Building (net)	30,000	Mark, capital	10,000
Total assets	$100,000	***Total***	$100,000

Liquidation

- Assume that Jane, Elaine, and Mark have shared profits and losses in the ratio of 3:1:1 (3/5, 1/5, 1/5).
- Assume that all of the noncash assets are sold for $150,000 for a gain of $60,000.
- How do we allocate this gain to the partners?

Liquidation

- $60,000 × 3/5 = $36,000 to Jane
- $60,000 × 1/5 = $12,000 to Elaine
- $60,000 × 1/5 = $12,000 to Mark
- After paying the $30,000 liabilities, how much cash is left?
- $10,000 + $150,000 – $30,000 = $130,000

Liquidation

To Jane: $40,000 + $36,000 = $76,000

To Elaine: $20,000 + $12,000 = $32,000

To Mark: $10,000 + $12,000 = $22,000

Objective 7

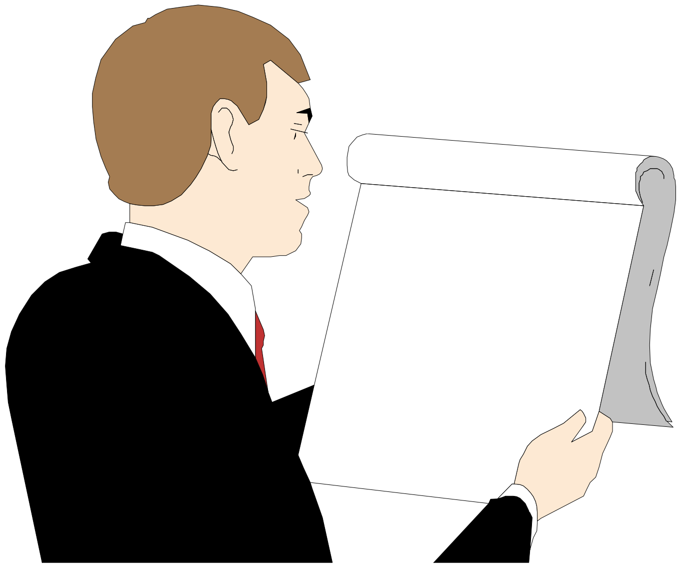
Prepare Partnership Financial Statements

Financial Statements

- Partnership financial statements are much like those of a proprietorship.
- The income statement includes a section showing the division of net income to the partners.
- The balance sheet shows the capital of each partner under owner's equity.

Statement of Owner’s Equity

- The statement of owner’s equity shows additional investments by partner.
- It also shows drawings by partner.



REVISION QUESTIONS

Q1: Which of the following is not a characteristic of the partnership form of business organization?

A. Limited Life
B. Mutual agency
C. Limited liability
D. Limited life

Q1 Answer: C

Each partner has unlimited personal liability for the debts of the business.

Q2: Any asset—cash, inventory, computers, and so on—that a partner invests in the partnership

A. Remains the legal property of that partner.
B. Becomes the joint property of all the partners.
C. Determines that partner's share of net income for the year.
D. Reverts back to that partner if the partnership liquidates.

Q2 Answer: B

The partner who invested the asset is no longer its sold owner.

Q3: In a partnership, mutual agency means

A. There must be at lease one general partner, who takes primary responsibility in each partnership.
B. Any partner can bind the business to a contract for personal matters.
C. Any partner can bind the business to a contract within the scope of its operations.
D. The partners share income and losses equally.

Q3 Answer: C

Q4: Conwell Company is a partnership. When it is terminated, creditor claims exceed partnership assets by $20,000. Partner A has personal assets of $800,000, Partner B has no personal assets. Partner A's partnership interest is 75% and Partner B's is 25%. How much of the $20,000 can creditors collect from Partner A?

Q4 Answer: $**20,000**

Q5: James and Carol agree to form a partnership. James invests cash of $4,000 and equipment from his former business. The equipment cost James $60,000 and has been depreciated $20,000. The current market value of the equipment is $50,000. How much is James' initial capital balance?

Q5 Answer:

$54,000 (cash plus current market value of the equipment)

Q6: James' and Carol's partnership agreement stipulates that James will receive a salary allowance of $30,000 and Carol, a salary allowance of $50,000. All other profits and losses will be shared equally. Net income for the year is $100,000. By how much will James' capital increase as a result of operations?

Q6 Answer: $40,000

Income distributable			$100,000
James Carol Salary	$30,000	$50,000	
			(80,000)
Remaining			$20,000
Distribute equally	10,000	10,000	
			(20,000)
	$40,000	$60,000	0

Q7: James started the year with a capital balance of $10,000. During the year, his share of partnership net income was $8,000 and he withdrew $5,000 for personal use. He made an additional investment of cash of $3,000 during the year. What amount is reported on the year-end balance sheet for James, Capital?

Q7 Answer:

Beginning balance	$10,000
Add: Share of net income	8,000
Additional investments	3,000
Deduct withdrawals	(5,000)
	$16,000

Q8: James and Carol have partnership capital balances of $20,000 and $15,000, respectively. James sells his partnership interest to Emma for $40,000. Carol agrees to accept Emma as a new partner. The entry to record this transaction is

A. Debit Cash $40,000; credit James, Capital $20,000 and Emma, Capital for $20,000
B. Debit James, Capital $20,000 and Carol, Capital $20,000; credit Emma, Capital $40,000
C. Debit Cash for $40,000; credit Emma, Capital $40,000
D. Debit James, Capital $40,000, credit Emma, Capital $40,000

Q8 Answer: D

Q9: James and Carol have partnership capital balances of $20,000 and $15,000, respectively. They share profits and losses equally. Emma is admitted as a new partner by investing $10,000 for a one-third ownership interest. How much is Emma’s beginning capital balance?

Q9 Answer: $15,000

Partnership capital before Emma is admitted	$35,000
Emma’s investment	10,000
Partnership capital after Emma is admitted	$45,000

Emma’s capital ($45,000 x 1/3) $15,000

Q10: James and Carol have partnership capital balances of $20,000 and $15,000, respectively. They share profits and losses equally. Emma is admitted as a new partner by investing $10,000 for a one-third ownership interest. How much is James' capital balance after Emma is admitted?

Q10 Answer: $20,000 – 2,500 = $17,500

Partnership capital before Emma is admitted	$35,000
Emma’s investment	10,000
Partnership capital after Emma is admitted	$45,000
Emma’s capital ($45,000 x 1/3)	$15,000
Bonus to new partner	$5,000

James’ capital decreases by half of the bonus to Emma.

Q11: A partnership is liquidating. Identify the proper sequencing of the steps in the liquidation process.

a. Sell non cash assets.
b. Pay all partnership liabilities.
c. Pay remaining cash to the partners based on their capital balances.
d. Allocate gain or loss from sale of assets to the partners’ capital accounts based on the profit-and-loss ratio.

1. a, b, c d
2. a, d, b, c
3. b, a, c, d
4. b, a, d, c

Answer: 2