

CHAPTER 12

Partnerships

Chapter Overview

This chapter introduces the student to partnership accounting. The characteristics of the partnership—the partnership agreement, its limited life, mutual agency, unlimited liability, co-ownership of property, no partnership income taxes, and partners' equity accounts are explained. Partnership financial statements are illustrated. General partnerships, limited partnerships, and limited liability partnerships are defined. The chapter then describes how to account for the organization of a partnership and how to divide partnership profits and losses. The partnership agreement should specify the method to be used; however, the text describes four methods that could be used. These methods are: sharing based on a stated fraction, sharing based on capital investments, sharing based on capital investments and service, and sharing based on "salaries" and interest. Partners' withdrawals are discussed and illustrated.

The next section covers admission of a new partner to the partnership and the withdrawal of a partner from the business. The text illustrates how the new partner can buy an existing partner's interest or invest additional capital in the partnership. In the latter case, the new partner may either receive a bonus from the existing partners or have to pay a bonus to the existing partners. The chapter then discusses withdrawal of a partner at the book value of the partner's capital balance, at less than the book value of the partner's capital balance, and at more than the book value of the partner's capital balance. The effect of the death of a partner upon the business is discussed. Liquidation of a partnership is then explained. The text provides a three-step process for liquidating a partnership. Illustrations show assets sold at a gain and at a loss. A discussion on the impact of IFRS concludes the chapter.

DID YOU GET IT? questions appear at the end of each Learning Objective for students to test their understanding of the Learning Objective just completed. The answers appear on MyAccountingLab.

DECISION GUIDELINES provide answers to basic partnership questions. A summary problem reviews the admission of a new partner and the partnership balance sheet.

Students should be directed to www.myaccountinglab.com for extra practice. Also included on MyAccountingLab are Excel templates for Exercise 12-6, Problem 12-3A and Problem 12-3B.

Learning Objectives

After studying Chapter 12, your students should be able to:

1. Identify the characteristics of a partnership
2. Account for partners' initial investments in a partnership
3. Allocate profits and losses to the partners by different methods
4. Account for the admission of a new partner
5. Account for the withdrawal of a partner
6. Account for the liquidation of a partnership
7. Identify the impact on partnerships of international financial reporting standards (IFRS)

Must cover

- Characteristics of a partnership
- Partnership financial statements
- Forming a partnership
- Sharing partnership profits and losses
- Partner withdrawals of cash and other assets
- Admission of a partner
- Withdrawal of a partner from the business
- Liquidation of a partnership

Recommended

- Types of partnerships
- Death of a partner
- Impact of IFRS

Chapter Outline

Learning Objective 1: Identify the characteristics of a partnership

- A. A **partnership** is an association of two or more partners who co-own a business usually with the intent to earn a profit. Exhibit 12-1 lists the ten largest accounting partnerships in Canada.
- B. The following are **characteristics** of a partnership:
1. The **partnership agreement** may be written or oral. A written agreement is preferable, because it clarifies issues such as how profits and losses are to be shared.
 2. A **partnership's life is limited** to the time the partners continue to own the business.
 - a. **Dissolution** ends the partnership, although the business may continue under either the same name or a different one.
 - b. **Admission** or **withdrawal** of a partner dissolves the old partnership and creates a new one.
 3. **Mutual agency** means that every partner may bind the partnership to contracts within the scope of regular business operations.
 4. All partners have **unlimited personal liability** for partnership debts unless the partnership is a limited partnership. A **limited partnership** has one or more general partners who assume the general liability and the other partners are limited partners who only have limited liability.
 5. All **property** contributed to, or purchased by, the partnership, is **co-owned** by all the partners.
 6. The partnership itself **does not pay income tax**. Instead, each partner reports his share of the profit or loss on his **personal tax return**.
 7. **Accounting** for a partnership is similar to accounting for a proprietorship. Each partner has an individual capital account and withdrawal account.
- C. The **financial statements** of a partnership are similar to those of a proprietorship. Exhibit 12-2 illustrates the financial statements of a partnership and a proprietorship.
1. The **income statement** may report the allocation of net income or net loss to the partners.
 2. The **statement of owners' equity** must report each partner's investments, withdrawals, and share of net income or net loss.
 3. The partners' capital accounts may be listed separately on the **balance sheet**.

Teaching Tip

Explain that the only difference between the financial statements of a partnership and proprietorship is that the partnership statements include details of each partners' share of income, and additions and withdrawals of equity.

Exhibit 12-3 lists the **advantages** and **disadvantages** of the partnership.

Teaching Tip

Emphasize the fact that even though the partners have a written partnership agreement, stating how profits and losses are to be shared, in a loss situation where Partner A does not have sufficient resources to cover his or her share, Partner B may, because of unlimited liability, be responsible for both A's and B's share of the loss.

D. There are two basic **types of partnerships**.

1. The **general partnership**—each partner is an owner and has unlimited liability. Each partner's share of partnership income is taxed to the individual partner.
2. The **limited partnership** has at least one general partner who has unlimited liability and limited partners who have limited liability. Many partnerships, such as accounting firms, organize as **limited liability partnerships (LLP)** where every partner has limited liability for negligence damages that result from another partner's actions, but liability for the partner's own negligence is still unlimited. The LLP must maintain sufficient liability insurance to protect the public.

Learning Objective 2: Account for partners' initial investments in a partnership

- A. The **initial investments** made by the partners are recorded in the same way a proprietor's investments to the proprietorship are recorded. Exhibit 12-4 illustrates the partnership balance sheet.
- B. Partners may invest assets *and* liabilities into the partnership.
 1. **Assets** are recorded at current market value.
 2. Any **liabilities** transferred to the partnership must be recorded.
 3. The difference between the market value of the assets and any liabilities contributed to the partnership equals the credit to the partner's individual **capital account**.

Teaching Tip

Students sometimes have difficulty understanding why property, plant, and equipment assets are recorded at market values, ignoring accumulated amortization amount. Emphasis should be placed on the fact that the partnership will need to determine useful life, residual value, and method of amortization; therefore, the accumulated amortization account will report a zero balance immediately after forming the partnership.

Learning Objective 3: Allocate profits and losses to the partners by different methods

- A. By law, the partners must share profits and losses equally unless there is some statement otherwise in the partnership agreement. Each partner's share of the profits (losses) is added to (deducted from) his or her capital account.
- B. Ways of **sharing profits and losses** include:
 1. Share profits and losses based on a **stated fraction** for each partner.

2. Share profits and losses based on each partner's **capital investment**. A percentage of total capital invested is calculated for each partner, and that percentage is applied to net income (loss) to determine the partner's share.
3. Share profits and losses based on each partner's **capital investment and service** to the partnership.
 - a. Profits are first allocated based on the partner's capital investments in the business,
 - b. Then profits is allocated based on the amount of service each partner provides the partnership.
 - b. The remainder of the profits (losses) is divided equally or on agreed formula.
4. Share profits and losses based on a "**salary**" to each partner **plus interest** on each partner's capital investment.
 - a. Profits are first allocated based on the amount of service, which is rewarded by paying a "salary" to the partner(s). This "salary" is a predetermined sum to be withdrawn, not a salary in the normal sense of the word.
 - b. Next, interest on capital balances is distributed to partners.
 - c. Any remaining net income is divided on agreed formula.

Salary and interest allocated to partners are *not* expenses but merely ways to divide partnership profits and losses.

Teaching Tip

The above allocation includes salary, interest on capital investments, and remaining net loss allocation based on an agreed-upon formula. Walk through the calculations, as this is one of the more challenging concepts. Stress the fact that no cash is paid to the partners when profits (losses) are allocated. It is a part of the year-end closing entries that closes Income Summary to separate partner's Capital accounts.

- C. **Withdrawals (drawings)** are recorded in the withdrawal account of the partner who made the withdrawal.
1. Withdrawals are accumulated until the partners' individual Withdrawal accounts are closed into their individual Capital accounts (at the end of the period during the closing process).
 2. **Partners are taxed** on their share of net income (determined by one of the methods described above), not on the amount *withdrawn* from the partnership.
 3. A partner's withdrawals are *not* expenses.

Teaching Tip

You should explain that an allocation schedule is necessary when any of the above income-sharing arrangements is present. Also discuss the relationship, or rather lack thereof, between income allocation and the amount reported in the partners' Withdrawal account for the period. For example, Partner A withdrew \$25,000 cash from the partnership during the year. According to the allocation schedule, Partner A's share of net income was \$20,000. Which amount will Partner A report as income from the partnership? \$20,000.

Learning Objective 4: Account for the admission of a new partner

A. When one partner leaves or a new partner is admitted to a partnership, the old partnership dissolves.

B. A **new partner** may be admitted to the partnership in several different ways.

1. The new partner may **purchase an old partner's interest** directly from the old partner.

- a. On the partnership books, the old partner's capital account is closed and the new partner's capital account is created. **The equity is merely transferred from one partner to the other.**

Old Partner, Capital	XX
New Partner, Capital	XX

- b. Cash is exchanged between the old partner and the new partner. The cash does *not* flow through the partnership.

Teaching Tip

You should explain to students that since no cash was received by the partnership, the value of the transaction for the partnership is simply the balance of the retiring partner's capital account. The old partner's capital account is debited for its balance and the new partner's account is credited for the same amount. The amount of cash exchanged is irrelevant.

2. The new partner may **purchase a partnership interest by investing directly** in the partnership.

- a. If the **old partners receive a bonus** (the new partner contributes cash or other assets *greater* than the new partner's equity), the bonus increases the old partners' capital accounts based on their profit-and-loss-sharing ratio.

Cash	XX
New Partner, Capital	XX
Old Partner, Capital	XX
Old Partner, Capital	XX

- b. If the **new partner receives a bonus** (the new partner contributes cash or other assets with a fair value *less* than the new partner's equity), the bonus decreases the old partners' capital accounts based on their original profit-and-loss-sharing ratio.

Cash	XX
Old Partner, Capital	XX
Old Partner, Capital	XX
New Partner, Capital	XX

Learning Objective 5: Account for the withdrawal of a partner

- A. **Withdrawal** from the partnership causes the old partnership to dissolve.
- B. A **partial-year** net income or loss is allocated to each partner if the withdrawal is between financial statement dates. Assets are **revalued**, and any gain or loss is allocated among the partners.
- C. Different methods of withdrawal are:
 - 1. One partner may sell **his interest** to an existing partner or to a new partner.

Teaching Tip

Emphasize that the partnership ceases to exist at this point. Once the transaction to withdraw the partner has been recorded and posted, business activity from that point forward is recognized as a separate entity.

- a. On the books, an entry is made to transfer equity from the withdrawing partner to the purchaser.
- b. No cash flows through the partnership; the transaction occurs solely between the withdrawing partner and the purchaser.
- c. Accounting for the sale of one partner's interest to an existing partner or to a new partner is the same as the accounting for a new partner's admission throughout the purchase of a partner's interest.

Old Partner, Capital	XX
New Partner, Capital	XX

- 2. A partner may **withdraw** from the partnership and take assets with value **equal to his capital account** (equal to book value).
 - a. Assets may have to be revalued in order for the partners to share changes in market values.
 - b. The withdrawing partner receives the value of the updated (current) capital balances.
 - c. The old partnership is dissolved and a new one is created.
- 3. A partner may **withdraw** from the partnership and take assets with a value **less than his capital balance** (less than book value).
 - a. The remaining partners share the difference (**a gain**) based on their profit-and-loss sharing ratio.

Withdrawing Partner, Capital	XX
Cash	XX
Remaining Partners, Capital	XX

- b. The old partnership is dissolved and a new one is created.
- 4. A partner may **withdraw** from the partnership and take assets **greater in value than his capital balance** (greater than book value).
 - a. The bonus to the withdrawing partner reduces the remaining partners' capital balances.

Withdrawing Partner, Capital	XX
Remaining Partners, Capital	XX
Cash	XX

- b. The decrease in the remaining partners' accounts is based on their profit-and-loss-sharing ratio.
- c. The old partnership is dissolved and a new partnership is created.

D. Death of a partner also dissolves a partnership.

- 1. Settlement with the deceased partner's estate is based on the partnership agreement. The deceased partner's capital account is closed with a debit.
- 2. A remaining partner may buy the deceased partner's equity.

Learning Objective 6: Account for the liquidation of a partnership

A. Liquidation of a partnership is a three-step process: selling the partnership assets, paying the liabilities, and distributing the remaining cash (if any) to the partners.

- 1. The first step in liquidating a partnership after the books are adjusted and closed is to **sell the assets and allocate gains and losses** to the partners based on their profit-and-loss-sharing ratio. Exhibit 12-5 illustrates the liquidation of a partnership when the assets are sold at a gain.
- 2. The second step in liquidating a partnership is to **pay all the liabilities**. All liabilities must be paid before the partners can receive any cash.
- 3. The final step in liquidation is to **distribute the remaining cash**. The distribution is *not* done based on the profit-and-loss ratio but rather **based on the partners' capital balances**.

Teaching Tip

Explain that business liquidation is the process of going out of business by selling the entity assets and paying its liabilities. The final step in liquidation is the distribution of the remaining cash to the owners. Review the steps of liquidation. You should do Exercise 12-13 with students as it illustrates the journal entries involved.

B. A deficiency may arise in a partner's capital account if the allocation of a loss creates a **debit** balance in a partner's capital account.

- 1. One way of dealing with capital deficiency is for the partner(s) with the deficiency to contribute additional cash or assets to erase his capital deficiency.
- 2. If the deficient partner(s) cannot contribute assets to erase the deficiency, remaining partners must absorb the deficit and share losses based on the partners' profit-and-loss-sharing ratio.

Learning Objective 7: Identify the impact on partnerships of international financial reporting standards (IFRS)

IFRS do not include specific guidance on how to account for partnerships like those shown in this chapter under Canadian GAAP for private enterprises. However, IFRS require that partnerships disclose information equivalent to that provided by limited companies; limited companies are covered in Chapters 13 and 14.

DECISION GUIDELINES answer basic questions about partnerships.

Answer Key to Chapter 12 Quiz

1. B 2. C 3. D 4. B 5. C 6. C 7. B 8. D 9. D 10. A

Assignment Grid (2nd column: * = Excel Template available; W = writing required)

Assignment		Topic(s)	Learning Objective(s)	Time in Minutes	Level of Difficulty
Starter 12-1		A partner's investment in a partnership	2	5	Easy
Starter 12-2		Partners' profits, losses, and capital balances	3	5-10	Easy
Starter 12-3		Dividing partnership profits based on capital contributions and service	3	10	Easy
Starter 12-4		Admitting a partner who purchases an existing partner's interest	4	5-10	Easy
Starter 12-5		Admitting a partner who invests in the business	4	5-10	Easy
Starter 12-6		Admitting a new partner, bonus to the old partners	4	10	Medium
Starter 12-7	W	Withdrawal of a partner	5	5-10	Medium
Starter 12-8		Withdrawal of a partner; asset revaluation	5	10-15	Medium
Starter 12-9		Liquidation of a partnership at a loss	6	10	Medium
Starter 12-10		Liquidation of a partnership	6	10	Medium
Starter 12-11		Partnership income statement	2,3	5-10	Medium
E12-1	W	Partnership characteristics	1	5-10	Easy
E12-2	W	Organizing a business as a partnership	1	10-15	Easy
E12-3		A partner's investment in a partnership	2	5	Easy
E12-4		Investments by partners	2	10	Easy
E12-5		Recording a partner's investment	2	10-15	Easy
E12-6	*	Computing partners' shares of net income and net loss	3	15-20	Medium
E12-7		Computing partners' capital balances	3	5-10	Easy
E12-8		Admitting a new partner	4	10-15	Easy
E12-9		Recording the admission of a new partner	4	10-15	Easy
E12-10		Withdrawal of a partner from a business	5	5-10	Easy
E12-11		Withdrawal of a partner	5	10-15	Medium
E12-12		Liquidation of a partnership	6	5-10	Medium
E12-13		Liquidation of a partnership	6	15-20	Medium
E12-14		Liquidation of a partnership	6	15-20	Difficult
E12-15		Preparing a partnership balance sheet—Serial Exercise	2	15-20	Difficult
E12-16		Preparing a partnership balance sheet— Challenge Exercise	2	15-20	Difficult
BN12-1	W	Partnership issues	1,5	20-30	Medium
Ethical Issue	W				
P12-1A		Investments by partners	2	15-20	Medium
P12-2A		Admitting a new partner	4	20-25	Medium
P12-3A	*	Computing partners' shares of net income and net loss	3	25-30	Difficult
P12-4A		Recording changes in partnership capital	4,5	20-25	Medium
P12-5A		Liquidation of a partnership	6	35-45	Difficult
P12-6A		Liquidation of a partnership (deficits)	6		Difficult
P12-7A		Capital amounts for the balance sheet of a partnership	2,3	25-35	Medium
P12-8A		Accounting for partners' investments; allocating profits and losses; accounting for the admission of a new partner; accounting for the withdrawal of a partner; preparing a partnership balance sheet	2,3,4,5	40-60	Difficult

<i>Assignment</i>		<i>Topic(s)</i>	<i>Learning Objective(s)</i>	<i>Time in Minutes</i>	<i>Level of Difficulty</i>
P12-9A		Accounting for partners' investments; allocating profits and losses; accounting for the admission of a new partner; accounting for the liquidation of a partnership	2,3,4,5,6	40-60	Difficult
P12-1B		Investments by partners	2	15-20	Medium
P12-2B		Admitting a new partner	4	20-25	Medium
P12-3B	*	Computing partners' shares of net income and net loss	2,3	25-30	Difficult
P12-4B		Recording changes in partnership capital	4,5	20-25	Medium
P12-5B		Liquidation of a partnership	6	35-45	Difficult
P12-6B		Liquidation of a partnership (deficit)	6	35-45	Difficult
P12-7B		Capital amounts for the balance sheet of a partnership	2,3	25-35	Medium
P12-8B		Accounting for partners' investments; allocating profits and losses; accounting for the admission of a new partner; accounting for the withdrawal of a partner; preparing a partnership balance sheet	2,3,4,5	40-60	Difficult
P12-9B		Accounting for partners' investments; allocating profits and losses; accounting for the admission of a new partner; accounting for the liquidation of a partnership	2,3,4,5,6	40-60	Difficult
CP12-1C	W	Deciding on a capital structure	1,2	15-20	Medium
CP12-2C		The effects of accounting decisions on profits	3	20-30	Difficult
Decision Problem	W	Settling disagreements among partners	3	10-15	Difficult
Financial Statement Problem		Analyzing partnership financial data	2	30-40	Medium

Name _____ Date _____ Section _____

CHAPTER 12

TEN-MINUTE QUIZ

Circle the letter of the best response.

1. Which of the following is *not* a characteristic of a partnership?
 - A. Mutual agency
 - B. Limited liability
 - C. Co-ownership of property
 - D. A partnership agreement

2. A partner contributed land to a partnership that was originally purchased for \$50,000 but has a current market value of \$90,000. The entry to record the investment is:
 - A. Debit Land, \$50,000; Credit Capital, \$50,000
 - B. Debit Land, \$50,000 and Gain on Land, \$40,000; Credit Capital, \$90,000
 - C. Debit Land, \$90,000; Credit Capital, \$90,000
 - D. Debit Land, \$90,000; Credit Capital, \$50,000 and Gain on Land, \$40,000

3. If the partners have not drawn up a partnership agreement, then the profits and losses must be divided among the partners
 - A. according to their original capital investments.
 - B. according to the balance in their capital accounts.
 - C. to minimize taxes.
 - D. equally.

4. Adam, Ben, and Carla form a partnership and agree to share their profits based on “salaries” plus 10% interest on their capital investments with any remainder divided equally. At the beginning of the year, their capital investments are \$100,000, \$50,000, and \$150,000, respectively. Adam has agreed to manage the partnership in return for a \$40,000 “salary.” If the partnership earns \$100,000 in its first year, how much profit will be allocated to Adam?
 - A. \$70,000
 - B. \$60,000
 - C. \$50,000
 - D. \$40,000

5. Frank Law and Gary Order invest \$80,000 and \$40,000, respectively, to form the Law and Order Partnership. The partners share profits and losses in a 3:1 ratio. During the year, Law withdraws \$70,000 and Order withdraws \$30,000. If the partnership earns \$80,000 during the year, what are the balances of Law’s and Order’s capital accounts?

	<u>Law</u>	<u>Order</u>
A.	\$60,000	\$20,000
B.	\$65,000	\$35,000
C.	\$70,000	\$30,000
D.	\$140,000	\$60,000

6. Which one of the following situations will involve an increase in the original partners' capital accounts?
 - A. Admission of a new partner to the partnership at a price less than book value.
 - B. Admission of a partner at book value.
 - C. Sale of assets at a gain during the liquidation process.
 - D. Withdrawal of a partner at more than book value.

7. Chris Ham invests \$120,000 in a partnership for a 1/4 interest. Prior to Ham's admission, the partnership had two partners with capital balances of \$120,000 each. Ham's capital balance in the partnership will be:
 - A. \$60,000
 - B. \$90,000
 - C. \$100,000
 - D. \$120,000

8. Liquidation of a partnership includes all of the following *except*:
 - A. Selling the partnership assets.
 - B. Allocating any gain or loss from the sale of assets to each partner.
 - C. Paying all partnership liabilities.
 - D. Distributing the remaining cash in the partners' profit-and-loss-sharing ratio.

9. Partners Thelma Lou and Aunt Bee each have a \$50,000 capital balance and share profits and losses in a 2:1 ratio, respectively. The cash balance is \$40,000, non-cash assets total \$210,000, and liabilities total \$150,000. If the non-cash assets are sold for \$180,000, what amount will Thelma Lou receive after liquidation?
 - A. \$70,000
 - B. \$50,000
 - C. \$40,000
 - D. \$30,000

10. Which of the following statements about partnership financial statements is false?
 - A. The salary that a partner receives for profit sharing is reported on the partnership income statement.
 - B. A partnership's balance sheet will contain a capital account for each partner.
 - C. The financial statements of a partnership are similar to those of a proprietorship.
 - D. The partnership balance sheet will contain a withdrawal account for each partner.