CHAPTER 15
Accounting for Partnerships

CHAPTER OUTLINE

LEARNING OBJECTIVES

After studying this chapter, you should be able to do the following:

- Describe the advantages and disadvantages of the partnership form of organization.
- Explain where the major differences lie in the accounting for corporations and partnerships.
- Apply the three accounting methods available to record the admission of a new partner, and evaluate the strengths and weaknesses of each method.
- Apply the accounting methods for the recording of the retirement of a partner.
- Prepare the journal entries to record the liquidation of a partnership when a cash payment to partners is made only after the sale of all of the partnership assets.
- Prepare a schedule of the liquidation of a partnership where instalment payments to partners are made as cash becomes available.
- Prepare a cash distribution plan prior to the commencement of the partnership liquidation.

This chapter will examine the accounting practices involved in the partnership form of business organization. The major differences between corporations and partnerships appear in the equity section of the balance sheet. The accounting principles involved have been in use for many years; they are a prime example of principles that are not the subject of professional pronouncements, but rather are generally accepted by virtue of their use by similar organizations over time. Before discussing the accounting for partnerships, we will briefly describe this form of organization and some of its advantages and disadvantages.

All of the common law provinces in Canada have partnership acts that, while not identical in all respects, contain very similar provisions in most of the major areas that are of concern to us. Our future references to "the acts" will refer to these similar provisions mentioned. The acts define a partnership as the relationship that exists between persons carrying on a business to make a profit; the term "persons" can refer to individuals, other partnerships, and corporations. Normally the formation of a partnership does not require government approval — indeed, it does not even require a written agreement among the partners, although a carefully formulated contract is highly desirable. Some other important characteristics of partnerships are briefly discussed next.

Limited Life A partnership legally ceases to exist upon the withdrawal or death of an existing partner, the admission of a new partner, or the voluntary dissolution of the entity.

Mutual Agency Each partner co-owns the assets and liabilities of the partnership. Each partner may act as an agent for the partnership and legally enter into contracts on its behalf.

Unlimited Liability In case of insolvency, each partner is individually responsible for the liabilities of the partnership, regardless of the amount of equity that the partner has in the partnership. This feature is one of the major differences between partnerships and the corporate form of organization, where shareholders are not personally liable for the company's debts. This major disadvantage of unlimited liability can be circumvented by the formation of a limited partnership, but the acts that allow this type of partnership require that at least one partner be a general partner and that the partnership name not contain any of the names of the limited partners.

Income Tax Aspects Partnerships are not taxed as separate entities; rather, each partner is taxed on his or her share of the yearly net income whether it has been distributed or not. This may be viewed as a major disadvantage, and one that could be avoided by using the corporate form of organization.

Partnership Accounting

In our discussion of partnership accounting we will examine partners' accounts in the accounting records, the distribution of periodic net income, the admission of new and the retirement of existing partners, and the liquidation of the partnership.

Partners' Accounts

Traditionally, partnership accounting records contain three accounts for each partner. A *capital account* records the partner's equity investment at any point in time. It is credited initially with the fair market value of the assets contributed by the partner at the time of formation of the partnership; subsequent changes reflect the partner's share of net income earned, additional assets invested, and assets withdrawn. A *partner's loan account* would be used to record amounts borrowed from or loaned to the partner.[1] Finally, a *drawings account* is used to record cash withdrawals in anticipation of yearly profits. This account is similar to the dividend account used by corporations and is closed to the partners' capital accounts at the end of the accounting period.

The distribution of net income to the partners' equity accounts is made in accordance with the partnership agreement. An important component of any distribution plan is the profit and loss sharing ratio. If the partnership agreement does not contain such a ratio, the acts state that the ratio is one that will provide an equal distribution to each partner.[2]

Illustration On January 1, Year 1, the ABC partnership is formed. A and B contribute cash of $30,000 and $20,000 respectively, while C contributes assets with the following fair values:

Inventory	$ 5,000
Land	22,000
Buildings	23,000
	$50,000

The partners agree on a profit and loss sharing ratio of 3:2:5. During the first year, net income is $70,000 and the partners' drawings are A — $12,000, B — $15,000, and C — $30,000. All of the above transactions are recorded by the following journal entries:

Cash	30,000	
A capital		30,000
Cash	20,000	
B capital		20,000
Inventory	5,000	
Land	22,000	
Buildings	23,000	
C capital		50,000

These three entries, which record the initial investment made by each partner, are prepared as at January 1. During the year, the cash withdrawals made by each partner are debited to the drawings accounts. The following summarizes the entries made to the three drawing accounts during the year:

---

[1] Loan accounts are not equity accounts and would therefore appear on the balance sheet of the partnership as either receivable from or payable to the partner.

[2] This equal distribution would only be forced on the partners if they disagreed and referred the matter to the courts.

A drawing	12,000	
B drawing	15,000	
C drawing	30,000	
Cash		57,000

At the end of Year 1, the revenues and expenses are closed to an income summary account. The income summary account is then closed and the net income allocated in accordance with the profit and loss sharing ratio by the following entry:

Income summary	70,000	
A capital (30% × 70,000)		21,000
B capital (20% × 70,000)		14,000
C capital (50% × 70,000)		35,000

Finally, the drawing accounts are closed as follows:

A capital	12,000	
B capital	15,000	
C capital	30,000	
A drawing		12,000
B drawing		15,000
C drawing		30,000

The Year 1 financial statements consist of a balance sheet, an income statement, and a statement of partner's capital, which could be prepared as follows:

ABC PARTNERSHIP
STATEMENT OF PARTNERS' CAPITALS
for the Year Ended December 31, Year 1

	A capital	*B capital*	*C capital*	*Total capital*
Initial investment	$30,000	$20,000	$50,000	$100,000
Add net income	21,000	14,000	35,000	70,000
	51,000	34,000	85,000	170,000
Deduct drawings	12,000	15,000	30,000	57,000
Balance, Dec. 31, Year 1	$39,000	$19,000	$55,000	$113,000

Note that while the capital balances ratio was equal to the profit and loss ratio on the date of formation, these ratios are not equal at the end of Year 1, because both A and C withdrew amounts that were less than their share of the year's net income, while B withdrew $1,000 more than her share of net income. It is not usual for capital balances to stay in the same relative ratio that they were in on the date of formation, because profit and loss ratios are often used to reflect a combination of time spent and capital contributed, and unless the partnership agreement states otherwise, an individual partner's drawings do not have to equal his or her share of net income in a particular year.

If partners wish to vary the net income distribution method to better reflect time spent and capital invested, they can do so by allowing salaries to partners and interest on capital balances. The next variation of this example illustrates this.

Variation In the last illustration, A, B, and C shared profits and losses in the ratio of 3:2:5. Let us now assume that the partnership agreement provides for 10 percent interest on opening capital balances, and for salary allowances of $25,000 to A and $20,000 each to B and C, with any balance to be distributed in the ratio of 3:2:5.

Because the amount for interest and salaries is determined by the owners themselves — perhaps without reference to market conditions — partnership accounting does not normally show interest and salaries among expenses. Instead, these components appear as an allocation of the yearly net income at the bottom of the income statement, as follows:

ABC PARTNERSHIP
INCOME STATEMENT
for the Year Ended December 31, Year 1

Revenues	$ XXX
Expenses	XXX
Net income	$70,000

Allocated as follows:

	A	*B*	*C*	*Total*
Salaries	$25,000	$20,000	$20,000	$65,000
Interest on capital	3,000	2,000	5,000	10,000
Residual income in profit and loss ratio	(1,500)	(1,000)	(2,500)	(5,000)
	$26,500	$21,000	$22,500	$70,000

It should be noted that the allocations are made regardless of the size of net income. In our example, we started with a net income of $70,000 and allocated $75,000 as salaries and interest. This left a "loss" of $5,000 to be allocated in the profit and loss ratio.

In this example the interest was based on the opening capital. Interest could also be based on the weighted average capital for the period, or on the ending capital. The partnership agreement should clearly specify how interest is to be calculated.

Ownership Changes

In this section we look at the accounting involved when ownership in the partnership changes either because of the admission of a new partner or because of the retirement of an existing partner. In both situations the business usually carries on, but legally the old partnership is dissolved and a new partnership is formed. This factor could provide justification for a revaluation of net assets, even though the business itself is undisturbed. Some accountants feel that a revaluation should take place because legally a new entity exists. Other accountants feel that since accounting principles do not allow the revaluation of the net assets of a corporation

[3] An exception would be the situation where there has been such a change in control that push-down accounting would be permitted.

every time the composition of the shareholders changes,[3] the accounting for a partnership should be the same. The professional accounting organizations have not seen fit to pronounce on this matter, so either alternative is an acceptable accounting practice.

Admission of a New Partner

The admission of a new partner requires the unanimous consent of the existing partners. A new partner could be admitted through the acquisition of a portion of the interests of the existing partners, or through the investment of additional net assets into the partnership.

Example We will use the following example to illustrate the accounting that could be used when a new partner is admitted. Jill Rain and Cathy Sleet are partners in the Badweather Company and share profits and losses in the ratio of 7:3. They have agreed to admit Jan Snow as a partner in the company as at January 1, Year 6; after that date a new profit and loss sharing ratio will be established. A summarized balance sheet of the company as at December 31, Year 5, is shown below:

BADWEATHER COMPANY
BALANCE SHEET
December 31, Year 5

Assets (misc.)	$100,000	Liabilities		$ 20,000
		Rain capital	50,000	
		Sleet capital	30,000	80,000
	$100,000			$100,000

Details of the assets and liabilities have been omitted in order to focus attention on the broad accounting concepts involved.

Acquisition of Interest Assume that Snow will acquire one-half of Sleet's capital by making a cash payment of $18,000 to Sleet. There are two methods that could be used to record this event.

Method A The simplest method available to record the admission of the new partner is to transfer one-half of Sleet's existing capital balance to Snow as follows:

Sleet capital	15,000	
Snow capital		15,000

Most accountants would probably give their approval to this method because it is similar to the accounting used for corporations when the composition of the owners changes in a transaction that doesn't involve the company. The company's balance sheet after the admission of Snow is shown below:

BADWEATHER COMPANY
BALANCE SHEET
January 1, Year 6

Assets (misc.)	$100,000	Liabilities		$ 20,000
		Rain capital	50,000	
		Sleet capital	15,000	
		Snow capital	15,000	80,000
	$100,000			$100,000

Method B As an alternative, the net assets of the company could be revalued on the basis of the $18,000 paid for one-half of Sleet's capital. It can be implied that Sleet's capital should be $36,000, and therefore should be increased by $6,000. Because Sleet is entitled to 30 percent of all net asset changes, total assets should increase by $20,000 (6,000 ÷ 30 percent) as part of the recording of the $6,000 increase to Sleet's capital. Therefore, it can be implied from the $18,000 price paid by Snow that the net assets of the company are undervalued by $20,000. If specific assets cannot be identified as undervalued, the usual procedure is to record goodwill on the books of the company before recording the transfer of capital. The journal entries are as follows:

Goodwill	20,000	
Rain Capital (70% × 20,000)		14,000
Sleet capital (30% × 20,000)		6,000
Sleet capital	18,000	
Snow capital		18,000

The company's balance sheet after Snow's admission is shown below:

BADWEATHER COMPANY
BALANCE SHEET
January 1, Year 6

Assets (misc.)	$100,000	Liabilities		$ 20,000
Goodwill	20,000	Rain capital	64,000	
		Sleet capital	18,000	
		Snow capital	18,000	100,000
	$120,000			$120,000

Admission by Investing Assets The next series of examples will be based on the assumption that Snow will invest cash into the partnership for 20 percent of capital. We will look at three situations that vary the amount of cash that Snow invests for this 20 percent interest. The objective from an accounting point of view is to record the admission in a manner that (a) is sensible and (b) satisfies the required capital positions of the existing partners and the new partner.[4] We can arrive at solutions that satisfy the required capital positions by initiating the following type of analysis:

[4] For example, if Snow is to have 20 percent of capital, the combined capital balances of Rain and Sleet must equal 80 percent of capital.

Existing capital (1)	+	New investment (2)	=	Potential capital (3)

A solution can always be reached by using the amounts from columns 2 and 3. In some situations, a third solution can be reached from the amount in column 1.

Situation 1 Assume that Snow will invest $15,000 for 20 percent of capital. Using the prescribed analysis, we determine the following amounts:

Existing capital (1)	+	New investment (2)	=	Potential capital (3)
$80,000		$15,000		$95,000

The bonus method. The bonus method is popular with accountants because net assets are not revalued, so a transfer of capital balances between partners is all that is involved. With the bonus method, column 3 is used. Total capital in this case is $95,000; thus, Snow's capital $19,000 (20% × 95,000). To arrive at this capital balance, there must be a transfer of a $4,000 from the capitals of Rain and Sleet to Snow. This transfer is made by using the profit and loss ratio that existed before the new partner was admitted.

The journal entry for the admittance of Snow on January 1, Year 6, is as follows:

Cash	15,000	
Rain capital (70% × 4,000)	2,800	
Sleet capital (30% × 4,000)	1,200	
Snow capital		19,000

The balance sheet of the partnership after the admittance of Snow is as follows:

BADWEATHER COMPANY
BALANCE SHEET
January 1, Year 6

Cash	$ 15,000	Liabilities		$ 20,000
Assets (misc.)	100,000	Rain capital	47,200	
		Sleet capital	28,800	
		Snow capital	19,000	95,000
	$115,000			$115,000

Asset revaluation methods. Column 2 will always produce an amount that can be used to revalue the net assets of the existing partnership. In this situation, $15,000 (the cash invested by Snow) represents 20 percent of total capital. Therefore, total capital is $75,000 (15,000 ÷ 20%), and the capital balances of Rain and Sleet total $60,000 (80% × 75,000). The net assets (i.e., capital balances) of the existing partnership are $80,000; this analysis implies that the assets are overvalued by $20,000. The journal entries to record the revaluation of the net assets of the existing partnership and the admittance of Snow are:

Rain capital (70% × 20,000)	14,000	
Sleet capital (30% × 20,000)	6,000	
Various assets		20,000
Cash	15,000	
Snow capital		15,000

In this case, some identifiable net assets were written down. The same result could have been achieved by increasing certain liabilities by $20,000. However, as mentioned previously, the entry should make sense, and if the partners feel that the net assets of the existing partnership are properly valued at $80,000, this method should not be used. The balance sheet after the assets of the existing partnership have been revalued and Snow has been admitted is as follows:

BADWEATHER COMPANY
BALANCE SHEET
January 1, Year 6

Cash	$ 15,000	Liabilities		$ 20,000
Assets (misc.)	80,000	Rain capital	36,000	
		Sleet capital	24,000	
		Snow capital	15,000	75,000
	$ 95,000			$ 95,000

In certain situations a second asset revaluation method can evolve from the use of the amount from column 1. This situation is an example of one that will work. We use the net assets being invested by the existing partners ($80,000) to revalue the assets invested by the new partner. The $80,000 represents 80 percent of total capital. Therefore, total capital is $100,000 (80,000 ÷ 80%) and Snow's capital is $20,000 (20% × 100,000). Since Snow is investing $15,000 in assets, there is an implication that Snow is bringing in goodwill of $5,000. The journal entry is as follows:

Cash	15,000	
Goodwill	5,000	
Snow capital		20,000

The balance sheet after the new partner is admitted is as follows:

BADWEATHER COMPANY
BALANCE SHEET
January 1, Year 6

Cash	$ 15,000	Liabilities		$ 20,000
Assets (misc.)	100,000	Rain capital	50,000	
Goodwill	5,000	Sleet capital	30,000	
		Snow capital	20,000	100,000
	$120,000			$120,000

Situation 2 In this case we will assume that Snow invests $22,000 for 20 percent of capital. Using the suggested analysis as a starting point:

Existing capital (1)	+	New investment (2)	=	Potential capital (3)
$80,000		$22,000		$102,000

The bonus method. Using column 3, total capital is $102,000, and Snow's capital balance is $20,400 (20% × 102,000). There is a capital bonus of $1,600 from Snow to Rain and Sleet. This is credited to their capital accounts in accordance with their profit and loss sharing ratio in the following entry:

Cash	22,000	
Rain capital (70% × 1,600)		1,120
Sleet capital (30% × 1,600)		480
Snow capital		20,400

Asset revaluation methods. We can always arrive at a feasible solution by using column 2. Here, $22,000 represents 20 percent of total capital, which amounts to $110,000 (22,000 ÷ 20 percent). The implication is that the net assets of the existing partnership are undervalued by $8,000 (110,000 less 102,000). If specific assets or liabilities cannot be identified for revaluation, goodwill is recognized in the existing partnership as follows:

Goodwill	8,000	
Rain capital (70% × 8,000)		5,600
Sleet capital (30% × 8,000)		2,400

The entry to record the admission of Snow with an investment of $22,000 for 20 percent of capital is as follows:

Cash	22,000	
Snow capital		22,000

In this particular situation, a solution cannot be obtained by using column 1. If the capital of the existing partnership ($80,000) represents 80 percent of total capital, the total capital must be $100,000 (80,000 ÷ 80 percent). But Snow is investing $22,000, so the total capital has to be at least $102,000 (80,000 + 22,000). Therefore, a feasible solution cannot be arrived at by using column 1.

The balance sheets after the admission of Snow have not been presented in this situation, but readers should verify that after each journal entry presented, Snow's capital balance is 20 percent of total capital, and the capital balances of Rain and Sleet are 80 percent of total capital.

Situation 3 In this last situation we assume that Snow invests $20,000 for 20 percent of capital. There is only one way to record this:

Cash	20,000	
Snow capital		20,000

The amount invested represents the new partner's share of the total assets of the partnership after her investment; therefore, the bonus and asset revaluation method cannot be applied.

The previous examples have illustrated the admission of Snow into the Badweather partnership. Prior to the admission of Snow, Rain and Sleet shared profits and losses in the ration 7:3. Now the three partners must agree on a new ratio. If Sleet and Rain wish to maintain the same relative ratio with each other, and if Snow is to have 25 percent of profits and losses, the new ratio should be as follows:

Rain (70% × 75%)	52.5%
Sleet (30% × 75%)	22.5
Snow	25.0

But as mentioned earlier, the partners should choose a method that recognizes effort and capital contributed. This may best be represented by a scheme that grants salary allowances and interest on capital balances, with any remainder allocated in some profit and loss sharing ratio.

Retirement of a Partner

The retirement of a partner can also be recorded by bonus and asset revaluation methods when the amount of assets withdrawn by the retiring partner differs from this partner's capital balance.

Example Let us return to the Badweather Company and assume that on December 31, Year 10, Rain retires. With the agreement of the other partners, she is to be paid $80,000 in cash from the partnership.

The balance sheet of the partnership just prior to Rain's retirement is shown below. We assume that the partners share profits and losses in the ratio 4:3:3.

BADWEATHER COMPANY
BALANCE SHEET
December 29, Year 10

Assets (misc.)	$220,000	Liabilities		$ 90,000
		Rain capital	62,000	
		Sleet capital	35,000	
		Snow capital	33,000	130,000
	$220,000			$220,000

The bonus method. Rain is to be paid an amount that is $18,000 greater than Rain's present capital balance. A solution to this is to transfer $18,000 in capital to Rain from Sleet and Snow in proportion to their profit and loss sharing ratio, one to the other. Then Rain's capital balance will equal the cash that she is withdrawing. The journal entries are as follows:

Sleet capital (50% × 18,000)	9,000	
Snow capital (50% × 18,000)	9,000	
Rain capital		18,000
Rain capital	80,000	
Cash		80,000

Asset revaluation. Another acceptable accounting method is to revalue the net assets by such an amount that Rain's capital ends up with a balance of $80,000. If Rain's capital must increase by $18,000, and Rain is entitled to 40 percent of any asset increases, the total undervaluation of the company's assets is implied to be $45,000 (18,000 ÷ 40 percent). The journal entries to record the asset revaluation and the payment to Rain are as follows:

Goodwill	45,000	
Rain capital (40% × 45,000)		18,000
Sleet capital (30% × 45,000)		13,500
Snow capital (30% × 45,000)		13,500
Rain capital	80,000	
Cash		80,000

In this example, goodwill was created under the assumption that no other assets can be identified as undervalued. The balance sheet after the retirement of Rain is shown below:

BADWEATHER COMPANY
BALANCE SHEET
December 29, Year 10

Assets (misc.)	$140,000	Liabilities		$ 90,000
Goodwill	45,000	Sleet capital	48,500	
		Snow capital	46,500	95,000
	$185,000			$185,000

Partnership Liquidation

We will now examine the accounting involved when the partners have decided to wind up their business by selling the partnership assets. If the proceeds from the sale of assets are insufficient to discharge the liabilities, we have an insolvency situation similar to the one that was discussed in Chapter 11. In this chapter the examples used will assume that there is sufficient cash to pay all creditors; we are basically concerned with determining the amount to pay each partner. In a straightforward liquidation, the assets are sold and any gains or losses are distributed to the partners in their profit and loss sharing ratio.[5] After the liabilities have been paid in full, any remaining cash balance is equal to the credit balances in the partners' capital accounts. The cash is then distributed in accordance with these balances. The following example will illustrate this.

Example Partners W, X, Y, and Z have conducted business together for a number of years; they divide all profits and losses in the ratio 5:2:2:1. On October 31, Year 15, they decide to wind up the partnership by collecting their receivables and selling all

[5] The partnership agreement could specify that a special liquidation profit and loss sharing ratio will be used instead of the normal ratio. Our examples will assume that the profit and loss sharing ratio used for operating profits is also used to allocate losses or gains from liquidation.

of the remaining assets of the business. A summarized balance sheet of the partnership on this date is shown below:

WXYZ COMPANY
BALANCE SHEET
October 31, Year 15

Cash	$ 5,000	Liabilities		$10,000
Misc. assets	60,000	Partner's equity:		
		W capital	16,000	
		X capital	18,500	
		Y capital	13,000	
		Z capital	7,500	55,000
	$65,000			$65,000

During the month of November the miscellaneous assets realize $48,000 in cash, the resulting $12,000 loss is allocated to the partners, the liabilities are paid in full, and the remaining $43,000 in cash is distributed to the partners.

All of the events that occur during the liquidation of a partnership can be summarized in a liquidation schedule. The liquidation schedule for WXYZ Company is shown in Exhibit 15.1.

It should be clear from examining this schedule that after all noncash assets are sold, and after any losses or gains are distributed to the partners, and after all liabilities have been paid in full, the cash on hand is equal to the total of the partners' capital accounts. Cash is distributed to the partners in accordance with the credit balances in their capital accounts and not in accordance with their profit and loss sharing ratios.

Exhibit 15.1

WXYZ COMPANY
SCHEDULE OF PARTNERSHIP LIQUIDATION
Month of November, Year 15

	Cash	*Assets*	*Liab.*	*W*	*X*	*Y*	*Z*
Balance before liquidation	5,000	60,000	10,000	16,000	18,500	13,000	7,500
Sale of assets and distribution of loss	48,000	60,000*	—	6,000*	2,400*	2,400*	1,200*
Pay liabilities	10,000*	—	10,000*	—	—	—	—
Balances	43,000	–0–	–0–	10,000	16,100	10,600	6,300
Final payment to partners	43,000*	—	—	10,000*	16,100*	10,600*	6,300*
Balances	–0–	–0–	–0–	–0–	–0–	–0–	–0–

** Deduct.*

The journal entries to record the November events are reproduced below:

Cash	48,000	
W capital (50% × 12,000)	6,000	
X capital (20% × 12,000)	2,400	
Y capital (20% × 12,000)	2,400	
Z capital (10% × 12,000)	1,200	
Miscellaneous assets		60,000
Sale of assets and distribution of $12,000 loss to partners		
Liabilities	10,000	
Cash		10,000
Payment made to creditors		
W capital	10,000	
X capital	16,100	
Y capital	10,600	
Z capital	6,300	
Cash		43,000
Cash distribution to partners		

This example has illustrated the basic concepts behind the liquidation of a partnership. With these concepts established, we now turn our attention to certain situations where this relatively simple process becomes more complicated. Partners' capital accounts with debit balances, partners with loan accounts, and cash instalment payments made to partners during the liquidation period can all complicate the process.

Debit Balances in Capital Accounts

If a partner's capital account is not large enough to absorb his or her share of the loss from the sale of assets, the account ends up with a debit balance. The partner involved has an obligation to pay an amount of cash into the partnership equal to the amount of the debit balance because he or she has not maintained a capital balance sufficiently large to absorb losses in accordance with the partnership agreement. If this cash is not paid into the partnership, the remaining partners with credit balances in capital will have to absorb this debit balance in their relative profit and loss sharing ratios. For example, consider the following trial balance of a partnership after all assets have been sold and all liabilities have been paid. (The bracketed percentages indicate the profit and loss ratio.)

	Debit	*Credit*
Cash	$10,000	—
L capital (50%)	6,000	—
M capital (30%)	—	9,000
O capital (20%)	—	7,000
	$16,000	$16,000

Partner L has refused to invest enough cash into the business to bring his capital balance to zero. Partners M and O will have to absorb the debit balance of L in the ratio of 6:4, after which they can individually take legal action against L for

recovery of their share of the loss. The journal entry to allocate L's debit balance is as follows:

M capital (60% × 6,000)	3,600	
O Capital (40% × 6,000)	2,400	
L capital		6,000

The journal entry to record the distribution of the cash to the partners would be:

M capital	5,400	
O capital	4,600	
Cash		10,000

Partners' Loan Account

The partnership acts list the order of cash payment in a liquidation as (1) partnership creditors, (2) partners' loans, and (3) partners' capitals. In other words, after the outside creditors have received full payment, partners' loans must be paid in full before any cash can be distributed to partners on behalf of their capital. This concept has to be modified in situations where a particular partner's capital account has a debit balance, and the partnership also has a liability to this partner. Obviously, it does not make sense to pay out cash to discharge the liability to a partner and to then request an investment by the partner to cover the debit balance. Instead, the legal doctrine of the *right of offset* applies so that a loan account is combined with a debit balance in a capital account. If the result is a credit balance in capital, this amount is paid to the partner. If the result is a smaller debit balance in capital, this amount is allocated to the remaining partners (assuming that no further investment is made by the partner with the deficiency in capital). In preparing a schedule of liquidation, this right of offset should be assumed and the amount shown in each partner's column should be a combination of that partner's capital and loan accounts. When the schedule indicates a payment to a partner, the payment reduces the loan account first; any payment in excess of the amount of the loan reduces the capital account.

In the examples that follow, we will assume that partners with debit balances in capital will not make any additional investment, and that as a result the debit balance will have to be allocated to partners with credit balances in capital.

Example The following balance sheet of the EFGH partnership was prepared as at March 31, Year 6.

EFGH COMPANY
BALANCE SHEET
March 31, Year 6

Cash	$ 6,500	Liabilities		$13,000
Misc. assets	68,000	E loan		20,000
Goodwill	10,000	Partner's equity		
		E capital	800	
		F capital	24,050	
		G capital	16,900	
		H capital	9,750	51,500
	$84,500			$84,500

The four partners, who share profits and losses in the ratio of 5:2:2:1, have decided to wind up their business and sell the assets on a piecemeal basis. The goodwill is considered to be worthless. During April, Year 6, the sale of all of the miscellaneous assets yielded cash of $31,000, and the amount owing to outside creditors was paid in full. After expenses incurred in the liquidation process of $4,200 were paid, the remaining cash of $20,300 was distributed to the partners. The schedule of liquidation prepared at the end of the month is shown in Exhibit 15.2.

The following points about this schedule bear mentioning:

- The amount for partner E is made up of the summation of E's capital ($800) and loan ($20,000) accounts.
- The expenses were allocated to the partners in their profit and loss ratio.
- Journal entries must be made for each event depicted on the schedule.
- Even though partner E had a loan account of $20,000, no cash was distributed to this partner, because this partner's share of the losses and expenses was greater than the combined loan and capital accounts.

Instalment Liquidation

In the previous example, the partnership was completely liquidated and all cash distributed within one month of the decision to wind up the business. In most cases it probably takes much longer to sell all of the assets, and in such situations the partners may request that payments be made to them as the cash becomes available.

Exhibit 15.2

SCHEDULE OF PARTNERSHIP LIQUIDATION
Month of April, Year 6

	Cash	*Assets*	*Liab.*	*E*	*F*	*G*	*H*
Balance before liquidation	6,500	78,000	13,000	20,800	24,050	16,900	9,750
Balance before liquidation	6,500	78,000	13,000	20,800	24,050	16,900	9,750
Sale of assets and distribution of loss	31,000	78,000*		23,500*	9,400*	9,400*	4,700*
Payment of liabilities	13,000*		13,000*				
Payment of expenses	4,200*			2,100*	840*	840*	420*
	20,300	–0–	–0–	4,800**	13,810	6,660	4,630
Allocate E's debit balance	—			4,800*	1,920*	1,920*	960*
Balances	20,300			–0–	11,890	4,740	3,670
Final payment to partners	20,300*			–0–	11,890*	4,740*	3,670*
Balances	–0–			–0–	–0–	–0–	–0–

** Deduct.*
*** Debit balance in capital account.*

There is no problem with making instalment payments to partners provided that (a) all creditors have been paid in full or enough cash has been set aside to fully cover all liabilities, and (b) the payments to partners are calculated in such a way that no partner will later be asked to return a payment received because, in retrospect, it should not have been made. This latter provision is satisfied by making a *safe payment calculation*. Such a calculation is based on two assumptions: all assets still on hand will bring in zero dollars; and any partner's debit balances will have to be allocated to the remaining partners with credit balances. In addition, it is often prudent to assume that there will probably be some future expenses involved with the liquidation, or that there are unrecorded liabilities, and enough cash should be held back to cover these items. When the safe payment calculation is made, the cash holdback for expenses and unrecorded liabilities should be treated in the same manner as a possible loss on assets and should be allocated to the partners in their profit and loss ratio.

Example Let us now return to the EFGH Company example to illustrate these concepts. The cash sale proceeds and expenses are the same as before, but this time we assume that the assets are sold over a two-month period as follows:

	Cash proceeds	*Book value*	*Loss*
Month of April, Year 6	$16,400	$22,000	$ 5,600
Month of May, Year 6	14,600	56,000	41,400
	$31,000	$78,000	$47,000

At the end of April, outside creditors were paid $4,000, future expenses were estimated as $5,100, and a cash instalment was paid to partners in accordance with a safe payment schedule.

At the end of May, the remaining creditors were paid, the actual liquidation expenses turned out to be $4,200, and the cash on hand was distributed to the partners.

Because the total proceeds from the sale of assets ($31,000) are the same as in the previous example, the total cash distributed to the partners over the two-month period should be identical to the previous single distribution. Exhibit 15.3 shows details of the liquidation events for April and May.

The basic concepts involved with the preparation of this schedule are the same as those used in Exhibit 15.2. The only new procedure is the safe payment calculation made at the end of April, which is shown in Exhibit 15.3A.

The account balances on the first line of this calculation are carried forward from Exhibit 15.3. The possible future losses from asset sales and liquidation expenses are allocated to the partners, and cash equal to the liabilities is held back. This leaves the $4,800 cash on hand equal to total partners' capitals; but E has a debit balance of $12,550 that is allocated to F, G, and H in the ratio of 2:2:1. This allocation results in a debit balance of $1,460 in the capital of partner G, which is allocated to partners F and H in the ratio of 2:1. The cash instalment is paid in accordance with the credit balances remaining in partners' capital accounts.

The journal entries necessary to record the events of April and May are shown on pages 592 and 593. While it should be clear that these entries are depicted in the

schedule of liquidation (Exhibit 15.3), note that no journal entries are involved with the "what if" events depicted in the safe payment calculation (Exhibit 15.3A).

April, Year 6		
Cash	16,400	
E capital	2,800	
F capital	1,120	
G capital	1,120	
H capital	560	
Miscellaneous assets (in detail)		22,000
Sale of assets and distribution of loss to partners		
Liabilities	4,000	
Cash		4,000
Partial payment of liabilities		
F capital	4,717	
H capital	83	
Cash		4,800
Instalment payment to partners		

Exhibit 15.3

EFGH COMPANY
SCHEDULE OF PARTNERSHIP LIQUIDATION
Months of April and May, Year 6

	Cash	*Assets*	*Liab.*	*E*	*F*	*G*	*H*
Balance before liquidation	6,500	78,000	13,000	20,800	24,050	16,900	9,750
April transactions:							
Sale of assets and distribution of loss	16,400	22,000*	—	2,800*	1,120*	1,120*	560*
Payment of liabilities	4,000*	—	4,000*	—	—	—	—
Balances before payment	18,900	56,000	9,000	18,000	22,930	15,780	9,190
Safe payment to partners (see Exhibit 15.3A)	4,800*	—	—	—	4,717*	—	83*
Balances, end of April	14,100	56,000	9,000	18,000	18,213	15,780	9,107
May transactions:							
Sale of assets and distribution of loss	14,600	56,000*	—	20,700*	8,280*	8,280*	4,140*
Payment of liabilities	9,000*	—	9,000*	—	—	—	—
Payment of expenses	4,200*	—	—	2,100*	840*	840*	420*
	15,500	–0–	–0–	4,800**	9,093	6,660	4,547
Allocate E's debit balance	—			4,800*	1,920*	1,920*	960*
Balances	15,500			–0–	7,173	4,740	3,587
Final payment to partners	15,500*			–0–	7,173*	4,740*	3,587*
Balances	–0–			–0–	–0–	–0–	–0–

** Deduct.*

*** Debit balance in capital account.*

Exhibit 15.3A

EFGH COMPANY
SAFE PAYMENT CALCULATION
April 30, Year 6

	Cash	*Assets*	*Liab.*	*E*	*F*	*G*	*H*
Account balances	18,900	56,000	9,000	18,000	22,930	15,780	9,190
Possible future loss	—	56,000*	—	28,000*	11,200*	11,200*	5,600*
Cash holdbacks:							
For future expenses	5,100*	—		2,550*	1,020*	1,020*	510*
For liabilities	9,000	—	9,000*	—	—	—	—
Balances	4,800	–0–	–0–	12,550**	10,710	3,560	3,080
Allocate E's debit balance	—			12,550*	5,020*	5,020*	2,510*
Balances in capital	—			–0–	5,690	1,460**	570
Allocate G's debit balance	—			—	973*	1,460*	487*
Safe payment	4,800			–0–	4,717	–0–	83

** Deduct.*
*** Debit balance in capital account.*

May, Year 6		
Cash	14,600	
E capital	20,700	
F capital	8,280	
G capital	8,280	
H capital	4,140	
Miscellaneous assets		46,000
Goodwill		10,000
Sale of assets, write-off of goodwill, and distribution of resulting loss to partners		
Liabilities	9,000	
Cash		9,000
Payment of balance of liabilities		
E capital	2,100	
F capital	840	
G capital	840	
H capital	420	
Cash		4,200
Allocation and payment of liquidation expenses		
F capital	1,920	
G capital	1,920	
H capital	960	
E capital		4,800
Allocation of partner E's debit balance		
F capital	7,173	
G capital	4,740	
H capital	3,587	
Cash		15,500
Final payment to partners		

Compare the two payments from Exhibit 15.3 with the single payment made in Exhibit 15.2: the total paid to each partner is identical.

Plan of Cash Distribution to Partners

It should be noted from Exhibit 15.3 that one safe-payment calculation was necessary for two instalment payments to partners. If we had made six instalments to partners, we would have had to make five safe-payment calculations. This method of determining amounts to be paid to partners can be quite cumbersome, and fortunately there is an alternative method available under which a complete cash distribution plan can be determined before the liquidation process commences. This plan of cash distribution to partners is described next using the EFGH Company as the example (see page 589). There are two basic steps involved with a cash distribution plan. These steps are shown in Exhibit 15.4.

In step 1, each partner's ability to absorb future losses is evaluated. The capital and loan balances of each partner are combined; this total is then divided by the partner's profit and loss ratio. The result indicates each partner's ability to absorb

Exhibit 15.4

EFGH COMPANY
PLAN OF CASH DISTRIBUTION TO PARTNERS
March 31, Year 6

Step 1

	Partners' capital and loans		*Profit and loss ratio*		*Ability to absorb losses*	*Rank order*
E	20,800	÷	.5	=	41,600	1
F	24,050	÷	.2	=	120,250	4
G	16,900	÷	.2	=	84,500	2
H	9,750	÷	.1	=	97,500	3
	71,500					

Step 2

		Individual Equity Balances			
	Total equity	*E*	*F*	*G*	*H*
Balance before liquidation	71,500	20,800	24,050	16,900	9,750
Loss to eliminate E	41,600	20,800	8,320	8,320	4,160
Balance	29,900	–0–	15,730	8,580	5,590
New ratio			4	4	2
Loss to eliminate G	21,450		8,580	8,580	4,290
Balance	8,450		7,150	–0–	1,300
New ratio			2		1
Loss to eliminate H	3,900		2,600		1,300
Balance	4,550		4,550		–0–

future losses. For example, Partner E could only absorb a loss of $41,600, while partner F could absorb a loss of $120,250. These are relative amounts based on each partner's current balance in equity in conjunction with the partners' profit and loss sharing ratio. Next, each partner is rank ordered as *least able* to absorb losses. A basic assumption involved with these calculations is that any debit balances will have to be allocated to partners with credit balances.

Having determined the rank orderings, we now proceed to step 2. We prepare a column for total equity (capital plus loan balances) and a column for the equity of each partner; we then proceed in the order of the rankings determined from step 1. We deduct the $41,600 loss that would reduce E's equity to zero from total equity and allocate it to the individual partners in their profit and loss ratio. This leaves a balance in equity of $29,600. If there were any losses greater than $41,600, E would have a debit balance that we are assuming would have to be allocated to the remaining partners with credit balances. Because of this, any additional losses will have to be shared by F, G, and H in the ratio 4:4:2. Partner G is next in the rank order, and so we make a calculation that indicates that a further loss of $21,450 (8,580 ÷ .4) would eliminate G's equity balance. This loss is allocated to F, G, and H in their relative profit and loss ratios. With G eliminated, any additional losses will be allocated two-thirds to partner F and one-third to partner H. Partner H is the next to be eliminated if a further loss of $3,900 occurs. After this loss is allocated, the only partner left with equity is F.

After a cash sum has been set aside to discharge all obligations to outside creditors and any estimated future expenses, *payments to partners* can be made as follows:

		E	*F*	*G*	*H*
First	$ 4,550	0	100%	0	0
Next	3,900	0	2	0	1
Next	21,450	0	4	4	2
Above	29,900	5	2	2	1

Remember that the basic idea behind partnership liquidation is to arrive at a situation where cash to be distributed is equal to the credit balances of the partner's equity accounts. The cash distribution plan indicates that after $29,900 has been distributed in accordance with the plan, any further cash is distributed to all of the partners in their profit and loss ratio. In such a situation, the partners' capital balances would be aligned in accordance with their profit and loss ratio.

We can demonstrate that this plan will produce the desired results by returning to our example of EFGH Company. The April and May payments to partners can be determined as shown in the following tables. Note that the amounts are identical to those from Exhibit 15.3.

April						
Opening cash		$ 6,500				
Proceeds from asset sale		16,400				
		22,900				
Liabilities paid		4,000				
		18,900				
Cash held back for:						
Liabilities	9,000					
Expenses	5,100	14,100				
Paid to partners as follows		$ 4,800				
			E	*F*	*G*	*H*
First		$ 4,550	–0–	$4,550	–0–	–0–
Balance into next layer		250	–0–	167	–0–	83
Total paid		$ 4,800	–0–	$4,717	–0–	$83
May						
Opening cash		$14,100				
Proceeds from asset sale		14,600				
		28,700				
Payments:						
Liabilities	9,000					
Expenses	4,200	13,200				
Paid to partners as follows		$15,500				
Balance of second layer		$ 3,650	–0–	$2,433	–0–	$1,217
Balance into next layer		11,850	–0–	4,740	4,740	2,370
Total paid		$15,500	–0–	$7,173	$4,740	$3,587

SUMMARY

In general, the accounting principles used by partnerships are the same as those used for other forms of business organization. However, some differences arise in the accounting for changes in the composition of the ownership of the partnership. The justification given for these differences is that the admission of a new partner or the retirement of an old partner results in the legal termination of the entity. Another difference exists in the presentation of partners' salaries; these are usually considered to be distributions of income rather than determinants of income. Since the *CICA Handbook* has little to say about accounting for unincorporated businesses, the general acceptance of partnership accounting principles comes from their continuous historical use.

When a partnership is liquidated, noncash assets are sold, losses or gains are allocated to partners' equities, liabilities to outside creditors are paid, and any remaining cash is distributed to the partners in accordance with their capital

balances. A further investment in the partnership is required from a partner who has a debit balance in capital. If this investment is not made, the partner's debit balance is allocated to the other partners in accordance with their relative profit and loss ratios. Instalment payments can be made to partners during the liquidation process provided that sufficient care is taken to ensure that no partners are overpaid. There are two methods available for ensuring this. The first involves making a safe payment calculation whenever an instalment payment is to be made. The second method involves calculating payments to partners before the liquidation process commences. If done correctly, these methods will yield identical results.

REVIEW QUESTIONS

1. Is there a federal partnership act that applies to all partnerships in Canada? Explain.
2. What is the purpose of having salary and interest allowances in the profit and loss agreement?
3. Why should the partnership agreement be specific in its description of the calculation of interest on capital balances?
4. Is it possible for a partner to have been allocated a loss from partnership operations in a year when the partnership itself had a net income? Explain.
5. What alternative methods can be used to record the admission of a new partner?
6. Is there any difference between the dissolution of a partnership and the liquidation of a partnership?
7. During the liquidation process, is it possible for partners without loan accounts to receive cash payments before payments are made to partners with loan accounts? Explain.
8. Are safe payment calculations the source of journal entries in the accounting records of the partnership? Explain.
9. What is the right of offset, and how is it used in a partnership liquidation?
10. What basic assumption must be made in order to make an instalment payment to partners during a liquidation?

MULTIPLE CHOICE

Use the following information for questions 1 to 5.

On January 1, Year 2, Jeanette, Barry, and Len decided to form a partnership to produce and market Jeanette's newest invention. The partners agreed to the following terms:

	Contributions	*Salaries*	*Profit sharing ratio*
Jeanette	250,000	35,000	40%
Barry	150,000	25,000	30%
Len	200,000	30,000	30%

Interest was to be accrued at 7% on opening capital balances each year. During the year, each partner drew $20,000 from the firm.

At the end of Year 5, the partnership balances are as follows:

Jeanette	650,000
Barry	450,000
Len	500,000

1. Assume that at the end of the Year 2, the partnership reported net income of $156,000. Which of the following is the amount that would be reported for Jeanette's capital account at December 31, Year 2?
   a. $291,400
   b. $292,100
   c. $292,400
   d. $312,100
2. Assume that at the end of the Year 2, the partnership reported net income of $105,000. Which of the following is the amount that would be reported for Barry's capital account at December 31, Year 2?
   a. $157,400
   b. $161,000
   c. $173,600
   d. $177,400

Each of the next three questions should be considered independently.

3. On January 1, Year 6, Yvonne purchases one-half of Jeanette's interest in the partnership for $400,000. The partners feel that the assets cannot be individually reassessed, but they want to revalue the partnership and record goodwill based on Yvonne's payment. Which of the following would be reported as Len's capital account immediately after the admission of Yvonne into the partnership?
   a. $500,000
   b. $612,500
   c. $625,000
   d. $700,000

4. On January 1, Year 6, Yvonne contributes $400,000 cash to the partnership for a 25% interest. The partners wish to use the bonus method to record Yvonne's interest. What will be the balance in Jeanette's capital account immediately after the admission of Yvonne into the partnership?
   a. $610,000
   b. $617,000
   c. $650,000
   d. $800,000
5. On December 31, Year 5, Len retires. The partners agree that he should be paid $575,000, and the remaining partners wish to use the asset revaluation method and record goodwill upon Len's retirement. What will be the balance in Barry's capital account immediately after the retirement?
   a. $375,000
   b. $450,000
   c. $525,000
   d. $550,000

CASE*

Mike (the plumber) had been hard to find, but when he was finally found and the faucet fixed, he had a story to tell. It seems that he had declared bankruptcy and lost his house in the process.

A year before, Mike had had enthusiastic reports of having entered a partnership with Joe to take on residential and commercial plumbing contracts on a larger scale. The partnership terms were agreed upon, and the business was registered with the Nova Scotia Registrar of Joint Stock Companies. Operations had started small: a few contracts were completed evenings and weekends over the next few months with satisfactory profits, while both Mike and Joe kept their day jobs. Then Joe took ill. Without both partners able to devote sufficient effort to the business, they casually agreed to each take their own tools and go their separate ways. Each would complete any jobs they had entered into as if they were individuals. Mike had thought no more of the relationship and proceeded to take on a few jobs in his own name to supplement his income.

Joe recovered from his illness and returned to work; but then severe illness left him unable to complete new fixed price contracts he had entered into after the oral agreement to end his partnership with Mike. Unable to meet the terms of his contracts, Joe was taken to court and Mike found himself also named on court documents. When a judgment was reached, Joe — divorced, with limited assets, and in poor health — was unable to make good on the losses. Accordingly, Mike was held liable for losses associated with these contracts, as well as court costs. Facing a judgment large enough that his salary would have been garnished by court order for up to ten years, Mike took his lawyer's advice and voluntarily declared bankruptcy.

Required:

In your role as Mike's friend and occasional advisor, explain to Mike "what happened' in terms of how the characteristics of the partnership form of organization may have led to the difficulties he faced.

What advice can you give Mike with respect to future business ventures?

---

* Prepared by Peter Secord, Saint Mary's University.

PROBLEMS

Problem 1

Kantor and Freeman began a partnership by investing $104,000 and $156,000 respectively. During the first year of operation, the partnership earned $90,000.

Required:

Prepare calculations showing how the income should be allocated to the partners under each of the following plans for sharing net incomes and losses:

(a) The partners failed to agree on a method of sharing income.

(b) The partners agreed to share income by allowing Kantor a $40,000 salary and Freeman a $30,000 salary, and by allocating the balance in the ratio 2:3.

(c) Repeat the calculations for (b) under the assumption that instead of the $90,000 income, the partnership experienced a $20,000 loss.

(d) Assume that instead of a partnership, Kantor and Freeman incorporated, with Kantor receiving 104 shares and Freeman 156 shares. Would a division of earnings between Kantor and Freeman be necessary at year end? Explain.

(*CGA adapted*)

Problem 2

The partnership of Dopey, Sneezy, and Grumpy was formed on January 1, Year 1. The original investments were as follows:

Dopey	$ 80,000
Sneezy	120,000
Grumpy	180,000

According to the partnership agreement, net income or loss will be divided among the respective partners as follows:

- Salaries of $12,000 for Dopey, $10,000 for Sneezy, and $8,000 for Grumpy.
- A share of profits equal to interest at 10% to be allowed based on the partners' initial investments.
- Remainder divided in the ratio 5:3:2.

Additional Information

- Net income of the partnership for the year ended December 31, Year 1, was $80,000.
- Dopey invested an additional $20,000 in the partnership on July 1, Year 1.
- Grumpy withdrew $30,000 from the partnership on October 1, Year 1.
- Dopey, Sneezy, and Grumpy made regular drawings against their shares of net income during Year 1 of $10,000 each.

Required:

(a) Prepare a schedule showing the division of net income among the three partners. Show supporting calculations in good form.

(b) Prepare a schedule showing each partner's capital balance at December 31, Year 1. Show supporting calculations in good form.

(*CGA adapted*)

Problem 3

Lucille and Marie have worked together for some years in the garment industry and have decided to establish their own business, in a partnership format, making high-fashion ladies' wear. They have persuaded Marie's brother, Yves, a successful dentist, to provide them with the money they need to start the business. Lucille will contribute $15,000, Marie $20,000, and Yves $200,000. Lucille and Marie will receive annual salaries of $25,000 and $30,000 respectively. There will be 15% interest on the opening balance of the capital accounts. The partners will share all residual profits equally, but Yves has agreed not to interfere in the operations of the business. Lucille and Marie will work full-time; Yves's contribution is only the $200,000 cash.

Ignore any tax aspects of the situation.

Required:

(a) Assume that Yves is your client and that he is not knowledgeable about business and law. Explain to him the situation he is considering entering. Include in your explanation two possible alternative structures or formats of the business.

(b) Assume that the partnership is formed and that at the end of the first year it has a net loss of $45,000 calculated without regard to partners' salaries or interest. The cash withdrawals are as follows: Lucille $15,000, Marie $22,000, Yves $0. Prepare a statement of partners' capital at the end of the year.

(c) Without regard to (b), assume that the capital account of Lucille was in a debit balance at the end of the year. What are the implications of a debit balance in a capital account balance in a partnership?

(*CGA adapted*)

Problem 4

The Alexis, Bridgit, and Carole partnership was formed on January 1, Year 1. Their investments on this date were as follows:

Alexis	$115,000
Bridgit	172,000
Carole	259,000

They agreed that yearly net income is to be divided as follows:

- Salaries:

Alexis	$18,000
Bridgit	14,000
Carole	16,000

- Interest of 12% on opening capital balances each year.
- Remainder in the ratio 2:3:5.

During the year, each partner had drawings of $18,000.

Required:

(a) Prepare a statement of partners' capitals for the year, assuming that the Year 1 net income was $125,300.

(b) Prepare a statement of partners' capitals for the year, assuming that the Year 1 net income was $90,000.

Problem 5 Perry, Thomas, and Johnson are partners in Thomas and Company. Their capital balances and profit and loss sharing ratios on June 30, Year 4, are as follows:

Perry	$216,000	.4
Thomas	300,000	.5
Johnson	159,000	.1

Required:

PART A

On July 1, Carnie invests $127,000 for a one-fifth interest in capital. Prepare journal entries for all of the possible methods available to record the admission of Carnie.

PART B

Assume instead that on July 1, Carnie invests $127,000 for a one-eighth interest in capital. Prepare journal entries for all of the possible methods available to record the admission of Carnie.

Problem 6 Allen, Bruce, and Carl are partners in Allen and Company. Their capital balances and profit and loss ratios are as follows:

Allen	$162,000	.5
Bruce	108,000	.2
Carl	135,000	.3

Required:

PART A

Assume that Allen will retire from the partnership and that he will be paid $195,000. Prepare alternative journal entries to record Allen's retirement.

PART B

Assume that Allen does not retire and that Doris is to be admitted into the partnership on investing cash of $150,000 for 25% of capital. Prepare alternative journal entries to record the investment of Doris.

Problem 7 On March 1, Year 4, the partnership of Smith, Jones, and Fleesum decided to admit a new partner, I. Burnham. The balance sheet at that date was:

Cash	$ 15,000	
Receivables	38,000	
Inventory	52,000	
Fixed assets	120,000	
	$225,000	
Current liabilities	$ 25,000	Profit and loss ratio
Smith, capital	85,000	50%
Jones, capital	65,000	30
Fleesum, capital	50,000	20
	$225,000	

The partnership is considering a number of alternatives for the process of admitting the new partner:

Proposal A: The new partner will contribute to the partnership $45,000 of cash and an asset, which cost Burnham $10,000 but has a current market value of $25,000. Burnham will receive a 25% share of the profits and a 20% share of the capital.

Proposal B: The new partner will pay $20,000 directly to each partner, with nothing paid to the partnership itself. Each partner will transfer 20% of his or her capital to Burnham, who will have a 25% profit share.

Required:

(a) Prepare all feasible journal entries that are available to record Proposal A.
(b) Prepare all feasible journal entries that are available to record Proposal B.

(*CGA adapted*)

Problem 8

Reeves and Sutherland are partners in a successful film-making company. They share profits/losses in a 2:1 ratio. A summarized balance sheet at December 31, Year 6, is shown below:

REEVES AND SUTHERLAND
BALANCE SHEET (SUMMARIZED)
December 31, Year 6

Assets	
Cash	$10,000
Inventory	15,000
Other assets	20,000
	$45,000
Equities	
Reeves, capital	$20,000
Sutherland, capital	25,000
	$45,000

On January 1, Year 7, Reeves and Sutherland decided to admit a new partner, Pinsent, who contributed $44,500 for a one-quarter equity and a one-quarter share of the profits. The new profit/loss ratio is such that the ratio between the old partners was retained in the new ratio. An audit performed before Pinsent was admitted showed that inventory was undervalued by $3,000, and that accounts payable was understated by $4,500. Net income for the year ending December 31, Year 7, was $28,000.

Required:

(a) Assume that the accounts have been closed for Year 6. Prepare a journal entry to correct the inventory and accounts payable. The company uses a periodic system.
(b) Prepare journal entries to record two possible ways to account for the admission of Pinsent.
(c) Prepare a journal entry to distribute the Year 7 profit to the three partners.

(*CGA adapted*)

Problem 9

Lancaster and Reed are partners in a successful sporting goods store. Their profit and loss sharing agreement stipulates that interest of 10% is to be allowed on beginning capital balances, that annual salaries of $40,000 to Lancaster and $29,000 to Reed are to be paid, and that any remaining profit or loss is to be shared 2:1 between Lancaster and Reed.

The January 1, Year 5, condensed balance sheet is shown below:

LANCASTER AND REED
BALANCE SHEET
January 1, Year 5

Assets	
Cash	$ 10,000
Inventory	475,000
Office equipment — net	25,000
Other assets	5,000
	$515,000
Liabilities	
Accounts payable	$211,000
Sales tax payable	9,000
	$220,000
Partners' equity	
Lancaster	$190,000
Reed	105,000
	$295,000
	$515,000

During Year 5, the partnership earned $130,000 before partners' salary and interest, and Lancaster and Reed had drawings of $50,000 and $60,000 respectively.

On January 1, Year 6, the partnership decided to admit Jackson as a partner with a 25% interest in the partnership for a cash contribution of $125,000. The bonus method was used to admit Jackson.

The profit and loss sharing agreement was amended as follows:

- Interest of 12% on beginning capital.
- Annual salaries of $40,000 to Lancaster and $31,200 to Reed.
- Remaining profit or loss to be shared in a 2:1:1 ratio by Lancaster, Reed, and Jackson.

The partnership reported profit before partners' interest and salary of $180,000 in Year 6, and each partner withdrew $50,000.

Required:

Prepare, in good form, a statement of changes in partners' capital accounts from January 1, Year 5, to December 31, Year 6. Show your calculations.

(*CGA adapted*)

Problem 10

PART A

Aken, Prince, and Bird share profits and losses in the ratio of 2:3:5. They have decided to liquidate their partnership. The partnership balance sheet on January 31, Year 8, is as follows:

Assets		*Liabilities and equities*	
Cash	$ 40,000	Liabilities	$ 50,000
Noncash assets	200,000	Bird, loan	20,000
		Aken, capital	45,000
		Prince, capital	75,000
		Bird, capital	50,000
	$240,000		$240,000

Required:

Prepare a cash distribution plan for the APB partnership on January 31, Year 8.

PART B

During the liquidation of the partnership, the following events occur.

- In February Year 8, noncash assets with a book value of $85,000 are sold for $55,000, and $21,000 is paid to outside creditors of the partnership.
- In March Year 8, the remaining noncash assets are sold for $70,000, and the rest of the outside creditors are paid. Liquidation expenses of $3,800 are also paid.
- Cash is distributed to partners at the end of each month.

Required:

Calculate the amount that each partner received in both February and March.

Problem 11

The following are partners' loan and capital balances and profit and loss ratios on the date that liquidation begins:

		P & L ratio
P loan	$ 43,200	
Q loan	72,000	
P capital	144,000	.40
Q capital	154,800	.35
R capital	129,600	.15
S capital	72,000	.10

The liquidation has commenced, and distributions of cash have been made to the partners. Partner S has received a total of $14,600. The liquidator now has $60,000 available for distribution.

Required:

Calculate how the $60,000 should be distributed.

Problem 12

On June 30, Year 1, the partners of Harvey and Company agreed to the liquidation of their partnership. On that date the liability of the partnership to individual partners and the partners' capital balances and profit and loss ratios were as follows:

		P & L
Harvey loan	$21,600	
Ronald loan	36,000	
Harvey capital	72,000	.4
Ronald capital	77,400	.3
Jones capital	64,800	.2
Kirk capital	36,000	.1

Required:

(a) Prepare a calculation as at June 30, Year 1, that will clearly indicate how cash will be distributed to partners as it becomes available for distribution.

(b) In July and August, cash was distributed correctly to partners. This resulted in Kirk receiving payments totalling $7,500. Calculate how much cash has been distributed as at August 31 by the partnership to each of Harvey and Ronald as reductions of their respective loan balances.

Problem 13

The following balance sheet is for the partnership of Allen, Bill, Charles, and Don, who share profits in the ratio of 5:2:2:1.

Assets	
Cash	$ 90,000
Other assets	594,000
	$684,000
Liabilities and capital	
Liabilities	$184,000
Allen capital	300,000
Bill capital	90,000
Charles capital	60,000
Don capital	50,000
	$684,000

Required:

PART A

The partners consider that the book values of the partnership net assets are fairly representative of current market values. They have agreed to admit Earl into the partnership. Earl will invest $115,000 for a 20% interest in capital.

(a) By means of journal entries, indicate the possible ways of recording the admission of Earl to the partnership.

(b) Evaluate each of the journal entries you have prepared.

PART B

The partners decide to liquidate the business rather than admit Earl. Don received a total of $7,250 during the liquidation process, which is now complete. Calculate how much Allan, Bill, and Charles each received.

Problem 14 The following are the partners' capital balances and profit and loss sharing ratios of Adams & Company on November 30, Year 1, and on January 31, Year 9.

	Nov. 30, Year 1		*Jan. 31, Year 9*	
	P&L	*Capital*	*P&L*	*Capital*
Adams	.50	$ 90,000	.40	$120,000
Baur	.30	70,000	.25	80,000
Chernier	.20	25,000	.20	35,000
Decker		—	.15	60,000
		$185,000		$295,000

Required:

PART A

On December 1, Year 1, Decker was admitted as a partner of Adams & Company. Decker invested $40,000 cash into the partnership and received a capital balance of 20% of total capital. Decker's investment was recorded in the partnership records using the bonus method.

(a) Prepare the journal entry that was made to admit Decker on December 1, Year 1.
(b) Prepare two alternative journal entries that could have been used to record Decker's admittance on December 1, Year 1.

PART B

After Decker's admittance in Year 1, the partners agreed upon a new profit and loss sharing ratio. This ratio has remained unchanged since that date. On January 31, Year 9, the partners decided to liquidate the partnership. Adams was given the responsibility of selling the assets, discharging the liabilities, and distributing cash to the partners as it became available.

The first distribution of cash was made in February Year 9, and Baur received $3,000 as her share. In March Year 9 an additional $40,000 was distributed to the partners. How much did each partner receive from the March distribution? Show all calculations.

Problem 15 The following information is available:

MUFFIN AND CO.
BALANCE SHEET
as at July 1, Year 4

Cash	$ 18,000
Receivables	39,000
Inventory	80,000
Fixed assets, net	410,000
	$547,000
Current liabilities	$ 47,000
Note payable to Muffin	40,000
Muffin, capital	110,000
Nemrod, capital	160,000
Olerud, capital	190,000
	$547,000

The partners share the profits, 50%, 30%, 20% to Muffin, Nemrod, Olerud. The partners have decided to wind up their company, and as the accountant you must conduct the liquidation. The cash must be paid out as soon as it is received because of animosity among the partners.

You proceed to liquidate the assets and receive cash in the following manner:

Dates	*Cash received*	*Book value of assets**	
July 15, Year 4	$ 7,000	$ 9,000	Receivables
	31,000	40,000	Inventory
July 25, Year 4	$11,000	$ 15,000	Receivables
	24,000	40,000	Inventory
July 30, Year 4	$ 8,000	$ 15,000	Receivables
	86,000	100,000	Fixed assets

** Sold to generate cash.*

You now have $310,000 of fixed assets remaining, at book value, to dispose of, but you cannot determine what amount of cash these will generate.

Required:

Prepare a schedule of partnership liquidation that clearly shows how the cash would be paid out (i.e., to whom and how much):

(a) on July 15, Year 4.
(b) on July 25, Year 4.
(c) on July 30, Year 4.

(*CGA adapted*)