# Chapter-Four

# Accounting for partnership

# Definition:

# A partnership is a voluntary association of two or more people to pursue a business for a profit as a co-owner. Partnerships are common especially in small retail and service business. Many professional practitioners, including physicians, lawyers, and accountants, also organize their practices as a partnerships.

# Characteristics of partnerships

# Partnerships are an important type of organization because they offer certain advantages with their unique characteristics.

# Characteristics of partnership

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

# Mutual Agency: Each partner is a fully authorized agent of the partnership. As its agent, a partner can commit or bind the partnership to any contract within the scope of the partnership business on its behalf. Thus the acts of each partner bind the partnership and become the responsibility of all partners.

# Co-ownership of partnership property: partnership assets are owned jointly by all partners. Any investment by a partner becomes the joint property of all partners. Partners have a claim on partnership assets based on their capital account and the partnership contract.

# 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. Thus, if a partnership becomes insolvent, the partners must contribute sufficient personal assets to settle the debts of 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.

# Nontaxable entity: a partnership has the same tax status as a sole proprietorship and is not subject to federal income taxes on its income. The individual partners must report their distributive share of partnership income on their personal tax returns.

**Advantages and Disadvantages of Partnerships**

**Advantages:** a partnership is relatively easy and inexpensive to organize, requiring only an agreement between two or more persons. A partnership has the advantage of being able to bring more capital, more managerial skills, and more experiences than would a sole proprietorship. Because the partnership is a nontaxable entity, the combined income taxes paid by the individual partners may be lower than the net income taxes that would be paid by a corporation, which is a taxable entity.

**Disadvantages:** the disadvantages of a partnership are that its life is limited, each partner has unlimited liability and one partner can bind the partnership to contracts. Also, raising large amounts of capital is more difficult for a partnership than for a corporation.

**Accounting for Partnership**

1. **Recording Initial Investments:**

A separate entry is made for the investments of each partner in a partnership. The various assets contributed by a partner are debited to the proper asset accounts. In each entry, the monetary amounts at which the non cash assets are stated are those agreed upon by the partners. In arriving at an appropriate amount for such assets, consideration should be given to their market values at the time the partnership is formed. If liabilities are assumed by the partnership, the appropriate liability accounts are credited. The partner’s capital account is credited for the net amount.

**Illustration:**

A, B, and C formed a partnership; A contributed $50,000 in cash and inventory with a fair market value of $100,000 in the partnership; B contributed equipment with a fair market value of $180,000 and a building with a fair market value of $150,000 in the partnership; C contributed $100,000 in cash and equipment with a fair market value of $90,000 and in addition to this ‘C’ transferred a liability of $30,000 to the partnership. The entry to record the assets contributed and the liabilities transferred by ‘A’, ‘B’, and ‘C’.

Cash--------------------------------------$150,000

Inventory---------------------------------100,000

Equipment--------------------------------270,000

Building-----------------------------------150,000

Accounts Payable---------- 30,000

A, Capital-------------------- 150,000

B, Capital--------------------- 330,000

C, Capital--------------------- 160,000

1. **Division of Net income or Net loss**

As in the case of a sole proprietorship, the net income of a partnership may be said to include a return for the services of the owners, for the capital invested, and for economic or pure profit. It should be noted that division of the net income or net loss among the partners in exact accordance with their partnership agreement is of the utmost importance. If the agreement is silent on the matter, the law provides that all partners share equally, regardless of differences in amounts of capital contributed, of special skills possessed, or of time devoted to the business. The partners may, however, make any agreement they wish in regard to the division of net income and net loss.

* **Income Division Recognizing Services of Partners**

As a means of recognizing differences in ability and amount of time devoted to the business, articles of partnership often provide for the division of a portion of net income to the partners in the form of a salary allowances.

**Illustration:**

Assume that the articles of partnership of Abebe and Emebet provide for monthly salary allowances of Birr 2,500 and Birr 2,000 respectively, with the balances of the net income to be divided equally, and that the net income for the year is Birr 75,000.

Net income----------------------------------------------------------------------------------Birr 75,000

Division of net income: **Abebe** **Emebet** **Total**

Salary allowance-------------------Birr 30,000 Birr 24,000 Birr 54,000

Remaining income---------------- 10,500 10,500 21,000

Net income-------------------------Birr **40,500** Birr **34,500**  Birr **75,000**

The division of net income is recorded as a closing entry, regardless of whether the partners actually withdraw the amounts of their salary allowances. The entry for the division of net income is as follows:

December 31:

Income summary----------------------------75,000

Abebe, Capital-------------------------- 40,500

Emebet, Capital------------------------ 34,500

If Abebe and Emebet had withdrawn their salary allowances monthly, the withdrawals would have accumulated as debits in the drawing accounts during the year. At the end of the year, the debit balances of Birr 30,000 and Birr 24,000 in their drawing accounts would be transferred to their respective capital accounts.

* **Income Division Recognizing Services of Partners and Investment**

Partners may agree the most equitable plan of income sharing is to allow salaries based on the services rendered and also to allow interest on the capital investments. The remainder is then shared in an arbitrary ratio.

**Illustration:**

Assume that Abebe and Emebet (1) are allowed monthly salaries of Birr 2,500 and Birr 2,000 respectively; (2) are allowed interest at 12% on capital balances at January 1 of the current fiscal year, which amounted to Birr 80,000 and Birr 60,000 respectively; and (3) divide the remainder of net income equally.

Net income----------------------------------------------------------------------------------Birr 75,000

Division of net income: **Abebe** **Emebet** **Total**

Salary allowance-------------------Birr 30,000 Birr 24,000 Birr 54,000

Interest allowance-----------------Birr 9,600 Birr 7,200 Birr 16,800

Remaining income---------------- 2,100 2,100 4,200

Net income-------------------------Birr **41,700** Birr **33,300**  Birr **75,000**

* **Income Division-Allowances Exceed Net Income**

In the illustration presented above, the net income has exceeded the sum of the allowances for salary and interest. If the net income is less than the total of the special allowances, the “remaining balance” will be a negative figure that must be divided among the partners as though it were a net loss.

**Illustration:**

Take the above example but change the net income as though it were Birr 50,000.

Net income----------------------------------------------------------------------------------Birr 50,000

Division of net income: **Abebe** **Emebet** **Total**

Salary allowance-------------------Birr 30,000 Birr 24,000 Birr 54,000

Interest allowance-----------------Birr 9,600 Birr 7,200 Birr 16,800

Excess of allow. Over income--- (10,400) (10,400) (20,800)

Net income-------------------------Birr 29,200Birr **20,800**  Birr **50,000**

1. **Partnership Dissolution**

One of the basic characteristics of the partnership form of organization is its limited life. Any change in the personnel of the ownership results in the dissolution of the partnership. Thus, admission of a new partner dissolves the old firm. Similarly, death, bankruptcy, or withdrawal of a partner causes dissolution. Dissolution of partnership is not necessary followed by the winding up of the affairs of the business. For example, a partnership composed of two partners may admit an additional partner. Or if one of three partners in a business withdraws, the remaining partners may continue to operate the business. In all such cases, a new partnership is formed and new articles of partnership should be prepared.

**Admission of a Partner:**

An additional person may be admitted to a partnership enterprise only with the consent of the current partners. An additional person may be admitted to a partnership through either of two procedures.

1. Purchase of an interest from one or more of the current partners.
2. Contribution of assets to the partnership.

**Admission by purchase of an interest from one or more of the current partners:** when an additional person may be admitted to a partnership by purchasing an interest from one or more of the existing partners, the capital interest of the incoming partner is obtained from current partners, and neither the total asset nor the total owner’s equity of the business is affected. The purchase price is paid directly to the selling partners. Payment is for partnership equity owned by the partners as individuals, and hence the cash or other consideration paid is not recorded in the accounts of the partnership. The only entry needed is the transfer of the proper amounts of owner’s equity from the capital accounts of the selling partners to the capital account established for the incoming partner.

**Example:** assume that partners Tom and Nathan have capital balances of $50,000 each. On June 1, each sells one fifth of his respective equity to Joe for $10,000 in cash. The exchange of cash is not a partnership transaction and thus is not recorded by the partnership. The only entry required in the partnership accounts is as follows

Tom, Capital------------------------10,000

Nathan, Capital--------------------10,000

Joe, Capital------------------ 20,000

**Admission by Contribution of Assets: -** Instead of buying an interest from the current partners, the incoming partner may contribute assets to the partnership. In this case both the assets and the owner’s equity of the firm are increased.

**Illustration: -** Assume that Donald and Gerald are partners with capital accounts of $35,000 and $25,000 respectively. On June 1, Sharon invests $20,000 cash in the business, for which she is to receive ownership equity of $20,000. The entry to record this transaction is as follows:

Cash----------------------------------------20,000

Sharon, Capital----------------- 20,000

With the admission of Sharon, the total owners’ equity of the new partnership becomes $80,0000.

**Revaluation of Assets:** If the partnership assets are not fairly stated in terms of current market value at the time a new partner is admitted, the accounts may be adjusted accordingly. The net amount of the increases and decreases in asset values are then allocated to the capital accounts of the old partners according to their income-sharing ratio.

**Illustration:** Assume that in the above illustration for the Donald and Gerald partnership the balance of the merchandise inventory account had been $14,000 and the current replacement price had been $17,000. Prior to Sharon’s admission, the revaluation would be recorded as follows, assuming that Donald and Gerald share net income equally.

Merchandise inventory----------------3,000

Donald, Capital------------------ 1,500

Gerald, Capital------------------- 1,500

**Goodwill:** When a new partner is admitted to a partnership, goodwill attributable either to the old partnership or to the incoming partner may be recognized. Although there are various methods of estimating goodwill, such factors are the respective shares owned by the partners and the relative bargaining abilities of the partners will influence the final determination. The amount of goodwill agreed upon is recorded as an asset, with a corresponding credit to the appropriate capital accounts.

**Illustration 1:** Assume that on March 1 the partnership of Marsha and Helen admits William who is to contribute cash of $15,000. After the tangible assets of the old partnership have been adjusted to market value prices, the capital balances of Marsha and Helen are $20,000 and $24,000. The parties agree, however, that the enterprise is worth $50,000. The excess of $50,000 over the capital balances of $44,000 ($20,000 + $24,000) indicates the existence of $6,000 of goodwill. This $6,000 should be divided between the capital accounts of the original partners according to their income sharing agreement.

The entries to record the goodwill and the admission of the new partner, assuming that the original partners share equally in net income, are as follows:

1. To record the recognition of goodwill to the old partners

Goodwill-------------------------------------6,000

Marsha, Capital-------------------- 3,000

Helen, Capital---------------------- 3,000

1. To record the admission of a new partner

Cash-------------------------------------15,000

William, Capital---------------- 15,000

**Illustration 2:** Assume that Sandra is to be admitted to the partnership of Cowen and Dodd for an investment of $30,000. If the parties agree to recognize $5,000 of goodwill attributable to Sandra, the entry to record her admission is as follows:

Cash-----------------------30,000

Goodwill------------------5,000

Sandra, Capital----- 35,000

**Withdrawal of a Partner**

When a partner retires or for some reason wishes to withdraw from the firm, one or more of the remaining partners may purchase the withdrawing partner’s interest and the business may be continued without apparent interruption. In such cases, settlement for the purchase and sale is made between the partners as individuals, in a manner similar to the admission of a new partner by purchase of an interest, and thus is not recorded by the partnership. The only entry required by the partnership is a debit to the capital account of the partner withdrawing and a credit to the capital account of the partner or partner’s acquiring the interest.

**Illustration 1:** Alan is to retire/withdraw from the partnership of Theodor, Alan, and Smith. The capital balances of the partners are as follows: Alan, $ 200,000; Theodor, $100,000; and Smith, $ 100,000. Alan has sold his interest to Theodor for $200,000. Hence, the only entry required by the partnership to record the withdrawal of Alan is follows:

Alan, Capital-------------------------------200,000

Theodor, Capital------------------- 200,000

**N.B:** when a partner withdraws him/her from the partnership by selling his/her interest to one or more of the existing partners, the capital interest of the outgoing partner is given to the current partners purchasing the interest, and the total asset nor the total owner’s equity of the business is affected.

However, if the settlement with the withdrawing partner is made by the partnership, the effect is to reduce the assets and the owner’s equity of the firm. To determine the ownership equity of the withdrawing partner, the asset accounts should be adjusted to current market prices. The net amount of the adjustments should be divided among the capital accounts of the partners according to the income sharing ratio. In the event that the cash or the other available assets are insufficient to make complete payment at the time of withdrawal, a liability account should be credited for the balance owed to the withdrawing partner.

**Illustration 2:**

Alan is to retire/withdraw from the partnership of Alan, Theodor, and Smith. The capital balances of the partners are as follows: Alan, $ 200,000; Theodor, $100,000; and Smith, $ 100,000. Their net income/net loss sharing ratio is 2:1:1 respectively. At the time of the valuation of assets at their market prices, the partners agreed that the merchandise inventory should be increased by $10,500 and the allowance for doubtful accounts should be increased by $2,100.

Required: - Present entries to record;

1. The adjustment of the assets to bring them into agreement with market prices.
2. The withdrawal of Alan from the partnership if (a) Alan receives the full amount in cash (b) Alan agreed to accept an interest bearing note of $150,000 in partial settlement of his ownership equity and the remainder of his claim to receive in cash.

**Solution:**

1. Merchandise inventory--------------------------------10,500

Alan, Capital------------------------------------ 4,200

Theodor, Capital------------------------------- 2,100

Smith, Capital---------------------------------- 2,100

Allowance for doubtful accounts--------- 2,100

1. (a) Alan, Capital-----------------------------204,200

Cash---------------------------------- 204,200

(b) Alan, Capital--------------------------204,200

Notes payable------------------ 150,000

Cash------------------------------- 54,200

**Death of a Partner**

The death of a partner dissolves the partnership. In the absence of any contrary agreement, the accounts should be closed as of the date of death, and the net income for the fractional part of the year should be transferred to the capital accounts. The balance in the capital account of the deceased partner is then transferred to a liability account until the law orders to whom should the deceased capital should be given.

**LIQUIDATION OF PARTNERSHIP**

Liquidation is refers to the process of a wind-up of a business firm. When a partnership goes out of business, it usually sells the assets (i.e. non cash assets). The sale of non cash assets is called realization. During the process of realization, any gain or loss resulted from the sale of non cash assets is shared among the partners based on their income sharing agreement. As cash is realized, it is applied first to the payment of the claims of creditors. After all liabilities have been paid, the remaining cash is distributed to the partners, based on their ownership equities as indicated by their capital accounts.

**Illustration:-**

The partnership of Dawit, Alemu, and Almaz share income in a ratio of 5:3:2, after discontinuing the ordinary business operations of their partnership and closing the accounts, the following summary of the general ledger is prepared:

Cash-------------------------------------$11,000

Non cash assets----------------------- 64,000

Liabilities------------------------------- $9,000

Dawit, Capital------------------------- 22,000

Alemu, Capital------------------------ 22,000

Almaz, Capital------------------------ 22,000

Total-------------------------------$**75,000** $**75,000**

Based on these facts, accounting for the liabilities of the partnership will be illustrated using three different selling prices for the non cash assets.

**Gain on Realization**

Dawit, Alemu, and Almaz sell all non cash assets for $72,000, realizing a gain of $8,000 ($72,000 - $64,000). The gain is divided among the capital accounts of the partners in the income sharing ratio of 5:3:2. The liabilities are paid, and the remaining cash is distributed to the partners according to the balances in their capital accounts. A statement of partnership liquidation, which summarizes the liquidation process, is presented hereunder:

**Dawit, Alemu, and Almaz**

**Statement of Partnership Liquidation**

**For period of xxxx**

Capital

Non cash Dawit Alemu Almaz

Cash Assets = Liab. + (50%) + (30%) + (20%)

Balance before realization.. 11,000 64,000 9,000 22,000 22,000 22,000

Sale of non cash assets &

Division of gain………….. +72,000 -64,000 - +4,000 +2,400 +1,600

Balance after realization… 83,000 -0- 9,000 26,000 24,400 23,600

Payment of liabilities…….. -9,000 - -9,000 - - -

Bal. after payment of liab.. 74,000 -0- -0- 26,000 24,400 23,600

Distrib. of cash to part…... -74,000 - - -26,000 -24,400 -23,600

Final balances……………. -0- -0- -0- -0- -0- -0-

The entries to record the several steps in the liquidation procedure are as follows:

1. To record the sale of non cash assets

Cash-------------------------------------72,000

Non cash assets------------------ 64,000

Loss & gain on realization--- 8,000

1. To record the division of gain

Loss & gain on realization-------8,000

Dawit, Capital------------------- 4,000

Alemu, Capital------------------ 2,400

Almaz, Capital------------------ 1,600

1. To record the payment of liabilities

Liabilities------------------------------9,000

Cash------------------------------- 9,000

1. To record the distribution of cash to partners

Dawit, Capital-----------------------26,000

Alemu, Capital----------------------24,400

Almaz, Capital----------------------23,600

Cash-------------------------- 74,000

**Loss on Realization; No Capital Deficiencies**

Assume that the foregoing example, Dawit, Alemu, and Almaz dispose all of non cash assets for $44,000, incurring a loss of $20,000 ($64,000 - $74,000). The various steps in the statement of partnership liquidation are presented hereunder:

**Dawit, Alemu, and Almaz**

**Statement of Partnership Liquidation**

**For period of xxxx**

Capital

Non cash Dawit Alemu Almaz

Cash Assets = Liab. + (50%) + (30%) + (20%)

Balance before realization.. 11,000 64,000 9,000 22,000 22,000 22,000

Sale of non cash assets &

Division of loss.………….. +44,000 -64,000 - -10,000 -6,000 -4,000

Balance after realization… 55,000 -0- 9,000 12,000 16,000 18,000

Payment of liabilities…….. -9,000 - -9,000 - - -

Bal. after payment of liab.. 46,000 -0- -0- 12,000 16,000 18,000

Distrib. of cash to part…... -46,000 - - -12,000 -16,000 -18,000

Final balances……………. -0- -0- -0- -0- -0- -0-

The entries to record the several steps in the liquidation procedure are as follows:

1. To record the sale of non cash assets

Cash-------------------------------------44,000

Loss & gain on realization--------20,000

Non cash assets------------------ 64,000

1. To record the division of loss

Dawit, Capital------------------- 10,000

Alemu, Capital------------------ 6,000

Almaz, Capital------------------ 4,000

Loss & gain on realization-------20,000

1. To record the payment of liabilities

Liabilities------------------------------9,000

Cash------------------------------- 9,000

1. To record the distribution of cash to partners

Dawit, Capital-----------------------12,000

Alemu, Capital----------------------16,000

Almaz, Capital----------------------18,000

Cash-------------------------- 46,000

**Loss on Realization; Capital Deficiency**

Assume that the foregoing example, Dawit, Alemu, and Almaz dispose all of non cash assets for $10,000, incurring a loss of $54,000 ($64,000 - $10,000). The various steps in the statement of partnership liquidation are presented hereunder:

**Dawit, Alemu, and Almaz**

**Statement of Partnership Liquidation**

**For period of xxxx**

Capital

Non cash Dawit Alemu Almaz

Cash Assets = Liab. + (50%) + (30%) + (20%)

Balance before realization.. 11,000 64,000 9,000 22,000 22,000 22,000

Sale of non cash assets &

Division of loss………….. +10,000 -64,000 - -27,000 -16,200 -10,800

Balance after realization… 21,000 -0- 9,000 -5,000 5,800 11,200

Payment of liabilities…….. -9,000 - -9,000 - - -

Bal. after payment of liab.. 12,000 -0- -0- -5,000 5,800 11,200

Distrib. of cash to part…... -12,000 - - - -2,800 -9,200

Final balances……………. -0- -0- -0- -5,000 3,000 2,000

The entries to record the liquidation to this point are as follows:

1. To record the sale of non cash assets

Cash-------------------------------------10,000

Loss & gain on realization--------54,000

Non cash assets------------------ 64,000

1. To record the division of gain

Dawit, Capital------------------- 27,000

Alemu, Capital------------------ 16,200

Almaz, Capital------------------ 10,800

Loss & gain on realization-------54,000

1. To record the payment of liabilities

Liabilities------------------------------9,000

Cash------------------------------- 9,000

1. To record the distribution of cash to partners

Alemu, Capital----------------------2,800

Almaz, Capital----------------------9,200

Cash-------------------------- 12,000

**N.B:** The affairs of the partnership are not completely wound up until the claims among the partners are settled. Payments to firm by the deficient partner are credited to that partner’s capital account. Any uncollectible deficiency becomes a loss to the partnership and is written off against the balances of the remaining partners. Finally, the cash received from the deficient partner is distributed to the other partners according to their ownership claims.

**Assumption 1:** Dawit pays the entire amount of the $5,000 deficiency to the partnership (no loss).

The receipt of the $5,000 paid by Dawit to the partnership and the distribution of the $5,000 to the partners are indicated in the following statement of partnership liquidation.

**Dawit, Alemu, and Almaz**

**Statement of Partnership Liquidation**

**For period of xxxx**

Capital

Non cash Dawit Alemu Almaz

Cash Assets = Liab. + (50%) + (30%) + (20%)

Balance…………………….. -0- -0- -0- -5,000 3,000 2,000

Receipt of deficiency…… +5,000 -0- - +5,000 - -

Balance………………..… 5,000 -0- -0- -0- 3,000 2,000

Distrib. of cash to part…... -5,000 - - - -3,000 -2,000

Final balances……………. -0- -0- -0- -0- -0- -0-

The entries to record the final settlement are as follows:

1. To record the receipt of deficiency

Cash--------------------------------------5,000

Dawit, Capital--------------------- 5,000

1. To record the distribution of cash to partners

Alemu, Capital---------------------------3,000

Almaz, Capital---------------------------2,000

Cash----------------------------------- 5,000

**Assumption 2:** Dawit pays $3,000 of the deficiency to the partnership, and the remainder is considered to be uncollectible ($2,000 loss)

The receipt of the $3,000 paid by Dawit to the partnership, the division of the $2,000 loss, and the distribution of the $3,000 to the partners are indicated in the following statement of partnership liquidation.

**Dawit, Alemu, and Almaz**

**Statement of Partnership Liquidation**

**For period of xxxx**

Capital

Non cash Dawit Alemu Almaz

Cash Assets = Liab. + (50%) + (30%) + (20%)

Balance…………………….. -0- -0- -0- -5,000 3,000 2,000

Receipt of deficiency…… +3,000 -0- - +3,000 - -

Balance………………..… 3,000 -0- -0- -2,000 3,000 2,000

Division of loss………… - - - +2,000 -1,200 -800

Balance----------------------- 3,000 -0- -0- -0- 1,800 1,200

Distrib. of cash to part…... -3,000 - - - -1,800 -1,200

Final balances……………. -0- -0- -0- -0- -0- -0-

It should be noted that the $2,000 loss was divided between Alemu and Almaz in their income sharing ratio of 3:2. The entries to record the final settlement are as follows:

1. To record the receipt of part of deficiency

Cash--------------------------------------3,000

Dawit, Capital--------------------- 3,000

1. To record the division of loss

Alemu, Capital---------------------------1,200

Almaz, Capital---------------------------800

Dawit, Capital---------------------- 2,000

1. To record the distribution of cash to partners

Alemu, Capital---------------------------1,800

Almaz, Capital---------------------------1,200

Cash----------------------------------- 3,000

**Assumption 3**: Dawit is unable to pay any part of the $5,000 deficiency (5,000 loss)

The division of the $5,000 loss indicated in the following statement of partnership liquidation.

**Dawit, Alemu, and Almaz**

**Statement of Partnership Liquidation**

**For period of xxxx**

Capital

Non cash Dawit Alemu Almaz

Cash Assets = Liab. + (50%) + (30%) + (20%)

Balance…………………….. -0- -0- -0- -5,000 3,000 2,000

Division of loss………… - - - +5,000 -3,000 -2,000

Final balances……………. -0- -0- -0- -0- -0- -0-

It should be noted that the $5,000 loss was divided between Alemu and Almaz in their income sharing ratio of 3:2. The entries to record the final settlement is as follows:

1. To record the division of loss

Alemu, Capital---------------------------3,000

Almaz, Capital---------------------------2,000

Dawit, Capital---------------------- 5,000