# CHAPTER Four

# ACCOUNTING FOR PARTNERSHIPS

# Introduction

A **partnership** is an association of two or more persons to carry on as co-owners of a business for profit. Partnerships are sometimes used in small retail, service, or manufacturing companies. Also accountants, lawyers, and doctors find it desirable to form partnerships with other professionals in the field.

**Characteristics of Partnerships**

Partnerships are fairly easy to form. People form partnerships simply by a verbal agreement, or more formally, by written agreement. We explain the principal characteristics of partnerships in the following sections. ጀ

* **Association of Individuals** A partnership is a legal entity. A partnership can own property (land, buildings,equipment), and can sue or be sued. **A partnership also is an accounting entity.** Thus, the personal assets, liabilities, and transactions of the partners are excludedfrom the accounting records of the partnership, just as they are in a proprietorship.The net income of a partnership is not taxed as a separate entity.
* **Mutual Agency** means that each partner acts on behalf of the partnership when engagingin partnership business. The act of any partner is binding on all other partners.This is true even when partners act beyond the scope of their authority, so longas the act appears to be appropriate for the partnership.
* **Limited Life** mean it does not have unlimited life. A partnership may be endedvoluntarily at any time through the acceptance of a new partner or the withdrawalof a partner. It may be ended involuntarily by the death or incapacity of a partner. **Partnership dissolution** occurs whenever a partner withdraws or a new partner isadmitted. Dissolution does not necessarily mean that the business ends. If the continuingpartners agree, operations can continue without interruption by forming anew partnership.
* **Unlimited Liability** Each partner is **personally and individually liable** for all partnership liabilities.Creditors’ claims attach first to partnership assets. If these are insufficient, theclaims then attach to the personal resources of any partner, irrespective of thatpartner’s equity in the partnership. Because each partner is responsible for all thedebts of the partnership, each partner is said to have **unlimited liability**.
* **Co-Ownership of Property** Partners jointly own partnership assets. If the partnership is dissolved, each partner has a claim on total assets equal to the balance in his or her respective capital account. This claim does not attach to **specific assets** that an individual partner contributed to the firm. Similarly, if a partner invests a building in the partnership valued at $100,000 and the building is later sold at a gain of $20,000, the partners all share in the gain. Partnership net income (or net loss) is also co-owned. **If the partnership contract does not specify to the contrary, all net income or net loss is shared equally by the partners.**

## Advantages and Disadvantages of the Partnership

**Advantages**

* Capitalization
* Combined experience and talent
* Ease of formation
* Cost of organization
* Tax advantages
* Less government supervision

## Disadvantages

* + Loss of freedom
  + Limited life
  + Unlimited Liability
  + Mutual Agency
  + Division of authority

## The partnership Agreement

Ideally, the agreement of two or more individuals to form a partnership should be expressed in a written contract, called the **partnership agreement** or **articles of co-partnership**. The partnership agreement contains such basic information as the name and principal location of the firm, the purpose of the business, and date of inception. In addition, it should specify relationships among the partners, such as:

1. Names and capital contributions of partners
2. Rights and duties of partners
3. Basis for sharing net income or net loss
4. Provision for withdrawals of assets
5. Procedures for submitting disputes to arbitration
6. Procedures for the withdrawal or addition of a partner
7. Rights and duties of surviving partners in the event of a partner’s death

## Partnership Accounting

Accounting for a partnership is the same as accounting for a proprietorship except for transactions directly affecting partners’ equity. Because ownership rights in a partnership are divided among partners, partnership accounting:

* Partnership accounting requires establishing a separate capital and a separate withdrawals account for each partner up on formation.
* Allocates net income or loss to partners according to the partnership agreement.
* Dissolve partnership
* Liquidate partnership

### Partnership Formation /Recording Investments

When a partnership is formed, a journal entry is made to record the assets contributed by each partner and the liabilities of each partner that are assumed by the partnership. A separate entry is made for the investment of each partner in a partnership.

GAAP require that non-cash assets contributed by individual partners be valued at their fair value on the date they are transferred to the partnership.

### Example

On April 1 of the current year, Fassil and Selamawit agreed to combine their existing business and form a partnership. The partners are to contribute the assets of their previous business. It is agreed that the liabilities of the proprietorships will be assumed by the partnership. The contribution made by each partner is as follows.

Amount

Asset contributed Fassil Selamawit

Cash 3,500 5,700

Accounts Receivable 7,600 4,200

Merchandise inventory 15,900 11,000

Supplies 700 300

Equipment 8,500 -

Building - 55,000

Land - 16,000

Liability assumed

Account payable 3,100 -

Notes payable - 19,600

The journal entries to open the accounts of the partnership are:

April 1. Cash 3,500

Account Receivable 7,600

Merchandise inventory 15,900

Supplies 700

Equipment 8,500

Account payable 3,100

Fassil, capital 33,100

(To record the investment of Fassil)

April 1. Cash 5,700

Account Receivable 4,200

Merchandise Inventory 11,000

Supplies 300

Building 55,000

Land 16,000

Notes payable 19,600

Selamawit, capital 72,600

(To record the investment of Selamawit)

### Division of Net income or Net loss

Income division is the manner in which profits and losses are allocated to individual partners**.** The method of dividing partnership income should be stated in the partnership agreement. In the absence of an agreement or if the agreement is silent on dividing net income or net losses, all partners share equally.

**Methods to divide income or lose use**:

1. Division based on fractional share to each partner.
2. Division based on the ratio of capital invested.
3. Division based on salary allowances. Technically, partners’ salaries are profit shares, not expenses of the business.
4. Division based on interest allowances.
5. Division based on both salary and interest allowances. Salary and interest allowances exceed the amount of net income; the excess net income will simply be negative.

###### Income Division: Services of partners

**Salary Allowance**

Articles of partnership often provide for the division of a portion of net income to the partners in the form of a salary allowance taking into account the ability and amount of time devoted to the business.

### Example

Assume that the articles of partnership of Alem and Tesfaye provide for monthly salary allowance or $ 2,000 and $ 3,000 respectively, with the balance of the net income to be divided equally. The net income for the year is $ 90,000. The division of the $ 90,000 net income is a follows.

Net income to divide **$90,000**

Division of net income Alem Tesfaye Total

Salary Allowance $ 24,000 $ 36,000 $60,000

Remaining income 15,000 15,000 30,000

Partners shares $ 39.000 $ 51,000 $90,000

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.

Dec 31 Income Summary 90,000

Alem, capital 39,000

Tesfaye, capital 51,000

**Income Division: services of partners and investment**

Partners may agree that the most equitable plan of dividing income is to provide for:

1. Salary allowance and
2. Interest on capital investments.

Any remaining net income is then divided as agreed.

### Example

Assume that the partnership agreement for Alem and Tesfaye divides income as follows.

1. Monthly salary allowances of $ 2,000 for Alem and $ 3,000 for Tesfaye.

2. Interest of 10% on each partner’s capital balance on January 1.

3. Any remaining net income divided equally between the partners.

Alem had a credit balance of $ 70,000 in her capital account on January 1 of the current fiscal year, and Tesfaye had a credit balance of $ 90,000 in his capital account. The $ 90,000 net income for the year is divided in the following schedule.

Net income **$ 90,000**

Division of net income

Alem Tesfaye Total

Annual salary allowance $ 24,000 $ 36,000 $ 60,000

Interest allowance 7,000 9,000 16,000

Remaining income 7,000 7,000 14,000

Net income $ 38,000 $ 52,000 $ 90,000

$ 70,000 x 10% = $ 7,000

$ 90,000 x 10% = 9,000

For the above example, the entry to close the income summary account is shown below.

Dec 31. Income summary $ 90,000

Alem, capital 38,000

Tesfaye, capital 52,000

**Income Division: Allowances Exceed Net Income**

In the examples so far, the net income has exceeded the total of the salary and interest allowances. If the net income is less than the total of the allowances, the remaining balance will be a negative amount. This amount must be divided among the partners as it were a net loss.

**Example:**

Assume the same salary and interest allowances as in the above example, but assume that the net income is $ 50,000. The salary and interest allowances total $ 31,000 for Alem and $ 45,000 for Tesfaye. The sum of these amounts, $ 76,000, exceeds the net income of $ 50,000 by $ 26,000. It is necessary to divide the $ 26,000 excess between Alem and Tesfaye. Under the partnership agreement, any net income or net loss remaining after deducting the allowances is divided equally between Alem and Tesfaye. Thus each partner is allocated one-half of the $ 26,000 and $ 13,000 is deducted from each partner’s share of the allowances. The final division of net income between Alem and Tesfaye is shown below.

Net income **50.000**

|  |  |  |  |
| --- | --- | --- | --- |
| *Division of Net income* | Alem | *Tesfaye* | Total |
| *Annual salary allowance* | *$ 24,000* | *$ 36,000* | *$ 60,000* |
| *Interest allowance* | *7,000* | *9,000* | *16,000* |
| *Total* | *$ 31,000* | *$ 45,000* | *$ 76,000* |
| *Excess of allowances over income* | *(13,000)* | *(13,000)* | *(26,000)* |
| Net income | *$ 18,000* | $ 32,000 | *$ 50,000* |

The entry to close the income summary account

Dec 31 Income summary 50,000

Alem, capital 18,000

Tesfaye, capital 32,000

### Partnership Dissolution

When a partnership dissolves, its affairs are not necessarily wind up. When a new partner is admitted or an old partner withdraws, the old partnership ends. Still, the business can continue to operate as a new partnership among the remaining partners.

### Admission of a partner

There are two ways a new partner is admitted to a partnership with the consent of all the current partners.

1. Purchasing an interest from one or more of the current partners.
2. Contributing cash or other assets to the partnership.

### Purchasing an interest in a partnership

The purchase of partnership interest is a personal transaction between one or more current partners and the new partner.

The capital interest of the incoming partner is reallocated and obtained from current partners.

Neither the total assets nor the total owner’s equity of the business is affected.

### Example

Assume that partners Abraham and Kebede have capital balance of $ 100,000 and $ 75,000 respectively. On September1, Abraham sells one-half of his interest for $60,000 and Kebede sells one-fifth of his equity for $ 20,000 to Nardos. 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.

Sept 1. Abraham capital 50,000

Kebede, capital 15,000

Nardos, capital 65,000

To record admission of Nardos by purchase.

Partnership Accounts

Abraham, capital Kebede, capital Nardos, capital

|  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- |
| 50,000 | 100,000  50,000 |  | 15,000 | 75,000  60,000 |  |  | 65,000 |

**Investing/contributing Assets to a partnership**

Admitting a partner by accepting assets is a transaction between the new partner and the partnership. The invested assets become partnership property.

In this case, both the assets and the owner’s equity of the firm increase.

### Example: -

Assume that partner Genet (with a $ 72,000 capital) and Sisay (with a $ 84,000) agreed to accept Nebyat as a partner with her investment of $ 34.000 on March 1. The entry to record Nebiyat’s investment is:

March 1. Cash 34,000

Nebiyat capital 34,000

To record admission of Nebiyat by investment.

**Partnership Accounts**

Net Assets Genet, capital Sisay, capital Nebyat, capital

|  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
| 34,000 |  |  |  | 72,000 |  |  | 84,000 |  |  | 34,000 |

### Revaluation of Assets

A partnership’s asset account balances should be stated at current values when a new partner is admitted. The net adjustment (increase or decrease) in asset values is divided among the capital accounts of the existing partners according to their income-sharing ratio.

**Example:**

Assume that in the preceding example for Genet & Sisay partnership, the balance of the merchandise inventory account is $25,000 and the current replacement value is $ 29,000. Prior to Nebyat’s admission, the revolution would be recorded as follows, assuming that Genet & Sisay share net income equally.

March 1. Merchandise Inventory 4,000

Genet, capital 2,000

Sisay, capital 2,000

### Partner Bonuses

When a new partner is admitted to a partnership, the incoming partner may pay a bonus to the existing partners for the privilege of joining the partnership.

Existing partners can pay a bonus to a new partner. This usually occurs when they need additional cash or the new partner has exceptional or special talents & skill.

The amount of any bonus paid to the partnership is distributed among the partner capital accounts.

### Bonus to old partners

Assume that on June 1 the partnership of Asenafi and Dereje is considering admitting a new partner, Hiwot. After the assets of the partnership has been adjusted to current market values, the capital balance of Ashenafi is $150,000 and the capital balance of Dereje $ 30,000. Ashenafi and Derege agree to admit Hiwot to the partnership for $ 80,000. In return, Hiwot will receive a 25% share in both equity and partnership income or losses.

Hiwot’s equity is determined as follows:

Equity of existing partners:

Ashenafi $ 150,000

Dereje 30,000

Investment of new partner, Hiwot 80,000

Total partnership equity $ 260,000

Equity of Hiwot (25% of total) $ 65,000

Contribution of Hiwot $ 80,000

Hiwot’s equity after admission 65,000

Bonus paid to Ashenafi & Derege $ 15,000

The bonus is distributed to Ashenafi and Dereje according to their income-sharing ratio. Assume that Ashenafi & Dereje share profits and losses in the ratio of 5:1; the entry to record the admission of Hiwot to the partnership is as follows:

June1. Cash 80,000

Hiwot, capital 65,000

Ashenafi, capital 12,500

Derege, capital 2,500

To record admission of Hiwot and bonus to old partners

### Bonus to New partner

The new partner gets a larger share of equity than the amount invested (contributed).

Example:

Let’s say, from the preceding example, Ashenafi and Dereje agree to accept Hiwot as a partner with a 25% interest in both the partnership’s income or loss and equity, but they require Hiwot to only invest 20,000. Hiwot’s equity is determined as:

Equities of existing partners ($ 150,000 + $ 30,000) $ 180,000

Investment of new partner, Hiwot 20,000

Total partnership equity $ 200,000

Equity of Hiwot (25% x $200,000) $ 50,000

Bonus to new partner, (Hiwot) ($50,000-$20,000) = $ 30,000

The entry to record Hiwot’s investment is

June 1. Cash 20,000

Asenafi, capital ($30.000 x 5/6) 25,000

Dereje, capital ($ 30.000x 1/6) 5,000

Hiwot, capital 50,000

To record Hiwot’s admission and bonus

### Withdrawal of a partner

There are several ways in which an individual can withdraw from a partnership. A partner can:

1. Sell his or her interest to another partner or to an outsider with the consent of the other partners, the transaction is personal.
2. Withdraw assets equal to his or her capital balances (No bonus).
3. Withdraw assets that are less than his or her capital balance (Bonus to remaining partners)
4. Withdraw assets that are greater than his or her capital balance (Bonus to withdrawing partner)

### Example

Let’s assume that the capital balances of the partners Genet, Sisay, and Nebiyat are $ 86,000, $ 125,000, and $ 60,000, respectively, a total of $ 271,000. Genet wants to withdraw from the partnership on March 31.

Required: - Record the necessary journal entry taking the following independent offers for Genet’s interest:

1. To sell her interest to Sisay for $ 90,000.
2. To sell her interest to Hagos, an outsider, for $100,000
3. To take cash equal to her equity.
4. To take $70,000 in cash
5. To take $ 102,00 in cash

### Death of a partner

A partner’s death dissolves a partnership. The accounts should be closed as of the death of the partner and the partners’ capital accounts be updated.

The balance in the capital account of the deceased partner is then transferred to a liability account with the deceased’s estate. The remaining partners may purchase the deceased’s equity, sell it to outsiders, or deliver certain business assets to the estate.

### Liquidation of a partnership

Liquidation of a partnership is the process of ending the business by selling assets to pay the partnership’s liabilities and distributing any remaining assets among the partners.

Liquidation is a special form of dissolution. When a partnership is liquidated, the business will not continue.

When a partnership is liquidated, its business is ended. Four steps are involved:

1. Sale of Non-cash assets/realization/.
2. Allocation of gain or loss on realization to partners using their income/loss sharing ratio.
3. Payment of Liabilities.
4. Distribution of remaining cash to partners based on theirs capital balances.

The sale of the assets is called realization. In liquidation, some gains or losses commonly result from the sale of non-cash assets.

**Example: -**

Assume that Fassil, Tangut, and Kassa share income and losses in a ratio of 4:4:2 (4/10, 4/10. 2/10).  On May 12, 2002 after discontinuing business operations of the partnership and closing the accounts, the following summarized trial balance was prepared.

Cash 3,000

Non-cash Assets 24,000

Liabilities 6,000

Fassil, capital 10,000

Tangut, capital 8,000

Kassa, capital 3,000

Total $ 27,000 $ 27,000

Between May 13 and May 31 required sell of none cash assets were made. Based on the above facts and taking different selling prices for the non cash assets, prepare a statement of partnership liquidation & make the necessary journal entries to account for the liquidating process if the non-cash assets are sold for:

1. $ 29,000, Gain on realization.
2. $ 20,000, Loss on realization
3. $ 4,000, Loss on realization- capital deficiency

(**Note**: - capital deficiency means that at least one partner has a debit balance in his or her capital account at the final distribution of cash.)

* 1. Partner pays deficiency
  2. Partner can’t pay deficiency

Any uncollected deficiency becomes a loss to the partnership and is divided among the remaining partners’ and is divided among the remaining partners’ capital balances, based on their income-sharing ration.

1. Gain on Realization

Fassil, Tangut, and Kassa

Statement of partnership Liquidation

For Period May 13-31, 2002

|  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- |
|  | Assets | | Liabilities + | Capital | | |
| Cash + | Non cash =  Assets | Fassil  40% | Tangut  40% | Kassa  20% |
| Balance before realization | $3,000 | $ 24,000 | $ 6,000 | $ 10,000 | $ 8,000 | $ 3,000 |
| Sale of assets & division of gain | +29,000 | ( 24,000) |  | + 2,000 | + 2,000 | + 1,000 |
| Balance after realization | $ 32,000 | $ 0 | $6,000 | $ 12,000 | $ 10,000 | $ 4,000 |
| Payment of liabilities | (6,000) | - | (6,000) | - | - | - |
| Balance after payment of liabilities | $ 26,000 | $ 0 | $ 0 | $ 12,000 | $10,000 | $ 4,000 |
| Cash distributed to partners | (26,000) | - | - | (12,000) | (10,000) | (4,000) |
| Final balance | $ 0 | $ 0 | $ 0 | $ 0 | $ 0 | $ 0 |

The entries to record the steps in the liquidating process are as follows:

Cash 29,000

Non cash Assets 24,000

Gain on Realization 5,000

(To record sale of assets)

Gain on Realization 5,000

Fassil, capital 2,000

Tangut, capital 2,000

Kassa, capital 1,000

(To record division of gain from sale of assets)

Liabilities 6,000

Cash 6,000

(To record payment of Liabilities)

Fassil, capital 12,000

Tangut, capital 10,000

Kassa, capital 4,000

Cash 26,000

(To record Distribution of cash to partners)

1. Loss on Realization

Fassil, Tangut, and Kassa

Statement of partnership Liquidation

For Period May 13-31, 2002

|  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- |
|  | Assets | | Liabilities + | Capital | | |
| Cash + | Non cash =  Assets | Fassil  40% | Tangut  40% | Kassa  20% |
| Balance before realization | $3,000 | $ 24,000 | $ 6,000 | $ 10,000 | $ 8,000 | $ 3,000 |
| Sale of assets & division of loss | +20,000 | - 24,000 | - | (1,600) | (1,600) | (800) |
| Balance after realization | $ 23,000 | $ 0 | $6,000 | $ 8,400 | $ 6,400 | $ 2,200 |
| Payment of liabilities | -6,000 | - | -6,000 | - | - | - |
| Balance after payment of liabilities | $ 17,000 | $ 0 | $ 0 | $ 8,400 | $6,400 | $ 2,200 |
| Cash distributed to partners | (17,000) | - | - | (8,400) | (6,400) | (2,200) |
| Final balance | $ 0 | $ 0 | $ 0 | $ 0 | $ 0 | $ 0 |

The entries to liquidate the partnership are as follows

Cash 20,000

Loss on Realization 4,000

Non cash Asets 24,000

(To record sale of assets)

Fassil, capital 1,600

Tangut, capital 1,600

Kassa, capital 800

Loss of Realization 4,000

(To record division of loss from sale of assets)

Liabilities 6,000

Cash 6,000

(To record payment of Liabilities)

Fassil, capital 8,400

Tangut, capital 6,400

Kassa, capital 2,200

Cash 17,000

(To record Distribution of cash to partners)

1. Loss on Realization- capital Deficiency
   1. Partner pays Deficiency

Fassil, Tangut, and Kassa

Statement of partnership Liquidation

For Period May 13-31, 2002

|  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- |
|  | Assets | | Liabilities+ | Capital | | |
| Cash | Non cash = | Fassil  40% | Tangut  40% | Kassa  20% |
| Balance before realization | $3,000 | $ 24,000 | $ 6,000 | $ 10,000 | $ 8,000 | $ 3,000 |
| Sale of assets & division of loss | +4,000 | (24,000) | \_\_\_\_\_ - | (8,000) | (8,000) | (4,000) |
| Balance after realization | $ 7,000 | $ 0 | $6,000 | $ 2,000 | $ 0 | $ (1.000) |
| Payment of liabilities | (6,000) | - | (6,000) | - | - | - |
| Balance after payment of liabilities | $ 1,000 | $ 0 | $ 0 | $ 2,000 | $ 0 | $ (1,000) |
| Receipt of deficiency | 1,000 | - | - | - | - | 1,000 |
| Balances | $ 2,000 | $ 0 | $ 0 | 2,000 | $ 0 | $ 0 |
| Cash distributed to partners | (2,000) | - | - | (2,000) | - | - |
| Final balance | $ 0 | $ 0 | $ 0 | $ 0 | $ 0 | $ 0 |

The entries to record the liquidation are as follows:

Cash 4,000

Loss on Realization 20,000

Non cash Assets 24,000

(To record sale of assets)

Fassil, capital 8,000

Tangut, capital 8,000

Kassa, capital 4,000

Loss on Realization 20,000

(To record division of gain from sale of assets)

Liabilities 6,000

Cash 6,000

(To record payment of Liabilities)

Cash 1,000

Kassa, capital 1,000

(To record Receipt of cash from deficient partner)

Fassil, capital 2,000

Cash 2,000

(To record Distribution of cash to partners)