# UNIT 5: Partnership Organization And Operation

**5.1 Introduction**

Partnership is another form of organization, in addition to sole proprietorship and corporation. Partnerships are common in retail establishments and in small scale manufacturing companies. Similarly, if you enter a profession such as accounting, law, or medicine, you may find it desirable to form a partnership with other professionals in your field. In this chapter, we will discuss the essential features of partnerships, and explain the major issues in accounting for partnerships.

**5.2 Definition and Characteristics of a Partnership**

**Definition of a partnership**

Partnership is an association of two or more persons to carry, as co-owners, a business for profit. In a partnership, there are at least two persons. The assets of the partnership are owned jointly by the owners. The owners in a partnership are called partners. The partners share the profit or loss of the partnership depending on their agreement.

**Characteristics of a Partnership**

Partnerships have several characteristics that have accounting implications. The principal characteristics of the partnership form of business organization are described below:

**a. Limited Life**

A partnership has limited life. Its continuance as a going concern rests in the partnership contract. A partnership may be ended voluntarily at any time through the acceptance of a new partner into the firm or the withdrawal of the partner. A partnership may be ended in voluntarily by the death or incapacity of a partner. In short, any change in the member of partners, regardless of the cause, affects the dissolution of the partnership. Dissolution thus refers to changes in ownership in the partnership. Dissolution does not necessarily mean that the business ends. If the remaining partners agree, operations can continue without interruption by forming a new partnership.

**b.** **Unlimited Liability**

Each partner is personally and individually liable for all partnership liabilities. The claims of the creditors attach first to partnership assets and then to personal assets of any partner, regardless of that partner’s equity in the company.

**c. Voluntary Association of Individuals**

A partnership is a voluntary association of two or more individuals based on a legally binding contract. The contract may be written, oral, or implied. A partnership may be divided into two; namely, general partnership and limited partnership. General partnership is a partnership in which each partner is individually liable to creditors for the debts incurred by the partnership. In a general partnership, individual partner should contribute from his/her personal assets if the partnership becomes insolvent (unable to pay its debt). On the other hand, limited partnership is a partnership in which the liability of some partners is limited to the amount of capital investment. The remaining partners are general partners (partners who have unlimited liability). However, a limited partnership must have at least one general partner who has unlimited liability.

**d. Mutual Agency**

Mutual agency means that each partner acts on behalf of the partnership when engaging in partnership business. The act of any partner is binding on all other partners, even when partners act beyond the scope of their authority, as long as the act appears to be appropriate for the partnership. Because of mutual agency, an individual should be extremely cautious in selecting partners.

**e. Nontaxable entity**

The income of a partnership is not taxed as a separate entity. However, a partnership is required to file an information tax return showing partnership net income and each partner’s share of net income. Each partners’ share is taxable at personal tax rates, regardless of the amount of net income withdrawn from the business during the year.

**f. Co-ownership of Property**

Partnership assets are co-owned by the partners. Once assets have been invested in the partnership, they are owned jointly by all the partners. Moreover, if the partnership is terminated, the assets do not legally revert to the original contributor. Each partner has a claim on total assets equal to the balance in his/her respective capital account. This claim does not attach to specific assets that an individual partner may have contributed to the firm.

**Check your progress 5-1**

1. A partnership may have only one partner. Do you agree?
2. The owner in a partnership is called --------------------.
3. List the principal characteristics of a partnership.
4. What are the two types of partnerships?

**5.3 Advantages and Disadvantages of a Partnership**

The advantages of a partnership include:

* + A partnership is relatively easy and inexpensive to establish. It is relatively free from government regulations and restrictions. (case of formation).
	+ A partnership enables to bring more capital, more skills, and more experience as compared to sole proprietorship.
	+ The combined income taxes paid by the individual partners may be lower than the income taxes that would be paid by a corporation.
	+ Decisions can be made quickly on substantial matters affecting the firm, whereas in a corporation, formal meetings with the board of directors are often needed. (i.e. ease of decision making)

Even though partnership has many advantages, it is not without limitations. Thus, the main disadvantages (limitations) of a partnership include:

* + Partnership has limited life.
	+ Partnership has unlimited liabilities.
	+ One partner can bind a partnership to contracts (i.e. mutual agency).
	+ Raising large amount of capital is more difficult for a partnership than for a corporation.

#### Deciding Between Limited Liability Partnership (LLP) and corporation

1. **Income status of the enterprise and of its owners**. An LLP pays no income tax but is required to file an annual information return showing its revenue and expenses, the amount of its net income and division of the net income among the partners. A corporation is a separate legal entity subject to a corporate income the amount of net income distributed to shareholders in the form of dividend is taxable income to shareholder.
2. **Opportunity for obtaining large amount of capital**. Corporations have better opportunity than partnership in terms of raising larger amount of capital.

**5.4 The partnership Agreement**

A partnership is created by a contract expressing the voluntary agreement of two or more individuals. Partnership may be formed in written, oral, or implied. If the partnership is formed in writing, the contract is called partnership agreement, or articles of co-partnership. The articles of co-partnership include such basic information as:

* + The principal and location of the firm.
	+ The purpose of the business.
	+ Date of establishment.
	+ Names and capital contributions of partners.
	+ Rights and duties of partners.
	+ Basis for sharing net income or net loss.
	+ Provision for the withdrawal of assets.
	+ Procedures for submitting disputes to arbitration.
	+ Procedures for the withdrawal or addition of a partner.
	+ Rights and duties of surviving partners in the event of a partner’s death.

**5.5 Partnership Formation**

Most of the day-to-day accounting for a partnership is the same as the accounting for any other form of business organization. For example, the chart of accounts, with the exception of drawing and capital accounts for each partner, does not differ from the chart of accounts of a similar business conducted by a single owner. Transactions that are peculiar (unique) to partnership organizations are:

* Formation of a partnership
* Income distribution
* Dissolution
* Liquidation

This topic deals with how to record the initial investments of each partner in the accounting records of the partnership. The investment of each partner is separately recorded in a partnership. Those assets, which are contributed by the partner, are debited to the proper asset accounts. These assets should be recorded at their fair market value at the date of their transfer to the partnership. All partners must agree to the values assigned to assets. Similarly, if liabilities are assumed by the partnership, the appropriate liability accounts are credited. Then, the difference between the assets and liabilities (net amount) should be credited to partner’s capital account.

To illustrate, assume that Lemma and Kassa established a partnership, called LK partnership on October 10,2003. Lemma contributed cash of Br. 50,000, and Kassa contributed equipment, which was purchased 4 years ago for Br. 70,000. The partners agreed that the market value of this equipment is Br. 40,000. The entry to record the investment of each partner is shown below:

To record Lemma’s investment:

 Cash……………………………………… 50,000

 Lemma, capital…………………………….. 50,000

To record Kassa’s investment

 Equipment……………………………….. 40,000

 Kassa, capital………………………………. 40,000

Note that the original cost of the equipment (Br. 70,000) is no more relevant for the partnership because the equipment should be recorded at its current market value.

After each partner’s investment is recorded properly, the capital of the partnership can be determined. For the example under question, total capital of the partnership is computed as follows:

 Lemma, capital……………………………. 50,000

 Kassa, capital……………………………… 40,000

 Total capital………………………. 90,000

A balance sheet can also be prepared for the partnership after recording the partner’s investments. Notes the following balance sheet for the partnership being described:

**LK Partnership**

**Balance Sheet**

**October 10,2003**

|  |  |
| --- | --- |
| **Assets** | **Liabilities and Capital**Capital |
| Cash  | 50,000 |  Lemma, capital | 50,000 |
| Equipment  | 40,000 |  Kassa, capital  | 40,000 |
| Total Assets | 90,000 |  Total liab. &capital  | 90,000 |
|  |  |  |  |

At this time, LK partnership has no liability. No partner’s liability was transferred to the partnership.

**Example**

Assume that Mamo and Worku agree to combine their sole proprietorships to start a partnership named MW partnership. On November 2, 2003 their investments in the partnership are as follows:

|  |  |  |
| --- | --- | --- |
| **Items** | **Book Value** | **Market Value** |
|  | **Mamo**  | **Worku**  | **Mamo** | **Worku** |
| Cash  | Br. 7,000 | 8,000 | Br. 7,000 | Br. 8,000 |
| Office Equipment  | 6,000 |  | 5,000 |  |
| Accumulated Depreciation  | (2,000) |  |  |  |
| Accounts Receivable  |  | 3,000 |  | 3,000 |
| Allowance for Doubtful Accounts |  | (800) |  | (1,100) |
| Total | Br. 11,000 | Br. 10,200 | Br. 12,000 | Br. 9,900 |

Besides the partnership agreed to assume the liabilities (accounts payable) of former sole proprietorship, owned by Mamo, amounted to Br. 4,000.

**Required**

1. Prepare the entry to record the partner’s investments
2. Prepare the balance sheet for the new partnership on November 2, 2003.

**Solution**

a) **Investment of Mamo**:

 Cash………………………………………… 7,000

 Office equipment……………………………. 5,000

 Accounts payable……………………………… 4,000

 Mamo, capital…………………………………. 8,000

**Investment of Worku**:

Cash…………………………………………….. 8,000

Accounts Receivable…………………………….. 3,000

 Allowance for Doubtful Accounts………………………. 1,100

 Worku, capital…………………………………………… 9,900

b) Balance Sheet

**MW Partnership**

**Balance Sheet**

**November 2,2003**

|  |  |  |
| --- | --- | --- |
| **Assets**  |  |  |
| Cash (7,000 + 8,000) |  | Br. 15,000 |
| Accounts Receivable  |  3,000 |  |
| Less: Allowance for Doubtful Accounts  |  1,100 | 1,900 |
| Office equipment  |  | 5,000 |
|  Total assets  |  | 21,900 |
| **Liabilities and Capital**  |  |  |
| Accounts payable |  | 4,000 |
| Capital: |  |  |
|  Mamo, capital |  8,000 |  |
|  Worku, capital  |  9,900 |  |
|  Total capital |  | 17,900 |
| Total liabilities and capital  |  | 21,900 |

Note that both the original cost and the accumulated depreciation of the equipment are not recorded by the partnership. The equipment is recorded at its market value (i.e. Br. 5,000). Since the equipment has not been used by the partnership, there can be no accumulated depreciation. In contrast, the gross claims on customers ((Br. 3,000) are carried forward to the partnership, and the allowance for doubtful accounts is adjusted to Br. 1,100 instead of Br. 800. The difference between Br. 3,000 and its related allowance for doubtful account is equal cash net realizable value. i.e. the net amount that is expected to be received from customers on accounts receivable of Br. 3,000.

After the partnership has been formed, the accounting for its transactions is similar to accounting for transactions of any other type of business organization. The steps described in the accounting cycle are equally applicable to a partnership. i.e.

* + Journalize transactions
	+ Posting to accounts in the ledger
	+ Trail balance Preparation
	+ Worksheet Preparation
	+ Preparation of financial statements
	+ Journalizing and posting adjusting entries
	+ Journalizing and posting closing entries
	+ Post-closing trial balance preparation.

##### **Ledger Accounts for partners**

In accounting for partnership, there are three types of accounts for partners. There are

1. Capital Accounts
2. Drawing or Personal Accounts
3. Accounts for loans to and from partners

To explain Accounts for loans to and from partners, a partner may receive cash from the partnership with the intention of repaying it. Such transaction is recorded in partnership accounts as follows:

Loans Receivable from partners \*\*\*

 Cash \*\*\*

On the other hand, a partner may make a cash payment to the partnership that is considered a loan rather than an increase in the partner’s capital account balance. Such transaction is recorded as follows:

Cash \*\*\*

 Loans payable to partners \*\*\*

Loans Receivable from Partners is an asset while Loans Payable to Partners is a liability.

**Check your progress**

1. How should a partner’s initial investment of non-cash assets be valued?
2. What are the transactions that are unique to partnership form of organization?
3. Suppose that Bacha and Chaltu decide to organize the partnership called BC partnership. Bacha invests Br. 20,000 cash, and Chaltu contributes Br. 15,000 and equipment having a book value of Br. 4,000. Prepare the entry to record the investment of each partner, assuming that the equipment has a fair market value of Br. 4,500.

**5.6 Division of Net Income or Net Loss**

The partnership agreement should specify the basis for sharing net income or net loss. If the partnership agreement failed to specify the basis of sharing net income or net loss, partnership net income or net loss is shared equally. In other words, if the partnership agreement is silent as to the manner in which net income or net loss is shared, the amount of net income or net loss is shared equally. The same basis of division is usually applied to both net income and net loss.

The following are typical schemes (plans) that may be used to share net income or net loss.

**1. A fixed ratio, expressed as a proportion (6:4, a percentage 60% and 40%) or a fraction (2/3 and 1/3**).

**Example**

Suppose that TR partnership has net income of Br. 30,000 for 2002. The partners Tesfa, and Rahel, agreed to share net income using a proportion of 6:4.

**Required**

a. Compute the share of net income for each partner.

b. Prepare the entry to record the share of net income.

**Solution**

a. Share of Net Income

 Tesfa = 30,00 X 6/10 = Br. 18,000

 Rahel = 30,000 X 4/10 = Br. 12,000

b. After the net income is shared between the partners, the share of each partner should be recorded in the capital account of each partner. This is done to increase the balance of the partner’s capital account. This entry is in essence, a closing entry and it is made as follows:

 Income summary……………………………………………. 30,000

 Tesfa, capital………………………………………………… 18,000

 Rahel, capital………………………………………………… 12,000

The capital account of each partner is credited for the share of net income. If the amount is net loss, the partner’s capital account is debited for the share. Income summary account is debited because share of partnership net income is closed after revenues and expenses are closed.

 That is, the following closing entries are made before net income or net loss is closed. These are:-

1. Debit each revenue account for its balance and credit income summary for total revenues.

ii. Debit income summary for total expenses and credit each expense account for its balance.

After entry No.( I) and entry No.( ii) are posted, income summary account may have debit or credit balance.

It will have credit balance if total revenues are greater than total expenses. Income summary account will have debit balance if total expenses are greater than total revenues. A debit balance in income summary account represents net loss.

Therefore, closing the share of net income/net loss by the partners is done after revenues and expenses are closed to income summary account.

2**. A ratio based on capital balances at the beginning of the period**.

Partners may agree to share income or loss on the ratio of their beginning capital balance.

To illustrate, suppose that R and S have beginning capital balances of Br. 45,000 and Br. 55,000 respectively. The net income of the partnership is Br. 20,000 for year 2002. Partners agreed to share income on the basis of capital balances at the beginning of 2002.

Based on the above data, the share of net income for each partner can be computed.

 a. Partners share income as follows:

 R = 45,000 X 20,000 = Br. 9,000
 100,000

 S = 55,000 X 20,000 = Br. 11,000

 100,000

The denominator 45,000/100,000 is obtained by adding beginning capital balances of all partners. In the example above, the denominator (Br. 100,000) is the sum of R capital and S capital. The numerator represents the beginning capital balance of the partner for whom we are computing the share of net income.

The entry to record the share of net income is shown below:

Income summary………………………………………………. 20,000

 S. Capital………………………………………………………………. 9,000

 R. Capital……………………………………………………………… 11,000

**3. Salaries to partners and the remainder on some basis**

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 salary allowance. The articles may also provide for withdrawals of cash by the partners in lieu (instead of) salary payments. Therefore, a clear distinction must be made between the division of net income (which is credited to the capital account) and payments to the partners (which are debited to the drawing accounts)

**Example**

Assume that the articles of partnership of Hanna and Sosina provide for monthly salary allowances of Br. 500 and Br. 600 respectively. The net income for the year is Br. 60,000. The remaining net income is divided equally.

**Required**

1. Compute the share of net income for each partner.
2. Prepare the entry to close the share of net income.

**Solution**

a. Annual Salary:

Hanna = 500 X 12 = Br. 6,000

Sosina = 600 X 12 = Br. 7,200

**Division of Net Income:**

|  |  |  |  |
| --- | --- | --- | --- |
|  | **Hanna**  | **Sosina**  |  **Total**  |
|  Salary allowance  | 6,000 | 7,2000 | 13,200 |
|  Remaining Income  | 23,400 | 23,400 | 46,800 |
|  Net Income  | 29,400 | 30,600 | 60,000 |

b. Closing entry:

 Income summary…………………………………………………. 60,000

 Hanna, capital……………………………………………………. 29,400

 Sosina, capital…………………………………………….……….. 30,600

**4. Interest on partner’s capital and the remainder on some basis.**

This scheme is used by the partners when one partner contributed large portion of capital than the other. In order to recognize differences in capital investments, interest may be allowed on capital as a means of dividing net income or net loss.

To illustrate, assume that Haile and Getachew have beginning capital balances of Br. 40,000 and Br. 70,000 respectively. The partnership agreement states that the partners are allowed interest at 10% on beginning capital balances. The remaining net income is to be shared equally. Assume further that the company generated net income of Br. 18,000 in the year.

 The division of income is shown below:

Interest allowances:

 Haile = 40,000 X 10% X 1= 4,000

 Getachew = 70,000 X 10% X 1 = 7,000

**Division of net income:**

|  |  |  |  |
| --- | --- | --- | --- |
|  |  **Haile**  | **Getachew** |  **Total**  |
| Interest allowance  | 4,000 | 7,000 |  11,000 |
| Remaining income  | 3,500 | 3,500 |  7,000 |
| Net income  | 7,500 | 10,500 |  18,000 |

 Closing entry for income division is presented below::

 Income summary………………………………………………….. 18,000

 Haile, capital…………………………………………………………..7,500

 Getachew, capital…………………………………………………….10,500

**5. Salaries to partners, interest on partners’ capital, and the remainder on some basis.**

Partners may agree that 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.

**Example**

Assume that Serkalem and Ayantu are partners in the SA partnership. The partnership agreement provides for:

* + Annual salary allowances of Br. 5,000 to Serkalem and Br. 9,000 to Ayantu.
	+ Interest allowances of 10% on capital balances at the beginning of the year.
	+ The remainder equally.

Capital balances on January 1 were Serkalem, Br. 24,000, and Ayantu, Br. 20,000. In 2002, partnership net income is Br. 25,000.

**Required**

1. Compute the division of net income
2. Prepare the entry to record the division of net income.

**Solution**

1. Interest allowances:

Serkalem = 24,000 X 10% = 2,400

Ayantu = 20,000 X 10% = 2,000

**Division of Net Income:**

|  |  |  |  |
| --- | --- | --- | --- |
|  |  **Serkalem**  |  **Ayantu**  |  **Total**  |
| Interest Allowance  | 2,400 | 2,000 | 4,400 |
| Salary Allowance  | 5,000 | 9,000 | 14,000 |
| Remaining Income  | 3,300 | 3,300 | 6,600 |
| Net Income  | 10,700 | 14,300 | 25,000 |

b. Closing entry:

 Income summary…………………………………. 25,000

 Serkalem, capital…………………………………………………10,700

 Ayantu, capital……………………………………………………14,300

Sometimes the sum of interest allowance and salary allowance may exceed the amount of net income. For example, consider the above example and assume that net income is Br. 15,000 instead of Br. 25,000. The net income will be shared as follows:

 **Division of Net Income**

|  |  |  |  |
| --- | --- | --- | --- |
|  |  **Serkalem** |  **Ayantu** |  **Total** |
| Interest allowance | 2,400 | 2,000 | 4,400 |
| Salary allowance  | 5,000 | 9,000 | 14,000 |
|  Total allowances  | 7,400 | 11,000 | 18,400 |
| Excess of allowances over income  | (1,700) | (1,700) | (3,400) |
| Net Income  | 5,700 | 9,300 | 15,000 |

**6. Equally**

If each of the partner is to contribute equal services and amounts of capital, an equal sharing in partnership net income would be equitable. That is, partners may agree to share income or loss equally.

**Example**

Suppose that Sara and Tsige have capital balance of Br. 50,000 each in the partnership of SATE partnership. Sara and Tsige have the same qualifications and contribute equal service to the company. The net income for the year is B r. 3,000. Compute the division of net income if they agreed to share income equally.

**Solution**

Division of net income:

Sara = 3000/2= 1,500

Tsige = 3000/2 = 1,500

6**. Income Sharing based on bonus to managing partner**

A specified percentage of income may be provided to the managing partner in the form of bonus. The partnership contract should state clearly whether the percentage is applied to net income before deducting bonus, or net income after bonus.

To illustrate, assume that A is a managing director in AB partnership which is owned by A and B . Net income for the year is Br. 40000. The partnership agreement states that net income is to be shared based on bonus and the remaining equally. The director is allowed 20% bonus.

If the percentage is applied to income after tax, the amount of bonus to A and income sharing is shown below:

Bonus = 40,000 ╳ 20% = 8000

 A B Total

Bonus 8,000 \_\_\_ 8,000

Remaining income 16,000 16,000 32,000

Net income 24,000 16,000 40,000

On the other hand, if the percentage is applied to net income before bonus, the amount of bonus is shown below:

Bonus + NI after bonus= Income before bonus

Let X = Net Income After bonus

0.20 ╳ + ╳ = 40,000

 1.20 ╳ = 40,000

 ╳ = 33,333

Bonus = 0.20 ╳ = 0.20 ╳ 33,333 = 6667

 A B Total

Bonus 6667 \_\_ 6667

Remaining income 16,666,50 16,666,50 33,333

Net income 23,333,50 16,666,50 40,000

**Check your progress 5-3**

1. Suppose that in a partnership of Sara and Mitiku, both partners have equal amount of capital investments. However, Sara gives more time and service to the partnership than Mitiku. Which income division scheme do you suggest to the partners?

2. A partnership of Tsefaye and Adane generated a net loss of Br. 20,000 in 2002. The partnership agreement states that income is to be divided on the basis of 60% to Tesfaye and 40% to Adane.

**Required**
 a. Compute the amount of net loss to be divided between the partners.

b. Prepare the entry to record the division of net loss.

3. On January 1, 2002, the capital balances of Nigat and Solomon are Br. 200,000 and Br. 300,000 respectively in NS partnership. During 2002, the company reported net income of Br. 60,000.

**Assumptions**

1. Partners agreed to share income 2/3 to Nigat and 1/3 to Solomon.
2. Partners agreed to share income on the basis of beginning capital balances.
3. The articles of partnership provides for monthly salary allowances of Br. 1,000 to Nigat and Br.800 to Solomon, and the remainder to be divided equally.
4. The articles of partnership provide interest allowance of 10% of beginning capital balance, and the remainder to be divided 30% to Nigat and 70% to Solomon.
5. The articles of partnership provide yearly salary allowance of Br. 15,000 to Nigat, and Br. 12,000 to Solomon; interest of 10% on beginning capital balance, and the remainder equally.
6. The partners agreed to share income or loss equally.

**Required**

Compute the division of income/loss to each partner under each of the above assumptions:

# Withdrawals in A Partnership

Withdrawal refers to the taking out of cash or other assets by the partner from the partnership. In a partnership, withdrawal may be made in lieu (instead) of salary allowances, and/or for personal purposes. Regardless of the purpose for which the asset is withdrawn, the partner’s drawing account is debited and the asset withdrawn is credited.

# Example

Assume that DB partnership is owned and operated by Demeke and Bekele. During the month, Bekele withdrew cash of Br. 3,000 from the partnership. Prepare the entry to record the withdrawal.

# Solution

The withdrawal is debited to Bekele’s drawing account, and credited to cash, i.e.

 Bekele, Drawing…………………………………….. 3,000

 Cash………………………………………………………. 3,000

Bekele, drawing account is a temporary capital account. As a result, it is closed to Bekele, capital at the end of the period. The closing entry is presented below:

Bekele, Capital………………………………………. 3,000

 Bekele, Drawing………………………………………… 3,000

Withdrawal decreases the balance of capital. Thus, Bekele’s capital is decreased by Br. 3,000 during the month.

**5.7 Financial Statements for a partnership**

The financial statements of a partnership are similar to those of a sole proprietorship. There are three financial statements for a partnership. These are income statement, capital statement (or statement of owner’s equity) and balance sheet.

The income statement of partnership similar with that of sole proprietorship except that the income statement of the partnership discloses the details of the division of net income. The following is the partial income statement of H and G partnership in which Haile and Getachew have capital balances of Br. 40,000 and Br. 70,000 respectively. The net income of the partnership for the year ended December 31, 2002 was Br. 18,000. The partnership agreement provided interest allowance of 10% on beginning capital balances and the remaining income to be shared equally.

**H and G partnership**

Partial Income Statement

**For the year ended December 31,2002**

Net Income………………………………………………………………………Br. 18,000

**Division of Net Income:**

|  |  |  |  |
| --- | --- | --- | --- |
|  | Haile  |  **Getachew**  | **Total**  |
| Interest allowance  | Br. 4,000 |  Br. 7,000 | Br. 11,000 |
| Remaining Income  |  3,500 |  3,500 |  7,000 |
| Net Income  | Br. 7,500 | Br. 10,500 | Br. 18,000 |

Therefore, the bottom part of income statement for a partnership includes the manner in which income or loss was divided.

The capital statement of the partnership is different from sole proprietorship in the sense that there are more than two owners in a partnership. Capital statement shows or explains the changes in each partner’s capital account and in total partnership capital during the year. Changes in capital results from three causes; namely, additional investments, drawing, and net income/net loss.

To exemplify, assume the data given for H and G partnership and consider the following additional information:

|  |  |  |
| --- | --- | --- |
|  |  **Haile**  |  **Getachew**  |
| Additional Investment  | Br. 15,000 | Br. 16,000 |
| Drawings | 8,000 | 7,500 |

The capital statement of H and G partnership is shown below:

H and G partnership

**Capital Statement**

### For the year ended December 31, 2002

|  |  |  |  |
| --- | --- | --- | --- |
|  |  **Haile**  | **Getachew**  | **Total**  |
| Capital, January 1  |  40,000 | 70,000 | 110,000 |
| Add: Additional Investment  | 15,000 | 16,000 | 31,000 |
|  Net Income  | 7,500 | 10,500 | 18,000 |
|  Sub total  | 62,500 | 96,500 | 159,000 |
| Less: Drawings | 8,000 | 7,500 | 15,500 |
| Capital, December 31 | 54,500 | 89,000 | 143,500 |

The sources of information for the preparation of capital statement are income statement, partner’s capital account, and drawing accounts.

The balance sheet for a partnership is the same as that of a sole proprietorship except in the owner’s equity section. In a partnership, the capital balances of each partner are shown in the balance sheet. The owner’s equity section for H and G partnership is shown in the following partial balance sheet.

## H and G partnership

Partial Balance Sheet

December 31,2002

|  |  |  |
| --- | --- | --- |
| Total Liabilities (assumed amount)  |  | Br. 75,000 |
| Owner’s equity (capital)  |  |  |
|  Haile, capital  | Br. 54,500 |  |
|  Getachew, capital  |   |  89,000 |
|  Total owner’s equity  |  |  143,500 |
|  Total liabilities and owner’s equity  |  Br. 21,500 |  |

### Check your progress 5-4

In the ABC Company, beginning capital balances on January 1,2003 are Abebe Br. 20,000, Bekele Br. 60,000 and Chala Br. 35,000. During the year, drawings were Abebe Br. 8,000, Bekele Br. 12,000, and Chala Br. 10,000. Net income was Br. 40,000. The partners share income in the ratio of 3:4:3.

### Required

1. Compute the division of net income.
2. Prepare capital statement for the year.
3. Prepare the owner’s equity section of the balance sheet at December 31, 2003.

**5.8 Partnership Dissolution**

Partnership type of organization is characterized by limited life. Any change in the members (ownership) results in the dissolution of the partnership. Factors that result in partnership dissolution are admission of new partner, withdrawal of the existing partner, death, or bankruptcy. The winding up of the affairs of the business does not necessarily follow dissolution of a partnership. When a partnership is dissolved, a new partnership may be formed and the new article of partnership should be prepared.

 The following section describes accounting for the dissolution of a partnership.

**5.8.1 Admission of a new partner**

An additional person may be admitted to a partnership enterprise only with the consent of all the current partners. The admission of a new partner results in the legal dissolution of the existing partnership, and the beginning of a new partnership. However, from an economic standpoint, the admission of a new partner (or partners) may be of minor significance in the continuity of the business.

A new partner may be admitted to a partnership in one of the following two ways. These are:-

1. Purchasing the interest of one or more existing partners.
2. Investing assets in the partnership.

**5.8.1.1 Admission of a partner by purchasing the existing partner’s interest**

The capital interest of the incoming partner is obtained from one or more of the current partners. The admission of a partner by purchase of an interest in the firm is a personal transaction between one or more of the existing partners and the new partner. Each party is acting as an individual separate from the partnership entity. The price paid is negotiated and determined by the individuals involved. In a purchase of an interest, the partnership is not a participant in the transaction. No cash is distributed from the partnership. The amount of the purchase price passes directly from the new partners to partners who are giving up part or all of their ownership claims. Upon purchase of an interest, the new partner acquired each selling partner’s capital interest, and income-sharing ratio is decided then.

Note that the selling partner does not have to obtain the approval of the other partners to sell his or her interest. However, some partnership acts may state that the purchaser does not become a partner until he/she is accepted into the firm by the continuing partners.

Accounting for the purchase of an interest is straightforward. The only entry needed in the records of the partnership is the transfer of the proper amounts of owner’s equity from the capital account of the selling partner to the capital account of the incoming (new) partner. That is, the capital account is debited for the ownership sold, and the capital account of the incoming partner is credited for the ownership obtained.

Note that the amount of cash paid to the selling partner may be greater, less than or equal to the ownership obtained. Regardless of the amount of payment, the capital accounts of the partners are recorded at the ownership received.

When a new partner is admitted to a partnership by purchasing ownership interest, the total assets and total capital of the partnership are not changed.

**Example**

Assume that Kassa and Tollera agreed to sell one third of their interest to Assefa. At the time of admission of Assefa, each partner has a Br. 48,000 capital balance. Assume that Assefa paid Br. 18,000 each to the selling partners for 1/3 interest acquired.

**Required**

1. Prepare the entry to record the admission of Assefa.
2. Compute the total capital of the partnership after admission.

**Solution**

a. Kassa, Captial (48,000 – 16,000) …………………………. 16,000

Tollera, Capital (48,000 X1/3)………………………………16,000

Assefa, capital (48,000 X 1/3 X 2)………………………………..32,000

b. Total Capital

Assefa, Capital…………………………………32,000

Kassa, Capital (48,000 – 16,000)………………32,000

Tolera, cpatial (48,000 – 16,000)………………32,000

Total capital……………………………………96,000

Note that the total capital of the partnership before the admission (48,000 + 48,000 = Br. 96,000) is the same as after the admission of Assefa (Br. 96,000). Assefa’s ownership interest is one-third of the selling partner capital balance (Br. 16,000) regardless of the amount of cash he paid. In the foregoing example, Assefa paid Br. 18,000 to get ownership interest of Br. 16,000. The entry is the same whether the amount Assefa paid to the selling partner is equal to, greater than, or less than Br. 16,000. This implies that the amount paid by the buyer has no effect on the entry when the new partner is admitted to a partnership by purchasing the ownership interest from one or more of the existing partners.

**5.8.1.2 Admission by investment of assets in a partnership**

Instead of buying an interest from the current partners, the incoming partner may contribute (or invest) assets to the partnership. The admission of a new partner by an investment of assets is a transaction between the new partner and the partnership. In this case, the transaction increases both the assets and capital of the partnership. The investment by the new partner may be cash, equipment, furniture, automobile, or other asset. The market value of the asset contributed to the partnership is debited to the appropriate asset account and credited to capital account of the new partner.

**Example**

Assume that Demere and Adugna are partners with capital balances of Br. 40,000 and Br. 55,000 respectively. On December 1, 2003, they agreed to admit Bulcha for cash investment of Br. 30,000, for which he is to receive ownership equity of Br. 30,000.

**Required**

* 1. Compute total capital of the partnership before Bulcha’s admission.
	2. Prepare the entry to record Bulcha’s admission.
	3. Determine total capital of the partnership after admission.

**Solution**

1. Total capital before Bulcha’s admission:

 Demere, capital…………………………………. Br. 40,000

 Adugna, capital…………………………………. 55,000

 Total capital…………………………… Br. 95,000

2. Entry to record Bulcha’s admission is:

 Cash……………………………………….30,000

 Bulcha, capital……………………………. 30,000

3. Total partnership capital after Bulcha’s admission:

 Demere, capital……………………………………. Br. 40,000

 Adugna, capital……………………………………. 55,000

 Bulcha, capital…………………………………….. 30,000

 Total capital……………………………… Br. 125,000

Note that Bulcha’s cash investment of Br. 30,000 increases the total capital of the partnership by Br. 30,000 (i.e. 125,000 – 95,000 = 30,000). Total assets of the partnership are also increased by Br. 30,000. Due to this transaction, the capital balances of the existing partners are not affected.

At the time of admitting new partner by investing assets, the partnership assets should be stated in terms of their current market values. If the partnership assets are not fairly stated at their current market value, the capital accounts of the old partners should be adjusted accordingly. The net increases or decreases in assets of old partnership due to revaluation should be allocated to old partners capital accounts according to their income-sharing ratio. It is only then that the investment of new partner should be recorded.

**Example**

Assume that Adanech and Tigist are partners with capital balances of Br. 70,000 and Br. 50,000 respectively. On December 1,2003, they agreed to admit Kidist for cash contribution of Br. 40,000, for which she is to receive an ownership equity of Br. 40,000. Assume that the balance of equipment account had been Br. 90,000 before Kidist’s admission and its current market value is Br. 110,000. Adanech and Tigist share income equally.

**Required**

1. Determine total capital of the partnership before revaluation.
2. Prepare the entry to record the revaluation of equipment.
3. Compute the capital balance of each partner after revaluation, but before Kidist’s admission.
4. Prepare the entry to record the admission of Kidist.
5. Determine the partnership’s total capital after the admission of Kidist.

**Solution**

a. Total capital before revaluation

 Adanech, capital…………………………………………………….. Br. 70,000

 Tigist, capital……………………………………………………….. 50,000

 Total capital………………………………………………. Br. 120,000

b. The entry to record asset revaluation:

 Increase in equipment value = 110,000 – 90,000 = 20,000

 Share of increase in value of equipment between old partners.

 Adanech = 20,000/2 = 10,000

 Tigist = 20,000/2 = 10,000

**Entry**

Equipment ……………………………………………………..20,000

 Adanech, capital………………………………………….. 10,000

 Tigist, capital……………………………………………… 10,000

If a number of assets are revalued, the adjustments may be debited to a temporary account called Asset Revaluation. After all adjusting entries are made, the account is closed to the capital accounts. For the ongoing example, if assets revaluation account is used, the adjusting entry and closing entry are made as follows:

**Adjusting entry**

Equipment………………………………………………….20,000

 Asset Revaluation………………………………………… 20,000

**Closing Entry**

Asset Revaluation………………………………………….20,000

 Adanech, capital………………………………………… 10,000

 Tigist, capital……………………………………………. 10,000

If the current market value of the asset is less than its book value, adjusting entry debits old partners capital accounts and credits the asset account (if asset revaluation is not used).

1. Old partners capital balance after revaluation:

Adanech, capital (70,000 + 10,000)…………………….. Br. 80,000

 Tigist, capital (50,000 + 10,000)……………………….. 60,000

 Total capital……………………………………………. Br. 140,000

1. The entry to record Kidist’s admission:

Cash……………………………………… 40,000

 Kidist, capital…………………………………. 40,000

1. Total capital after admission:

Adanech, capital……………………………………….. Br. 80,000

Tigist, capital………………………………………….. 60,000

Kidist, capital………………………………………….. 40,000

 Total capital………………………………….. Br. 180,000

Note that the partnership capital is increased by Br. 60,000. Also note that Kidist;s interest in the partnership is 22% (i.e. 40,000/180,000 = 22%). This does not mean that Kidist will share 22% of the income of the partnership. It may or may not be equal to the 22% capital interest. Since the new partnership agreement will be written, a new income-sharing ratio will be agreed upon.

In the case of admission by the investment, further complications occur when the new partner’s investment differs from the capital equity acquired. When those amounts are not the same, the difference is considered the bonus either to (1) the existing (old) partners or (2) the new partner.

**Bonus to old partners**

The existing partners may be unwilling to admit a new partner without receiving a bonus for both personal and business reasons. In an established firm, existing partners may insist on a bonus as compensation for the personal scarifies they have made for the company over the years. Two accounting related factors underline the business reason. These are:

1. Total capital of the partnership equals the book value of the recorded assets of the partnership. At the time the new partner is admitted, the fair market values of assets such as land and building may be higher than their book values.
2. When the partnership has been profitable, goodwill exist.

In such cases, the new partner is usually willing to pay the bonus to become a partner. A bonus to old partners results when the new partner’s capital credit (acquired ownership interest) on the date of admittance is less than her/his investment in the firm. The bonus results in an increase in the capital balances of the old partners. The bonus is allocated to them on the basis of income sharing ratio before the admission of the new partner.

The procedures for determining the ownership of the new partner and the bonus to the old partners are described below:

Step 1: Determine the total capital of the new partnership by adding the new partner’s investment to the total capital of the old partnership.

Step 2: Determine the new partner’s ownership interest by multiplying the total capital of the new partnership by the new partner’s ownership interest percentage.

Step 3: Determine the amount of bonus

 New partner’s investment………………………………………………….. xxx

 Less: new partner’s ownership interest…………………………………… xxx

 Amount of Bonus…………………………………………………………. xxx

Step 4: Allocate the bonus to the old partners on the basis of their income-sharing ratio.

**Example**

Assume that Hawi and Melat have capital balances of Br. 100,000 and Br. 120,000 respectively in HAME partnership. Naol acquires a 25% ownership (capital) interest by making cash investment of Br. 90,000 in the partnership. According to partnership agreement, Hawi and Melat share income as follows: Hawi, 60%, and Melat, 40%.

**Required**

1. Compute:

1. The total capital of the new partnership.
2. The ownership interest of Naol.
3. The amount of bonus to old partners.
4. The share of bonus by old partners.

2. Prepare the entry to record the admission of Naol.

**Solution**

1) (a). Total capital of new partnership before bonus:

 Hawi, capital………………………………………. Br. 100,000

 Melat, capital……………………………………… 120,000

 Naol’s investment………………………………… 90,000

 Total ……………………………………. Br. 310,000

 (b). Naol’s ownership interest = 310,000 X 25% = Br. 77,500

 ( c). Bonus = Naol’s investment – Naol’s capital (ownership interest)

 = 90,000 – 77,500

 = 12,500

 (d). Share of bonus:

 Hawi = 12,500 X 60% = Br. 7,500

 Melat = 12,500 X 40% = 5,000

2) The entry to record the admission of Naol:

 Cash………………………………………………… 90,000

 Hawi, capital……………………………………….. 7,500

 Melat, capital……………………………………….. 5,000

 Naol, capital…………………………………………. 77,500

Some organizations refer to record the amount of bonus as goodwill. If this procedure is followed, the required entries are made as follows:

1. To record goodwill:

Goodwill………………………………………………….. 12,500

 Hawi, capital…………………………………………………. 7,500

 Melat, capital………………………………………………… 5,000

1. To record Naol’s admission:

Cash …………………………………………………………90,000

 Naol, capital………………………………………………… 90,000

**Bonus to new partner**

If a partnership admits a new partner who is expected to improve the fortunes of the firm, old partners may agree to give a bonus to new partner. In other words, the new partner possesses resources or special attributes that are desired by the partnership. A bonus to a new partner results when the new partner’s ownership equity is greater than his/her investment of assets in the firm. For example, when bank interest rates are high, the new partner may be able to supply cash that is urgently needed for expansion or to meet maturing debt. Alternatively, the new partner may be a recognized expert or authority in a relevant field. For example, an engineering firm may be willing to give known engineers a bonus to join the firm.

Similarly, the partner of a sporting goods store may offer a bonus to a spots celebrity in order to add the athlet’s name to the partnership name.

**Example**

Assume that Helen invests Br. 60,000 in cash for a 30% ownership interest in the Hanna and Hawi partnership, in which the capital balances of Hanna and Hawi are Br.90,000 and Br. 120,000 respectively. The old partners share income equally.

**Required**

1. Compute Helen’s capital
2. Prepare the entry to record the admission of Helen.

**Solution**

1. Helen’s capital:

Total capital of new partnership = 90,000 + 120,000 + 60,000 = 270,000

Helen’s equity = 270,000 x 30% = 81,000

1. Bonus to Helen = 81,000 – 60,000 = Br. 21,000

Allocation of Bonus:

 Hanna = 21,000/2 = 10,500

 Hawi = 21,000/2 = 10,500

**Entry**

Cash………………………………………………………………..…. 60,000

Hanna, capital………………………………………………………… 10,500

Hawi, capital…………………………………………………………. 10,500

 Helen, capital……………………………………………………..….. 81,000

**Check your progress 5-5**

1. Assume that Hanna, Hawi, and Helen share income on a 5:3:2 basis. They have capital balances of Br. 32,000 Br. 24,000, and Br. 21,000 respectively. When Tigist is admitted to the partnership.

**Required:**

Prepare the entry to record the admission of Tigist under each of the following independent assumptions:

1. Purchased one half of Hana’s equity for Br. 18,000.
2. Purchased one-half of Hawi’s equity for Br. 10,000.
3. Purchased one-half o Helen’s equity for Br. 9,000.

2. Assume that Gelena and Lemmesa share income on a 6:4 basis. They have capital balances of Br. 90,000 and Br. 70,000 respectively, when Bacha is admitted to the partnership.

**Required:** prepared the entry to record the admission of Bacha under each of the following independent assumptions:

* + 1. Investment of Br. 80,000 cash for a one-fourth ownership interest with bonuses to the existing partners.
		2. Investment of Br. 40,000 cash for a one-fourth ownership interest with a bonus to the new partner.

**5.8.2 Withdrawal of a partner**

A partner may withdraw from a partnership voluntarily by selling his/her equity in the firm, or involuntarily by reaching mandatory retirement age or dying. Like the admission of a partner, the withdrawal of a partner legally dissolves the partnership. The legal effects may be recognized in accounting for a withdrawal by dissolving the firm. However, it is customary to record only the economic effects. The partnership agreement should specify the terms of the withdrawal.

The withdrawal of a partner may be accomplished in two ways. These are:-

1. Selling to one or more of the remaining partners.
2. Payment from partnership assets.

Each of these ways of withdrawal will be explained in the following section.

**5.8.2.1 Withdrawing by selling to one or more of the remaining partners**

In this type of withdrawal, the withdrawing partner sells his/her ownership equity to one or more of the existing partners. Payment is made to the withdrawing partner from the personal assets of the buying partners, and not from partnership assets. The withdrawal of a partner when payment is made from partner’s personal assets is the direct opposite of admitting a new partner who purchases a partner’s interest. This transaction is a personal transaction between the partners. Partnership assets are not involved in the withdrawal of the partner. As a result, the total assets and total capital of the partnership are not changed. A change occurs only in individual partner’s capital account. The required accounting entry debits the equity of the withdrawing partners, and the capital account(s) of the buying partner(s). The amount received by the withdrawing partner does not affect the entry. Whether the amount of cash received by the withdrawing partner is equal to, less than, or greater than his/her ownership equity, the entry is the same. The entry required to record the withdrawal is made after all assets are revalued to reflect their current market value.

**Example**

Assume that Tsige, Kebede, and Tulu have capital balances of Br. 50,000, Br. 60,000, and Br. 45,000 respectively. Assume further that Kebede decides to withdraw from the partnership, and Tsige and Tulu agree to buy Kebede’s ownership equity. Each of them agreed to pay Kebede Br. 35,000 in exchange for one-half of Kebede’s ownership interest of Br. 60,000.

**Required**

1. Compute the total capital before Kebede’s withdrawal
2. Prepare the entry to record Kebede’s withdrawal
3. Determine the capital balance of each partner and total capital after Kebede’s withdrawal.

**Solution**

1. Total capital before withdrawal:

Tsige, capital…………………………………………. Br. 50,000

Kebede, capital……………………………………….. 60,000

Tulu, capital………………………………………….. 45,000

Total capital………………………………………….. Br. 155,000

1. The entry to record the withdrawal:

Kebede, capital……………………………………… 60,000

 Tsige, capital………………………………. 30,000

 Tulu, capital……………………………….. 30,000

1. Capital balance of each partner and total capital after withdrawal:

Tsige, capital (50,000 + 30,000) ……………………. Br. 80,000

Tulu, capital (45,000 + 30,000)……………………… 75,000

Total capital…………………………………………. Br. 155,000

Note that the total capital of the partnership remains the same at Br. 155,000. Note also that the Br. 70,000 paid to Kebede is not recorded. Similarly, Tsige capital is credited only for Br. 30,000, not the Br. 35,000 she paid. Tsige and Tulu will sign new articles of partnership.

**5.8.2.2 Payment from Partnership assets to the Withdrawing partner**

Using partnership assets to pay for a withdrawing partner’s equity is the reverse of admitting a new partner through investment of assets in the partnership. Payment from partnership assets is a transaction that involves the partnership. Thus, both total assets and total capital of the partnership are decreased. The withdrawing partner will be settled with the amount equal to his/her capital balance. This capital balance is determined by revaluing the current market value of the assets. This is the case when the fair market values of the assets at the time of the partner’s withdrawal are different from the recorded value of these assets. Any difference between the current market value and book value of the assets should be divided between (among) the partners’ capital accounts and adjusting entry is made accordingly.

**Example**

Assume that Tigist, Tesfa, and Meseret have capital balances of Br. 20,000 Br. 18,000, and Br. 26,000 respectively at the time Tigist decided to withdraw. At the same time, merchandise inventory with a book value of Br. 5,000 has market value of Br. 7,000. The partnership has paid Tigist’s interests after adjusting for the difference in merchandise inventory value. The partners share income on 5:3:2 basis.

**Required**

* 1. Prepare adjusting entry to revalue merchandise inventory.
	2. Compute each partner’s capital balance.
	3. Prepare the entry to record the withdrawal of Tigist.

**Solution**

1. Merchandise inventory………………………………………….. 2,000

 Tigist, capital (2000 X 5/10)………………………………………… 1,000

 Tesfa, capital (2000 X 3/10)…………………………………………. 600

 Meseret, capital (2000 X 2/10)………………………………………. 400

2. Partners’ capital balances:

 Tigist, capital (20,000 + 1,000)………………………21,000

 Tesfa, capital (18,000 + 600)………………………18,600

 Meseret, capital (18,000 + 400)…………………… 18,400

 Total capital…………………………….. 58000

3. The entry to record Tigist’s withdrawal:

 Tigist, capital……………………………………. 21,000

 Cash………………………………………………… 21,000

After Tigist’s withdrawal, total capital of the partnership is equal to Br. 45,000 (i.e. 18,600 + 26,400 = 45,000)

**Check your progress 5-6**

1. Lemma, Amare, and Getu have capital balances of Br. 32,000, Br. 38,000 and Br. 36,000 respectively, and their income sharing ratios are 5:2:3. Amare withdraws from the partnership under each of the following independent assumptions:
	1. Lemma and Getu agree to purchase Amare’s equity by paying Br. 20,000 each from their personal assets. Each purchaser received 50% of Amare’s equity.
	2. Lemma agrees to purchase all of Amare’s equity by paying B r. 42,000 cash from his personal assets.
	3. Getu agrees to purchase all of Amare’s equity by paying Br. 36,000 cash from his personal assets.

**Required**

Prepare the entry to record the withdrawal of Amare under each of the above independent assumption.

2. Assume that Solomon has a capital balance of Br. 45,000 ion S-K-L partnership. He decided to withdraw from the partnership. The partnership agreed to settle Solomon’s ownership equity from its assets.

**Required**

Prepare the entry to record the withdrawal of Solomon.

**5.8.3 Death of a Partner**

The death of a partner dissolves a partnership. When a partner dies it is necessary to determine the partner’s at the date of death. This is done by:

1. Determining the net income or net loss for the fractional part of a year.
2. Closing the accounts.
3. Preparing financial statements.

Then the balance in the capital account of the deceased partner is transferred to a liability account with the deceased’s estate. The surviving partners may continue the business or the affairs may be wound up. The ownership equity is paid to the deceased person’s heir (s).

**Example**

Assume that XYZ partnership has three partners; namely X,Y & Z. Their capital balances on January 1, 2003, the beginning of the fiscal period, are X Br. 12,000, Y Br. 15,000 and 2 Br. 19,000. Partner Y has died on August 30, 2003. Net income for the period between January 1 and August 30,2003 is Br. 8,000. The partners agreed to share income on 4:4:2. Y’s legal heir is W.

**Required**

1. Compute the share of net income on August 30.
2. Prepare the entry to record the division of net income.
3. Determine each partner’s capital balance.
4. If W decides to take the ownership equity of Y from the partnership, prepare the entry to record the payment to W.
5. If W decides to join the partnership in place of Y, prepare the entry to record the admission of W.

**Solution**

1. Division of Net Income:

X = 8,000 X 4/10 = 3,200

Y = 8,000 X 4/10 = 3,200

Z = 8,000 X 2/10 = 1,600

2. Entry to record the division of net income:

Income summary…………………………………… 8,000

 X, capital………………………………………… 3,200

 Y, capital………………………………………… 3,200

 Z, capital………………………………………… 1,600

3. Partner’s capital balances:

 X, capital = 12,000 + 3,200 = 15,200

 Y, capital = 15,000 + 3,200 = 18,200

 Z, capital = 19,000 + 1,600 = 20,600

4. Y, capital …………………………………… 18,200

 Cash……………………………………………….. 18,200

5. Y, capital…………………………………….. 18,200

 W, Capital………………………………………… 18,200

**5.9 summary**

A partnership form of organization is owned and operated by two or more persons for the purpose of profit. It is characterized by limited life, unlimited liabilities, mutual agency, non taxability and so on.

Partnership agreement may be in writing, orally, or impliedly. It is generally believed that partnership agreement should be in writing to avoid minimize potential conflict between the partners.

There are four unique (peculiar) transactions for partnership, namely, partnership formation, division of net income, or net loss, partnership dissolution, and partnership liquidation, the first three are dealt with in this chapter, and partnership liquidation will be addressed in unit six.

The possible means of sharing net income or net loss of the partnership are equally, based on some fixed rations, based the services of the partners, based the partners’ capital investments of the partnership liquidation may result due to admission of new partner, withdrawal of partner, death of partner etc.

A new partner may be admitted to a partnership either by purchasing ownership interest from one or more of the existing partners, or by investing assets into the partnership. On the other hand, withdrawal of a partner may take either by selling the ownership interest to one or more of the remaining partners, or by obtaining payment from the partnership.

**5.10 answeR to check your progress exercises**

**Check your progress 5-1**

1. I do not agree. A partnership should have at least two partners.
2. Partner.
3. Limited life, Association of individuals, unlimited liabilities, mutual agency, nontaxable entity, and co-ownership of property.
4. General partnership and limited partnership

**Check your progress 5-2**

1. At fair market value
2. Partnership formation, income distribution, dissolution, and liquidation
3. Bacha’s Investment

Cash……………………………………………………….20,000

Bacha, capital…………………………………………….20,000

 Chaltu’s Investment

Cash………………………………………………………15,000

Equipment………………………………………………….4,500

Chaltu, capital…………………………………………..19,500

**Check your progress 5-3**

1. The one that considers salary allowance

**2.**

**a.** Share of net loss**:**

Tesfaye = 20,000 X 60%= 12,000 **?????**

Adane = 20,000 X 40% = 8,000

 **b.** Tesfaye, capital……………………………………..12,000

Adane, capital……………………………………… 8,000

Income summary…………………………………..20,000

3.

* 1. Nigat = 2/3 X 60,000 = 40,000

Solomon = 1/3 x 60,000 = 20,000

* 1. Nigat = 200,000/500,000 X 60,000 = 24,000

Solomon = 300,000/500,000 X 60,000 = 36,000

* 1. Salary allowances:

Nigat = 1,000 X 12 = 12,000

Solomon = 800 X 12 = 9,600

|  |  |  |  |
| --- | --- | --- | --- |
|  |  **Nigat**  |  **Solomon** |  **Total** |
| Salary allowance  | 12000 | 9600 | 21600 |
| Remaining income  | 19200 | 19200 | 38400 |
| Net income  | 31200 | 28800 | 60000 |

**d) Interest allowances:**

Nigat = 200,000 X 10% = 20,000

Solomon = 300,000 X 10% = 30,000

Total ………………… 50,000

Remaining income = 60,000 – 50,000 = 10,000

Nigat = 10,000 X 30% = 3,000

Solomon = 10,000 X 70% = 7,000

Division of income to:

Nigat = 20,000 + 3,000 = 23,000

Solomon = 3,000 + 7,000 = 37,000

**e)**

|  |  |  |  |
| --- | --- | --- | --- |
|  |  **Nigat**  |  **Solomon** |  **Total** |
| Salary allowance  | 15,000 | 12,000 | 27,000 |
| Interest allowance  | 20,000 | 30,000 | 50,000 |
| Total  | 35,000 | 42,000 | 77,000 |
| Excess of allowances over  |  |  |  |
| Income  | (8,500) | (8,500) | (17,000) |
| Net income  | 26,500 | 33,500 |  60,000 |

**f. Division of income**

Nigat = 60,000/2 = 30,000

Solomon = 60,000 X ½ = 30,000

**Check your progress 5-4**

(a) Division of net income:

Abebe = 40,000 X 3/10 =12,000

Bekele = 40,000 X 4/10 = 16,000

Chala = 40,000 X 3/10 = 12,000

(b)

**ABC Company**

**Capital Statement**

**For the year ended December 31, 2003**

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
|  |  **Abebe**  |  **Bekele**  |  **Chala**  | **Total** |
| Capital, January 1 | 20,000 | 60,000 | 35,000 | 115,000 |
| Add: Net income  | 12,000 | 16,000 | 12,000 | 40,000 |
| Sub total  | 32,000 | 76,000 | 47,000 | 155,000 |
| Ded: Drawings  | 8,000 | 12,000 | 10,000 | 30,000 |
| Capital, December 31  | 24,000 | 64,000 | 37,000 | 125,000 |

**ABC Company**

**Balance Sheet (partial)**

**December 31,2003**

|  |  |
| --- | --- |
| **Owner’s Equity:** |  |
|  Abebe, capital | 24,000 |
|  Bekele, capital | 64,000 |
|  Chala, capital | 37,000 |
|  Total capital  | 125,000 |

**Check your progress 5-5**

1. a) Hanna, capital (32,000 X ½ ) ……………………..16,000

 Tigist, capital……………………………………..………..16,000

 b) Hawi, capital (24,000 X ½) ………………………….12,000

Tigist, capital…………………………………….………..12,000

 c) Helen, capital (21,000 X ½) ………………………….10,500

Tigist, capital…………………………………….………..10,500

2. a) Bonus to existing partners:

Total capital (90,000 + 70,000 + 80,000)………..………240,000

Bacha’s equity = 240,000/4 = 60,000

Bonus = 80,000 – 60,000 = 20,000

Share of bonus by the existing partners:

Gelana = 20,000 X 6/10 = 12,000

Lemessa = 20,000 X 4/10 = 8,000

**Entry**

Cash………………………………………………….80,000

Bacha, capital…………………………………………….60,000

Gelana, capital……………………………………………12,000

Lemmessa, capital……………………………………….. 8,000

b) Bonus to Bacha:

Total capital = 90,000 + 70,000 + 40,000 = 200,000

Bacha’s equity = 200,000 X ¼ = 50,000

Bonus to Bacha = 50,000 – 40,000 = 10,000

**Entry**

Cash…………………………………………………40,000

Gelana, capital (10,000 X 6/10)…………………….. 6,000

Lemmessa, capital (10,000 X 4/10)…………………. 4,000

Bacha, capital……………………………………………50,000

**Check your progress 5-6**

1. a) Amare, capital………………………………….38,000

 Lemma, capital…………………………………………19,000

Getu, capital……………………………………………19,000

b) Amare, capital…………………………………..38,000

Lemma, capital…………………………………………38,000

c) Amare, capital…………………………………..38,000

Getu, capital……………………………………………38,000

2. Solomon, capital………………………………….45,000

Cash……………………………………………………45,000