# UNIT 8. ACCOUNTING FOR PARTNERSHIPS

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1. **AIMS AND OBJECTIVES**

The unit aims at discussing the accounting for partnerships such as recording investments, computing each partner’s share of income or losses using different techniques, and recording them to the respective capital accounts. Also, the accounting implications of dissolution and liquidation of a partnership will be described. Having studied and worked through this chapter you would be able to:

* define partnerships and explain their characteristics.
* describe the advantages and disadvantages of a partnership
* record the investments made by the partners in forming a partnership.
* understand and apply the various methods of dividing the income or lass of a partnership.
* Record the admission and withdrawal of a partner(s)
* Understand and apply the steps in the liquidation of a partnership.

**8.1 INTRODUCTION**

In your previous course you have studied the three most dominant forms of business organization: sole proprietorship, partnership, and corporation. For accounting purposes, each form should be viewed as an economic unit separate from its owners, though legally only the corporation is considered separate from its owners. In the previous section you have also studied the basic accounting principles and practices used in accounting for a sole proprietorship form of business organization. The accounting for corporate form of businesses will be explained in the next unit. Therefore, the main focus of this chapter is to acquaint the learns with the basics of accounting for partnerships. As will be explained later in this section, the same accounting principles that are used in accounting for a sole proprietorship are applied in partnership form of businesses. However, there are accounting practices that are unique to partnerships. These unique accounting features relate to the partners’ capital and drawing accounts, division of income (or loss), and changes in ownership of the partnership.

* 1. **PARTNERSHIPS AND THEIR CHARACTERSTICS**

A partnership is an association of two or more persons to carry-on as co-owners of a business for profit. This association is based on a partnership agreement or contract known as the ***articles of a partnership***.

The partnership agreement should specify the name location, and purpose of the business; the capital contributions and duties of each partner; the methods of income and loss division; the rights of each partner upon liquidation (winding up) of a partnership, etc.

The partnership agreement should be in writing to avoid any misunderstandings about the formation, operation, and liquidation of a partnership.

### Characteristics of a partnership

For purposes of accounting, partnerships are treated as separate economic entities. The next paragraphs describe some of the important features of a partnership.

## *A) Voluntary Association*

A partnership is a voluntary association of individuals rather than a legal entity in itself. Therefore, a partner is responsible under the law for his or her partner’s business actions with in the scope of the partnership. A partner also has unlimited liability for the debts of the partnership. Because of these potential liabilities, an individual must be allowed to choose the people who join the partnership.

### *B) Limited Life*

Because a partnership is formed by the consent of two or more partners, it has a limited life. This means that, anything that ends the contract dissolves the partnership.

A partnership can be dissolved when (1) a new partner is admitted; (2) a partner withdraws, retires, dies or becomes bankrupt. At this point, the remaining partners should sign a new contractual agreement to continue the affairs of the business. In place of the old partnership a new partnership is formed. Thus, a partnership is said to have a limited life.

### *C) Unlimited Liability*

Each partner is liable for all the debts of the partnership. When and if the partnership fails to pay its debts, creditors can seize (take) each partner’s personal assets to satisfy their claims. Therefore, partnerships creditors claims are not limited to the assets of the business, but is extends to the personal property of the partners. Each partner, then, could be required by law to pay all the obligations (debts) of the partnership.

Suppose, for example, the liabilities of ABC company (a partnership business) as of a certain date is birr 600,000, however, the total properties (assets) of ABC company could only be sold for birr 450,000. Thus, to settle creditors claims fully, the house or personal assets of the partners may have to be sold.

### *D) Mutual Agency*

Each partner is an agent of the partnership within the scope of the business. This means that partner’s act to any contract is binding on the remaining partners as long as it is with in the apparent scope of the business’ operations.

For example, a partner in a public accounting firm can bind the partnership through the delivery of accounting services. redundent. But this partner cannot bind the partnership to a contract for delivering (or providing) cars because it is out of the scope of the business.

***E) Co ownership of partnership property***

Once invested, the properties contributed by the partners become the property of the partnership and is owned jointly by all the partners. Upon liquidation of the partnership and distribution of assets, the partner’s claim on the assets is measured by the amount of the balance in his/her capital account.

**8.3 Advantages and disadvantages of partnership**

**Advantages:**

A partnership form of business ownership has the following advantages:

1. Easy and inexpensive to form than a corporation. A partnership is easy to form. It only requires the consent of two or more parties. Two or more competent persons simply agree to be partners in some common business purpose.
2. Advantageous to raise a large amount of capital and managerial skill (talent) than a sole proprietorship. Because a partnership is formed by two or more persons, it is possible to raise a large amount of capital and managerial skill than a single owner.
3. Not subject to separate taxation as a case in a corporation because each partner reports his/her own share of partnership income and is individually taxed, and
4. Not required to observe on many restrictive laws unlike a corporation.

#### Disadvantages

Partnership has the following disadvantages:

1. Partners assume unlimited liability. The liability of the partners is not limited to what they have in the partnership, but it goes to the extent of their personal properties (assets).
2. Disadvantageous if each partner does not exercise his/her good judgment because one partner’s act can bind a partnership into a contract.
3. Limited life. Partnerships are subject to possible termination due to many uncontrollable circumstances such as the death of a partner.
4. The transfer of ownership from one partner to another person is difficult unless the remaining partners approve of this

**8.4 RECORDING THE FORMATION OF A PARTNERSHIP**

A separate capital account is maintained for each partner in a partnership. Each partner’s capital account is credited for the value of their investment upon formation of the partnership.

### *Illustration*

Dr. Teklay and Dr.Mamo decided to form a partnership business, which would provide medical services. They have been in business separately before they form the partnership. The partnership assumed the liabilities of their separate business. The assets were valued and recorded at their current fair market value.

Shown below are the assets contributed and the liabilities assumed by the partnership at their fair market value.

 ***Dr. Teklay******Dr. Mamo***

Cash Birr 6.500 Cash Birr 3,300

Accounts Receivable 8,600 Accounts Receivable 4,300

Supplies 21,000 Supplies 12,000

Medical Equipment 3,000 Medical Equipment 150,000

Accounts Payable (2,300) Accounts Payable (3,200)

The journal entry on January 1, 2002 to record the investment of each partner and the formation of the partnership would be:

2002, Jan.1. Cash 6,500

 A/R 8,600

 Supplies 21,000

 Medical Equipment 3,000

 A/p 2,300

 Teklay Capital 36,800

 2002, Jan.1. Cash 3,300

 A/R 4,300

 Supplies 12,000

 Building 150,000

 Accounts Payable 3,200

 Mamo, Capital 166,400

**Check Your Progress Exercise - 1**

1. On February 2, 2oo2, Dr. Teklay and Dr. Mamo made additional investments of cash Birr 4,200 and 4300 respectively. Show the entry to record the investments by the owners.

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1. What is the meaning of unlimited liability when applied to a partnership?

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1. What characteristics of a partnership could be interpreted as disadvantages?

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**8.5 DIVISION OF PARTNERSHIP INCOME AND LOSSES**

A partnership’s income and losses can be distributed according to whatever method the partners specifies in the partnership agreement. The agreement should be specific and clear, to avoid later disputes.

If a partnership agreement does not mention the distribution of income and losses, the law requires that they be shared equally by all partners. Also, if a partnership agreement specifies only the distribution of income, but is silent as to losses, the law requires that losses be distributed in the same ratio as income.

The Income of a partnership normally has three components:

1. return to the partners for the use of their capital – called interest on partners’ capital,
2. compensation for direct services the partners have rendered – called partners’ salaries, and
3. other income for any special characteristics individual partners may bring to the partnership or risks they may take.

The breakdown of total income into its three components helps clarify how much each partner has contributed to the firm.

Income can be shared among the partners in one of the following ways:

1. Net income divided in a stated ratio such as:
	1. equally
	2. agreed upon ratio (other than equally)
	3. ratio based on beginning capital balances
2. Net Income divided by allowing interest on the capital investments, salaries, or both with the remaining net income divided in an agreed ratio.

### *Example*

Assume that Dr. Teklay and Dr. Mamo partnership had a net income of Birr 60,000

1. A. Assume that the articles of a partnership provides equal share of Net Income or

 Loss.

- In this case the capital accounts of each partner will be credited for Birr. 30,000

Income Summary-------------------------------60,000

 Dr. Teklay capital-----------------------------------30,000

 Dr. Mamo capital------------------------------------30,000

 B. Net income is divided in ratio of 3.2 to Dr. teklay and Dr. Mamo respectively.

- Income summary-------------------------------------60,000

 Dr. Teklay capital (3/5 X 60,000) --------------------------36,000

 Dr. Mamo capital (2/5 X 60,000) ---------------------------24,000

C. Net income is divided in a ratio of partners’ capital account balances at the beginning

 of the fiscal period.

Income summary ------------------------------- 60,000

Dr. Teklay capital  -----------------------------10,860

Dr. Mamo capital  ------------------------------ 49,134

* 36800 + 166400 = 203200

2. Net income is divided by allowing 5% interest on their beginning capital balances, a

 salary of Birr. 5,000 to Dr. Teklay and the remainder is divide equally.

### *Net Income Division*

 Income to be

 Dr. Teklay Dr.Mamo Total Distributed

Net income Birr, 60,000

Interest (5%) 1,840 8,320 10,160 49,840

Salary 5,000 -- 5,000 44,840

Remainder 22,420 22,420 44,840 -- 0 –

 Distribution 29,260 30,740 60,000

### *Journal entry*

 Income summary ---------------------------- 60,000

 Dr. Teklay capital ---------------------------- 29,260

 Dr. Mamo capital ---------------------------- 30,740

## Check Your Progress Exercise - 2

1. Assume the same agreement as in number “2” above but the net income for the year was Birr. 10,000. Determine the amount to be distributed to each partner and record the distribution in journal entry form ----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------

#### 8.6 FINANCIAL STATEMENTS FOR A PARTNERSHIP

The income statement of a sole proprietorship and that of a partnership are the same. At the end of the period a statement of partners’ capital is prepared which summarizes the effect of transactions on the capital account balances of each partner. The statement of owners equity for Teklay and Mamo using assumed data and the income division shown above is illustrated below:

##  Dr. Teklay and Dr Mamo

**Statement of partners’ Capital**

**For the year Ended Dec, 31, 2002**

 Dr. Teklay Dr. Mamo

Capital Bal. January 1, 2002 Br. 36,800 Br. 166,400

**Add:** Additional investment 4,200 4,300

 Total Br. 41,000 Br. 170,700

Net income distribution 29,260 30,740

 70,260 201,440

**Deduct:** Withdrawals during the year 5,000 5,000

Capital Bal. Dec. 31, 2002 Br. 65260 Br. 196,440

NB- The balance sheet of a partnership is different from that of a sole proprietorship only

 in the owner’s equity section. In the partnership business since two or more persons

 owns the business, there are two or more capital accounts whereas for a sole

 proprietorship there will always be one capital account.

**Check Your Progress Exercise - 3**

1. Hilina and Meron agreed to form a partnership. Hilina contributed Br. 200,000 in cash , and Meron contributed assets with a fair market value of Br. 400,000. The partnership, in its initial year, reported net income of Br. 120,000.

Prepare the journal entry to distribute the first year’s income to the partners under each of the following condition.

* + Hilina and Meron failed to include stated ratio in the partnership agreement.
	+ Hilina and Meron agreed to share income and losses in a 3:2 ratio.
	+ Hilina and Meron agreed to share income and losses in the ratio of their original investments.
	+ Hilina and Meron agreed to share income and losses by allowing 10 percent interest on their original investments and sharing any remainder equally
1. What accounts are debited and credited to record the division of net income at the end of the fiscal period?

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1. What accounts are debited and credited to record the division of net loss among the partners’ at the end of the fiscal period?

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**8.7 DISSOLUTION OF A PARTNERSHIP**

* Dissolution of a partnership occurs whenever there is change in the original association of partners. When a partnership is dissolved, the partners lose their authority to continue the business as a going concern. This does not mean that the business operation necessarily is ended or interrupted, but it does mean – from a legal and accounting standpoint – that the separate entity stops to exist.
* The remaining partners can act for the partnership in finishing the affairs of the business or in forming a new partnership that will be a new accounting entity.
* A partnership is legally dissolved (terminated) when a new partner is admitted or an existing partner withdraws.

**8.7.1. Admission of a New Partner:**

The admission of a new partner dissolves the old partnership because a new association has been formed.

Dissolving the old partnership and creating a new one require the consent of all the old partners and the ratification of a new partnership agreement.

When a new partner is admitted, a new partnership agreement should be prepared.

* A new partner can be admitted into a partnership in one of two ways:
	+ 1. by purchasing ownership right from one or more of the original partners, or
		2. by investing assets in the partnership.
1. **Admission by Purchase of Ownership Right**

When an individual is admitted to a firm by purchasing ownership right from an old partner, each partner must agree to the change. A journal entry is needed in the partnership to transfer the ownership right purchased from the capital account of the selling partner to the capital account of the new partner. The partnership’s assets and liabilities remain unchanged.

Suppose, for example, Sister Helen joins the partnership of Dr. Teklay and Dr. Mamo by buying ownership right of Br. 8000 from Dr. Mamo. The entry to record the admission of Sister Helen and the transfer of the ownership right from the capital account of Dr. Mamo to the capital account of Sister Helen in the partnership books shown below

**Journal entry**

 Dr. Mamo---------------------------------- 8,000

 Sr. Helen --------------------------------------8,000

The price that sister Helen paid to Dr. Momo can be more or less than Br. 8,000 but that is irrelevant as it wouldn’t be reflected in the record (books) of the partnership.

**2. Admission by Investing Assets**

Assume that instead of purchasing ownership right from the existing partners, Sister Helen invested cash of Br. 80,000 into the partnership. In this case both partnership assets and total owners’ equity are increase. The journal entry must record such an investment and the increase in partnership assets.

Consider the following scenarios as an example:

* 1. Sister Helen receives a 50% ownership right in the partnership. Assume also that Dr. Teklay and Dr. Mamo’s capital balance were Br. 25,000 and Br. 55,000 respectively. Dr. Teklay and Dr. Mamo share income in a ratio of 2:1 respectively.

### *Journal Entry*

Sister Helen’s capital account would be credited for Br. 80,000 i.e., (55,000 + 25,000 + 80,000) X ½.

 Cash------------------------------------------80,000

 Sister Helen, Capital------------------------80,000

2- Sister Helen receives a one –fourth ownership right upon admission.

 Assume everything else as above. In this case Sister Helen’s capital account would be

 credited for birr 40,000 ie, (Birr 25,000 + Birr 80,000) X ¼.

The difference Br. 40,000, (80,000 – 40,000) would be shared between the remaining two partners with the income-sharing ratio.

 **Journal entry**

 Cash----------------------------80,000

 Helen capital ------------------------40,000

 Dr. Teklay capital --------------------- 26,667

 Dr. Mamo capital --------------------- 13,333

**Check Your Progress Exercise - 4**

1. Assume the same as above except that sister Helen received ¾ ownership right upon admission as she was thought to bring goodwill to the partnership. Record the admission.

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#### 8.7.2. Retirement or Withdrawal of a Partner

When an existing partner withdraws he/she can sell his/her ownership right or he/she can withdraw assets from the partnership. Both options are considered below:

**1. Sale of Ownership Right to the Existing Partner**

When ownership right is sold by a withdrawing partner to an existing partner, the entry on the partnership’s books transfers the retiring partner’s capital balance to the buyer’s capital account.

***Example:***

Dr. Mamo withdraws from the partnership because of a disagreement. He sells his Br. 38,333 ownership right to Dr. Teklay.

## *Journal entry*

 Dr. Mamo Capital----------------------------- 38,333

 Dr. Teklay Capital ----------------------------- 38,333

The amount paid by Dr. Teklay is not recorded on the partnership books, because the transaction involves no flow of assets to or from the partnership.

1. **Withdrawal of Assets From the Partnership**

When a partner withdraws he/she may be paid above or below the amount shown in his/her capital balances.

***Example:***

a. Assume Dr. Mamo was paid Br. 50,000 cash when he withdraws from the partnership of T,M&H. The capital balances of each partner were as follows as of that date:

Dr. Teklay capital ---------------------------Br. 100,000

Dr. Mamo capital --------------------------- --- 50,000

Sister Helen capital ----------------------------- 35,000

 Total Equities Birr 185,000

### *Journal entry*

 Dr,Mamo capital -------------------------------- 50,000

 Cash -----------------------------------------------------------50,000

b. Assume Dr. Mamo was paid Br. 56,000 instead of Br. 50,000, the excess amount of Birr 6,000 is charged to the remaining partner’s capital accounts based on the income- sharing ratio. (Assume a 3:2:1 income-sharing ratio between Dr Teklay Dr. Mamo and Sister Helen respectively).

### *Journal entry*

 Dr. Mamo capital ------------------------------50,000

 Sister Helen capital ---------------------------- 1,500

 Dr. Teklay capital ------------------------------ 4,500

 Cash ----------------------------------------------------56,000

* The Birr 6,000 excess is shared on the basis of a 3:1 ratio, i.e., Dr. Teklay would be charged for 6,000 X c/4 = birr 4500, and Sister Helan would be charged for

 Birr 6000 X ¼= Birr 1500.

#### Check Your Progress Exercise - 5

1. Assume everything else as in # b above except that Dr. Mamo was paid Br. 45,000 upon withdrawal. Record the dissolution.

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***Attempt the following questions:***

1. The partnership agreement for Kebede and Lema partnership does not disclose how they will share income and losses. How would the income and losses be shared in this partnership?
2. In January 19X1, Sisay Hailu and Gelane Jalene agreed to produce and sell Soaps. Sisay contributed br. 240,000 in cash to the business. Gelane contributed the building and equipment, valued at Br. 220,000 and Birr. 140,000, respectively. The partnership had an income of Birr 84,000 during 19X1 but was less successful during 19X2, when income was only Br. 40,000.
	1. Prepare the journal entry to record the investment of both partners in the partnership
	2. Determine the share of income for each partner in 19X1 under each of the following conditions:
* The partners agreed to share income equally.
* The partners failed to agree on an income- sharing arrangement.
* The partners agreed to share income according to the ratio of their capital investments
* The partners agreed to share income by allowing interest of 10% on their original investments and dividing the remainder equally.
* The partners agreed to share income by allowing salaries of Birr 40,000 for Sisay and Br. 28,000 for Gelane, and dividing the remainder equally.
1. Nadew, Tezera, and Woliyi have equity in a partnership of Birr 80,000, Birr 80,000, and Birr 120,000, respectively, and they share income and losses in a ratio of 20%, 20%, and 60%. The partners have agreed to admit Equbay to the partnership.

***Instruction****:* prepare journal entries to record the admission of Equbay to the partnership under the following conditions:

* 1. Equbay invests Birr 50,000 for 20% interest in the partnership, and a bonus is recorded for the original partners.
	2. Equbay invests Birr 60,000 for a 40% interest in the partnership, and a bonus is recorded for Equbay.
	3. **LIQUIDATION OF A PARTNERSHIP**

Liquidation of a partnership is the process of ending the business, of selling enough 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.

* ***A partnership may be liquidated if:***
	+ - 1. the objectives sought in forming the partnership has been achieved.
			2. the time period for which the partnership was formed expires (ends)
			3. newly enacted laws have made the partnerships activities illegal,
			4. the partnership becomes bankrupt.

The partnership agreement should indicate the procedures to be followed incase of liquidation. Usually, the books (records) are adjusted and closed, with the income or loss distributed to the partners and the assets are sold.

The sale of the assets at the time of liquidation of a partnership is known as ***realization.***

As the assets of the business are sold, any gain or loss should be distributed to the partners according to the income and loss sharing ratio.

As cash is realized, it must be applied first to outside creditors. Finally, the remaining cash is distributed to the partners in accordance with the balance of their capital accounts.

***Illustration***

The partnership of Resom, Sultan, and Tassew is liquidated on September 1,2002. The income and loss sharing ratio of the partners is: Resom 40%, Sultan 35%, and Tassew 25%. After discontinuing the ordinary business operations of their partnership and closing the accounts, the following summary of a trial balance is prepared:

**R, S And T**

**Trial Balance**

**Septamber 1, 2002**

|  |  |  |
| --- | --- | --- |
|  | Debit | Credit |
| Cash | 10,000 |  |
| Other assets | 90.000 |  |
| Liabilities |  | 10,000 |
| R. Capital |  | 30,000 |
| S. Capital |  | 30,000 |
| T. Capital | \_\_\_\_\_\_\_\_ | 30,000 |
| Total | 100,000 | 100,000 |

Based on the information on the trial balance, accounting for liquidation of **R,S**, and **T** partnership will be illustrated using different selling prices for the non cash assets.

### *Case One:* Gain On Realization

Assume that Resom, Sultan, and Tassew sell all noncash assets for Birr 95,000, realizing a gain of birr 5000, (Birr 95,000 – Birr 90,000). The gain is divided among Resom, sultan and Tassew in the income and loss sharing ratio of 40% 35%, and 25% respectively. Then, the liabilities are paid, and the remaining cash is distributed to the partners according to the balances in their capital accounts. The entries to record the steps in the liquidation of a business are as follows:

 Cash………………………………95,000

 Other assets………………………….90,000

 Gain on sale of assets……………….. 5,000

 *Entry to record the sale of non cash assets*

 *and the recognition of gain on realization*

 - Gain on sale of assets…………… 5,000

 R Cap. (5,000 X 40%)………………… 2.000

 S Cap. (5,000 X 35%)…………………. 1,750

 T Cap. (5000 X 25%)…………………...1,250

 *To* distribute gain on realization

 - Liabilities……………………….10,000

 Cash………………………………..10,000

 *To record the settlement of partnership liabilities*.

After the above entries are posted, the partners’ capital accounts shows:

 R’s Beg Bal. 30,000 + 2,000 = Birr 32,000

 S’s Beg Bal. 30,000 + 1,750 = Birr 31,750

 T’s Beg Bal. 30,000 + 1,250 = Birr 31,250

The cash account now shows a balance of Birr 95,000 (10,000 + 95,000 – 10,000). The entry recorded upon distribution of this cash among the partners would, therefore, be

 R, capital……………………… Birr 32,000

 S, capital……………………… Birr 31,750

 T, capital……………………… Birr 31,250

 Cash-------------------------------------95,000

 *To record the distribution of cash among the partners*.

### *Case two:* Loss on Realization: No capital Deficiencies

Assume that Resom, Sultan, and Tassew sell all non cash assets for Birr 70,000, instead of Birr 95,000, incurred a loss of birr 20,000,(Birr 90,000 – Birr 70,000)

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##### *Journal entry*

-Cash --------------------------------------70,000

Loss on realization-----------------------20,00

 Other Assets-------------------------------------90,000

 *To record the sale of the assets*

-R capital---------------------- (40% X 20,000) -----------------8,000

 S capital----------------------- (35,000 X 20,000) --------------7,000

 T capital ---------------------- (25% X 20,000) --------------- 5,000

 Loss on Realization ------------------------------------- 20,000

 *To distribute the loss on realization*

- Liabilities ---------------------------------- 10,000

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

 *To record the settlement of partnership liabilities*

After the above entries have been posted; the accounts show cash 70,000 R, cap. Birr22,000 S,cap. Birr 23,000 and T, cap. Birr 25,000. The entry to record the cash distribution to the partners would, therefore, be as follows:

 R cap --------------------------------- 22,000

 S cap ----------------------------------23,000

 T cap --------------------------------- 25, 000

 Cash -------------------------------------- 70,000

 *Entry to record the distribution of cash to partners.*

### *Case three:* Loss on Realization with Deficiency in one Partner Capital

* + Assume the non-cash assets of R,S and T partnership are sold for only Birr 10,200, incurring a loss of Birr 79,800,( Birr 90,000 – Birr 10,200). The entries to record the division of loss among the partners and the liquidation to this point are shown below:

Cash -------------------------------- 10,200

Loss on sale of Assets ----------- 79,800

 Other Assets-------------------------- 90,000

 *To record the sale of assets*

 R capital (79800 X 40%) ----------------------31,920

 S capital (79800 X 35%) ---------------------- 27,930

 T capital (79800 X 25%) ---------------------- 19,950

 Loss on sale of Assets ---------------------------- 79,800

 *To distribute loss on realization*

 - Liabilities ----------------------------------- 10,000

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

 *To record settlement of liabilities*

At this stage of the liquidation the capital accounts of the partners have the following balances

 R capital = 30,000 – 31920 = 1,920

 S capital = 30,000 – 27930 = 2,070

 T capital = 30,000 – 19950 = 10,050

Only Birr 10,200 cash is available (10,000 + 10200 – 10,000) for distribution to S and T while the combined balances of their capital accounts is Birr 12,120. Therefore, additional Birr 1,920, (12120 – 10200) is needed which is the amount owed by R to the partnership.

Therefore, either R will have to pay this amount first and the cash will be distributed to S and T, or S and T will have to share the Birr 1920 loss in their income and loss-sharing ratio of 35:25.

Let’s assume, the loss was distributed since R couldn’t pay the amount immediately.

### *Journal Entries*

S capital (35/60 X 1920) -------------- 1,120.00

T capital (25/60 X 1920) -------------- --800.00

 R capital -------------------------------------1,920

 *To charge R’s capital deficiency to S and T*

 S, capital -----------------------------------950.00

 T, capital -----------------------------------9,250.00

 Cash ----------------------------------------------10,200

 *To record the final cash distribution to partners.*

The various entries in the liquidation of R,S, and T partnership are summarized in the following statement.

######  R, S, T partnership

######  Statement of Partnership Liquidation

**For period Sept. 1-15,2002**

 Non cash = Liabilities + **Capital**

 Cash + Asset

 R(40%) S(35% T(25%)

Bal.before realization Birr 10,000 90,000 10,000 30,000 30,000 30,000

Sales of Assets &

Division of loss +10,200 -90,000 --- -31,920 -27,930 19,950

Bal.after realization 20,000 -0- 10,000 (1920) 2,070 10,050

Payment of Liab. – 10,000 --- -10.000 --- --- ---

Bal. After payment

Of liab. 10,200 -0- -0- (1920) 2,070 10,050

Division of deficiency --- --- --- 1920 (1120) 800

Bal. After division of

Deficiency – 10,200 -0- -0- -0- 950 9,250

Dist.of cash 10,000 --- --- --- -950 -9250

Balance -0- -0- -0- -0- -0- -0 -

* 1. **Summary**

A partnership is an association of two or more persons to carry on as co-owners of a business for profit. This association is based on a partnership agreement or contract known as the articles of a partnership.

A partnership form of business ownership has several characteristics. From among them are: voluntary association, limited life, unlimited liability, mutual agency, and co- ownership of partnership property.

The advantages of partnerships include: easy of formation, possible to raise large amount of capital than a single owner, not subject to separate taxation, and the absence of many restrictive laws unlike a corporation, etc.

Partnerships have also the following disadvantages: unlimited liability, mutual agency, limited life, etc.

In accounting for partners’ investment, it is necessary to maintain separate capital and withdrawals accounts for each partner and to divide the income and losses of the company among the partners. When recording the investments of the partners, all noncash assets must be recorded at their fair market value at the time they are transferred to the partnership.

A partnership income and losses can be distributed according to whatever method the partner specifies in the partnership agreement. The agreement should be specific and clear, to avoid later disputes.

If a partnership agreement does not mention the distribution of income and losses, the law requires that they be shared equally by all partners. If a partnership agreement specifies only the distribution of income, but is silent as to losses, the law requires that losses be distributed in the same ratio as income.

The income of a partnership normally has three components: (1) return to the partners for the use of their capital, (2) compensation for direct services the partners have rendered, and (3) other income for any special characteristics individual partners may bring to the partnership or risks they may take.

At the end of each fiscal period financial statements are prepared for a partnership business. Most of the financial statements of a partnership are the same as that of a sole proprietorship with the exception of the owners equity section of a balance sheet.

Dissolution of a partnership occurs whenever there is a change in the original association of partners. When a partnership is dissolved, the partners lose their authority to continue the business as a going concern. This does not mean that the business operation necessarily is ended or interrupted, but it does mean - from a legal and accounting stand point - that the separate entity stops to exist. A partnership is legally dissolved when a new partner is admitted or an existing partner withdraws.

Liquidation of a partnership is the process of ending the business, of selling enough assets to pay the partnership’s liabilities and distributing any remaining assets among the partners. Liquidation is a special from of dissolution. When a partnership is liquidated, the business will not continue.

A partnership may be liquidated if: (a) the objectives sought in forming the partnership has been achieved, (b) the time period for which the partnership was formed expires (or ends), (c) newly enacted laws have made the partnership’s activities illegal, (d) the partnership becomes bankrupt.

The partnership agreement should indicate the procedures to be followed incase of liquidation. Usually, the records are adjusted and closed, with the income or loss distributed to the partners, and the assets are sold. The sale of the assets at the time of liquidation of a partnership is known as realization. As the assets of the business are sold, any gain or loss should be distributed to the partners according to the income and loss sharing ratio. As cash is realized it must be applied first to outside creditors. Finally, the remaining cash is distributed to the partners in accordance with the balance of their capital accounts.

**8.10 ANSWERS TO CHECK YOUR PROGRESS QUESTIONS**

### *Check Your Progress Exercise -1*

**Journal entry**

 Cash-----------------------------8500

 Dr. Teklay capital-------------------------- 4200

 Dr. Mamo capital--------------------------- 4300

***Check Your Progress Exercise –2***

Net income division

Income to be

 Dr. Beklay Dr. Mamo Total Distributed

Net income 15,000

Interest (5%) 1,840 8,320 10,160 4,840

**8.11 MODEL EXAMINATION QUESTIONS**

**PART I**. **Choose The Best Answer:**

\_\_\_\_\_\_\_\_\_\_\_\_ 1. The term unlimited liability when used in connection with a

 partnership refers to the fact that:

* + - 1. A contract entered into by one partner is binding on all partners.
			2. Creditors can look beyond the partnership assets to the individual assets of the partners for satisfaction.
			3. The partnership has an unlimited obligation to provide professional services.
			4. The partnership is liable for all actions of the partners even when conducting personal business.
			5. All except D.

\_\_\_\_\_\_\_\_\_\_\_\_ 2. A and B agree to form a partnership. A is to contribute birr 60,000 in cash and to spent one – half time to the partnership. Bi is agreed to contribute birr 40,000 and to devote full time to the partnership. How will A and B share in the division of net income or net loss?

 A) 1:2 C) 3:2 E)None of the above

 B) 2:1 D) 1:1

Refer to the following information which is related to XYZ partnership and answer questions 3 and 4.

The capital account and income sharing ratios of the three partners after realization of non – cash assets and settlement of all liabilities are as follows:

 ***Partner Balance in Capital Income – Sharing***

 ***Account Ratio***

 X Birr 45,000 2

 Y (15,000) 3

 Z 36,000 3

\_\_\_\_\_\_\_\_ 3. If partner Y is unable to pay any part of his deficiency to the partnership,

 how much cash will be given to partner Z from the liquidation?

 A) Birr 30,375 C) Birr 13,500 E) None of the above.

 B) Birr 27,000 D) Birr 30,000

\_\_\_\_\_\_\_\_ 4. If partner Y pays two – third of the deficiency to the partnership, how much

 cash will be given to partner X?

 A) Birr 33,000 C) Birr 43,000 E) None of the above.

 B) Birr 47,000 D) Birr 45,000

\_\_\_\_\_\_\_\_\_ 5. Which of the following is not a characteristic of a partnership?

1. each partner can act as an agent of a partnership
2. Unlimited life.
3. Easy of formation
4. It is not legally separate from its owners.
5. None of the above

**PART II – Attempt the Following Questions**

* 1. What are the disadvantages of the partnership over the corporation as a form of organization for a profit making business enterprise?
	2. Explain the difference between the admission of a new partner to a partnership (a) by purchase of an interest from another partner and (b) by contribution of assets to the partnership.
	3. When a new partner is admitted to a partnership and goodwill is attributable to the old partnership, how should the amount of the goodwill be allocated to the capital accounts of the original partners?
	4. Why might partnership attribute goodwill to a newly admitted partner?
	5. Paulos, Kebede, and Abeje are partners sharing income 3:2:1. After the firm’s loss from liquidation is distributed, Paulos’s capital account has a debit balance of Birr 30,000. If Paulos is personally bankrupt and unable to pay any of the birr 30,000, how will the loss be divided between Kebede and Abeje?

### Exercise

Dagnachew and Firdu formed a partnership. Dagnachew invested Birr 90,000 and Firdu invested Birr 60,000. Dagnachew is to devote one-half time to the business while Firdu is to devote full time.

The following plans for the division of income are being considered:

1. equally
2. in the ratio of original investments
3. in the ratio of time devoted to the business
4. Interest of 12% on original investments and the reminder equally.
5. Interest of 12% on original investments, salaries of Birr 10,000 to Dagnachew and Birr 20,000 to Firdu, and the remainder equally.
6. The same as in #5 except that Dagnachew is also to be allowed a bonus equal to 25% of the amount by which net income exceeds salary allowances.

***Required:***

Determine the division of income to Dagnachew and Firdu under each plan assuming the partnership of Danagnachew and Firdu earned a net income of:

1. Birr 32,000
2. Birr 150,000

### Problem 1

The following balance sheet is related to YOGA partnership

**YOGA Partnership**

**Balance sheet**

**Meskerm 10,1995**

 **Assets:**  **Liabilities and Capital**

 Cash-------------------------Birr 20,000 Liabilities--------------Birr 30,000

 Other assets--------------------- 80,000 **Capital:**

 Y.capital-------------------- 40,000

 G. capital------------------- 21,000

 \_\_\_\_\_\_\_ A. capital------------------- 9,000

 **Total Liabilities and**

**Total Assets**---------------- Birr 100,000 **Capital**-----------------------100,000

The partners agreed to liquidate the business enterprise by selling other assets and dividing any remaining cash available in the partnership after settling the debt of the partnership as of the date of liquidation. All the partners are general partners. Partner Y, G and A share income or loss in the ratio of 20%, 40%, and 40% respectively.

***Required:***

1. prepare a liquidation statement assuming that the other assets were realized for:
	1. Birr 80,000
	2. Birr 100,000
	3. Birr 60,000
	4. Birr 50,000
2. Journalize the necessary entries for the business enterprise on the basis of the liquidation statement prepared for each case.

**8.12 REFERENCE BOOKS**

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3. Roger H. Hermanson, **:** Accounting Principles, 4th Edition, (1989) IRWIN

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**8.13 GLOSSARY**

**Partnership** **:** a business owned by two or more individuals as

 co-owners based on a partnership agreement.

**Partners** **:** owners of a partnership

**Dissolution** **:** formation of a new partnership because of the

 retirement’s admission or death of a partner.

**Liquidation** **:**  the winding up of operation and sale of business

 assets.

**Realization**  **:** sale of business assets for cash