chapter

12

Accounting for Partnerships and Limited Liability Companies

OPENING COMMENTS

This chapter compares and contrasts proprietorships, partnerships, and limited liability companies. After reviewing the characteristics and equity reporting of these business forms, the chapter focuses on partnerships and limited liability companies. The topics covered include partnership formation, dissolution, and liquidation. The chapter also discusses arrangements for distributing partnership income and loss. It ends with a presentation of the significance of the revenue to employee computation.

After studying the chapter, your students should be able to:

1. Describe the characteristics of proprietorships, partnerships, and limited liability companies.
2. Describe and illustrate the accounting for forming a partnership and for dividing the net income and net loss of a partnership.
3. Describe and illustrate the accounting for partner admission and withdrawal.
4. Describe and illustrate the accounting for liquidating a partnership.
5. Prepare the statement of partnership equity.
6. Analyze and interpret employee efficiency.

KEY TERMS

deficiency
limited liability company (LLC)
liquidation

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partnership
partnership agreement
realization
revenue per employee
statement of members' equity
statement of partnership equity
statement of partnership liquidation

STUDENT FAQS

- What is the best business form to use when setting up a business?
- Do all partners have to agree to accept a new partner into the company?
- How many people does it take to set up an LLC at the beginning?
- Can one person set up an LLC?
- Can LLC owners take money out of a business as they desire?
- Why do we have bonuses paid to existing partners or paid to a new partner when a new partner is admitted to the partnership? Why doesn't the new partner just pay for his or her share of the partnership based on what it is worth?
- What is the difference or advantage of an LLC versus a partnership?
- How could a partner's capital account end up with a debit (or deficit) balance?

OBJECTIVE 1

Describe the characteristics of proprietorships, partnerships, and limited liability companies.

SYNOPSIS

A proprietorship is simple to form, there is no limitation on legal liability, it is not taxable, it has a limited life, and there is a limited ability to raise capital. A partnership is made up of two or more persons who own and manage a business for profit. Partnerships should be formed with a partnership agreement. The characteristics of a partnership include moderately complex to form, no limitations of legal liability, not taxable, limited life, limited ability to raise capital, co-ownership of partnership property, mutual agency, and participation in income. A limited liability company provides limited liability to its owners but is treated as a partnership for tax purposes. The characteristics of an LLC include moderately complex to form, limited legal liability, not taxable, unlimited life, and moderate ability to raise capital. An LLC may elect to be member-managed or manager-managed; in the latter, members of the LLC may share the income from the LLC without concerning themselves with managing the company.

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Key Terms and Definitions

- **Limited Liability Company (LLC)** - A business form consisting of one or more persons or entities filing an operating agreement with a state to conduct business with limited liability to the owners, yet treated as a partnership for tax purposes.
- **Partnership** - An unincorporated business form consisting of two or more persons conducting business as co-owners for profit.
- **Partnership Agreement** - The formal written contract creating a partnership.

Relevant Exhibit

- Exhibit 1 – Characteristics of Proprietorships, Partnerships, and Limited Liability Companies

SUGGESTED APPROACH

The proprietorship form of business has been covered in previous chapters. The corporate form of business will be covered in the next chapter. In this objective, you will need to introduce your students to partnerships and limited liability companies. Ask for volunteers to describe the partnership form of organizing a business. Next, ask your class to identify characteristics of partnerships. Write your students' ideas on the board. Use Handout 12-1 to review any partnership characteristics not identified by your class.

Emphasize that the same journals, ledgers, and procedures to record transactions described in previous chapters are used by partnerships. The only change is in the owner's equity accounts. Each partner will have his or her own capital and drawing accounts.

The limited liability corporation is a relatively new business form that is a hybrid between a partnership and a corporation. Use Handout 12-2 to explain the characteristics of the limited liability corporation. Finally, use Exhibit 1 to compare proprietorships, partnerships, and limited liability companies.

Handout 12-3 can be used to demonstrate the differences in reporting the Equity section of the balance sheet for the various business forms. Equity reporting for partnerships and LLCs is described in Objective 5 of this chapter. Handout 12-4 is a review of the changes in owner's capital from Chapter 2.

OBJECTIVE 2

Describe and illustrate the accounting for forming a partnership and for dividing the net income and net loss of a partnership.

SYNOPSIS

To form a partnership, the investment of each partner is recorded in separate entries. The assets contributed by each partner are recorded in separate entries to each partner's capital account. The assets contributed are debited to the partnership's asset accounts. If any liabilities are assumed, the partnership's liability accounts are credited. The entry to record the assets, liabilities, and partner's capital is shown on page 589 in the text. The income for the period is divided as specified by the partnership agreement; each

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partner's income may include a salary allowance and a division of income. Salary allowances are recorded in the drawing account each pay period. The income is closed into the capital accounts at the end of the year. If the salary allowance exceeds the net income of the partnership, the loss is deducted from the capital accounts of the partners.

Relevant Example Exercises

- Example Exercise 12-1 – Journalize Partner's Original Investment
- Example Exercise 12-2 – Dividing Partnership Net Income

SUGGESTED APPROACH—Forming a Partnership

Each partner usually contributes cash and/or other assets to form a partnership. Remind students that the following rules are used in recording each partner's contribution.

Noncash Assets: Recorded at their current market value.

Receivables: Any receivable that will not likely be collected is written off. The remaining receivables are recorded at their face amount. An allowance for uncollectible accounts is established for the possibility of bad debts that cannot be detected when the partnership is formed.

Liabilities: Any liabilities assumed by the partnership are credited to the appropriate liability account.

Capital: Each partner's capital account is credited for the net amount of his/her contribution.

Remind students that contributions from members of an LLC are recorded using the same rules. The only difference is the name of the equity account credited. In an LLC, the equity account is called "Member Equity" instead of "Capital."

DEMONSTRATION PROBLEM—Journal Entry for Partnership Formation

Willis Gibs and George Reed each own a landscape business. They decide to combine their resources and form a partnership. Just before the partnership is formed, the trial balance of Gibs Landscaping (shown on Handout 12-5) is as follows:

Cash	$ 8,500	
Accounts Receivable	12,000	
Inventory	4,000	
Equipment	43,000	
Accumulated Depreciation—Equipment		$17,500
Accounts Payable		5,800
Willis Gibs, Capital		44,200
	$67,500	$67,500

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All of Gibs's assets and liabilities will be contributed to the partnership. Although all of the receivables appear to be collectible at this time, the partners agree to a $1,000 allowance for doubtful accounts. The partners also agree that the current market value of the equipment is $24,000.

The partnership's entry to record Gibs's contribution is as follows:

Cash	8,500	
Accounts Receivable	12,000	
Inventory	4,000	
Equipment	24,000	
Allowance for Doubtful Accounts		1,000
Accounts Payable		5,800
Willis Gibs, Capital		41,700

Just before the partnership is formed, the trial balance of Reed Landscaping (shown on Handout 12-6) is as follows:

Cash	$14,000	
Accounts Receivable	20,000	
Allowance for Doubtful Accounts		$ 3,400
Inventory	5,200	
Equipment	28,000	
Accumulated Depreciation—Equipment		14,000
Accounts Payable		11,300
George Reed, Capital		38,500
	$67,200	$67,200

Reed has agreed to transfer all of his business assets and liabilities except $4,000 of his cash. The partners agree that Reed's equipment has a current market value of $17,000. In addition, it is agreed that $2,000 of Reed's accounts receivable should be written off as uncollectible, and a $1,600 allowance for doubtful accounts will be sufficient for future bad debts.

The partnership's entry to record Reed's contribution is as follows:

Cash	10,000	
Accounts Receivable	18,000	
Inventory	5,200	
Equipment	17,000	
Allowance for Doubtful Accounts		1,600
Accounts Payable		11,300
George Reed, Capital		37,300

The entries for both partners' contributions are found on Handout 12-7. Point out that the partners' capital account titles change to "Member Equity" to reinforce the accounting treatment for LLCs.

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SUGGESTED APPROACH—Dividing the Net Income and Loss of a Partnership

Use Handout 12-8 to explain the steps in allocating partnership income/loss. Following that explanation, use the Demonstration Problems below to show one or more examples of how partnership income is allocated.

DEMONSTRATION PROBLEM—Division of Net Income/Net Loss

Present the following scenarios (shown on Handout 12-9).

Scenario 1: The partnership agreement of Gibs and Reed Landscaping provides an $18,000 salary allowance to Willis Gibs and a $24,000 salary allowance to George Reed. Both partners are given 10% interest on their capital balances at the beginning of the year. The beginning capital balance for Gibs was $41,700 and for Reed, $37,300. Any remaining income or loss is shared equally.

Assume that the business had revenues of $130,000 and expenses of $74,000 resulting in net income of $56,000 during its first year of operations. Calculate the net income distributed to each partner.

	Gibs	**Reed**	**Total**
Salary allowance	$18,000	$24,000	$42,000
Interest allowance	4,170	3,730	7,900
Subtotal			$49,900
Remainder = $6,100			
($56,000 – $49,900)	3,050	3,050	6,100
	$25,220	$30,780	$56,000

You may want to point out that allocating a portion of the partnership income as interest on each partner's capital account provides an incentive for partners to retain investments in the business. Ask your class if it is more equitable to allocate interest on the partners' beginning capital balances, end-of-year balances, or the average balances throughout the year. (Answer: Using an average balance is more equitable. This prevents a partner from withdrawing capital immediately after the beginning of the year or investing additional funds just prior to the end of the year in order to increase his/her interest allowance.)

Scenario 2: Assume that the business formed by Gibs and Reed had revenues of $130,000 and expenses of $90,000 resulting in net income of $40,000 during its first year of operations. Calculate the net income distributed to each partner.

	Gibs	**Reed**	**Total**
Salary allowance	$18,000	$24,000	$42,000
Interest allowance	4,170	3,730	7,900
Subtotal			$49,900
Remainder = –$9,900			
($40,000 – $49,900)	– 4,950	– 4,950	– 9,900
	$17,220	$22,780	$40,000

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Scenario 3: Assume that the Gibs/Reed partnership agreement has the following provisions:

1. Salary allowances are $20,000 for Gibs and $30,000 for Reed.
2. No interest is given on the partners' capital balances.
3. Any income/loss greater than the salary allowances is divided using a 2:3 ratio.

Revenues of $130,000 and expenses of $62,000 resulted in net income for the first year of operations of $68,000.

	Gibs	**Reed**	**Total**
Salary allowance	$20,000	$30,000	$50,000
Remainder = $18,000			
($68,000 – $50,000)			
Split 2:3 ratio			
Gibs gets 2/5	7,200		
Reed gets 3/5		10,800	18,000
	$27,200	$40,800	$68,000

A couple of points regarding the division of income need special emphasis. First, if there is no partnership agreement or the agreement does not address division of income, partnership profits or losses are divided evenly among the partners. Second, partners are not employees of the partnership, but owners. When profits are divided between the partners, this is not considered a salary expense. Any profits taken out of the business are recorded in the appropriate partner's drawing account. A partner's withdrawals usually do not equal his/her share of the partnership income.

GROUP LEARNING ACTIVITY—Closing Entries for a Partnership

Divide your class into small groups. Instruct them to prepare the closing entry for Gibs and Reed Landscaping under each of the preceding scenarios. The correct closing entries are illustrated on Handout 12-10.

LECTURE AID—Partnership Financial Statements

The textbook illustrates that the division of net income may be reported at the bottom of the partnership income statement. Otherwise, there are no differences between the income statements for a partnership and a sole proprietorship.

You may also want to discuss the differences in the balance sheet. The Assets and Liabilities sections of the balance sheet are identical for a partnership and a proprietorship. In the Owners' equity section, generally each of the partner's capital accounts is listed. However, some large partnerships may report partners' capital as a total amount, rather than reporting each individual partner's capital account balance.

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OBJECTIVE 3

Describe and illustrate the accounting for partner admission and withdrawal.

SYNOPSIS

This chapter explains two ways to admit new partners: a person may purchase an interest from one of the existing partners or contribute assets to the partnership. When an interest in the partnership is purchased from one or more of the existing partners, the transaction is between the new and existing partners as individuals. The admission of the new partner is recorded in the capital accounts by transferring equity to the new partner from the existing capital accounts. Assets and liabilities of the partnership are not affected. The partnership agreement should be amended to include the new partner's share of income and loss. When a new partner is admitted by contribution of assets, the total assets and total owners' equity are increased. Before a new partner is admitted, the balances of the partnership's asset accounts should be stated at current value. Any adjustments should then be divided among the existing partners. Failure to adjust the partnership's accounts could result in the new partner sharing in increases or losses that occurred prior to the new partner's admission. A new partner may pay the existing partners a bonus to join the business, or existing partners may pay a new partner a bonus to the join the partnership. When a partner retires or withdraws from a partnership, the partner's interest is normally sold to the existing partners or to the partnership. If the partnership interest is sold to the partners individually, only the capital accounts are changed; assets and liabilities do not change. If the partnership purchases the withdrawing partner's interest, the assets and owners' equity of the partnership are reduced by the purchase price. If a partner dies, the partnership accounts should be closed as of the date of death. The income for the period should be determined and divided among the partners' accounts. The asset accounts should be adjusted to current values and adjustments divided among the partners' accounts. After this process is complete, the deceased partner's account should be debited and a liability account, payable to the deceased's estate, should be credited.

Relevant Example Exercises and Exhibits

- Exhibit 2 – Two Methods for Admitting a Partner
- Example Exercise 12-3 – Revaluing and Contributing Assets to a Partnership
- Exhibit 3 – Partner Bonuses
- Example Exercise 12-4 – Partner Bonus

SUGGESTED APPROACH

A partnership is dissolved whenever there is any change in the ownership of a partnership. When a partner leaves the firm or a new partner is added, legally the former partnership is dissolved and a new partnership must be formed. Many partnerships provide for admitting new partners and for partner withdrawals by amending the existing partnership agreement. Under this provision, the company may continue to operate without having to form a new partnership and prepare a new partnership agreement.

From an accounting perspective, however, the change in ownership is recorded simply as a change in the capital accounts. This change may involve the capital accounts of the partners currently involved in the business as well as the partner(s) who are entering or leaving the business.

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LECTURE AID—Admission of a New Partner

Handouts 12-11 and 12-12 outline the two methods for admitting a new partner: (1) purchase of a partnership interest from one or more of the current partners and (2) contribution of new assets to the partnership.

The purchase of a partnership interest from current partners is a transaction between the new partner and existing partners acting as individuals. It is not a transaction between the new partner and the partnership. As a result, the total assets and total equity of the partnership are not affected. The amount paid for the partnership interest does not impact the entry to record the new partner's capital.

Admission of a new partner who contributes new assets to the partnership, however, is a transaction between the new partner and the partnership. The Demonstration Problem below illustrates this more complex situation.

DEMONSTRATION PROBLEM—Admission of a New Partner through Contribution of New Assets

Melanie Sherby and Nancy Libby operate a partnership. Sherby's capital account balance is $47,000 and Libby's is $36,000. Sherby and Libby have decided to admit a new partner to their business—Jim Fittro.

Fittro will contribute $20,000 cash to receive a one-third interest in the partnership. Prior to admitting Fittro, Sherby and Libby hired a certified public accountant to determine the current market values of the partnership assets. The CPA determined that the building owned by the partnership has a market value $15,000 greater than the book value shown on the financial statements. In addition, the partnership's inventory is undervalued by $2,000 in the accounting records. Sherby and Libby share any income/loss equally.

a. Revalue the partnership assets.

	Debit	Credit
Building	15,000	
Merchandise Inventory	2,000	
Sherby, Capital		8,500
Libby, Capital		8,500

b. Determine the total equity of the partnership after the new partner is admitted.

Sherby, capital ($47,000 + $8,500)	$ 55,500
Libby, capital ($36,000 + $8,500)	44,500
Fittro's contribution	20,000
Total	$120,000

c. Determine the new partner's share of the total equity.

Total equity	$120,000
New partner's share	× 1/3
	$ 40,000

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d. Compare the new partner's equity to his contribution.

Fittro's equity in the partnership	$40,000
Fittro's contribution	20,000
Bonus paid to Fittro	$20,000

Entry to record admission:

Cash	20,000	
Sherby, Capital	10,000	
Libby, Capital	10,000	
Fittro, Capital		40,000

Instead, assume that Fittro had contributed $80,000 to join the partnership.

a. Revalue the partnership assets.

Building	15,000	
Merchandise Inventory	2,000	
Sherby, Capital		8,500
Libby, Capital		8,500

b. Determine the total equity of the partnership after the new partner is admitted.

Sherby, capital ($47,000 + $8,500)	$ 55,500
Libby, capital ($36,000 + $8,500)	44,500
Fittro's contribution	80,000
Total	$180,000

c. Determine the new partner's share of the total equity.

Total equity	$180,000
	× 1/3
New partner's share	$ 60,000

d. Compare the new partner's equity to his contribution.

Fittro's equity in the partnership	$60,000
Fittro's contribution	80,000
Bonus paid to Sherby and Libby	$20,000

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Entry to record admission:

Cash	80,000	
Sherby, Capital		10,000
Libby, Capital		10,000
Fittro, Capital		60,000

Note that the bonus is distributed to Sherby and Libby based on the income-sharing ratio.

WRITING EXERCISE—Admission of a Partner

To stimulate critical thinking, ask your students to write answers to the following questions (shown on Handout 12-13):

1. Why are the assets contributed by each partner recorded at their current market values?

   Possible response: Since the business is not purchasing the asset, the cost is not a known factor. When costs are not known, the market value of the asset contributed is the next most reliable measure of the asset contributed.

2. In what circumstances would existing partners be willing to pay a bonus to a new partner?

   Possible response: If the new partner brings additional value in the form of expertise, management skills, or existing customer base, or anything that might bring additional future success to the business, these are circumstances that would warrant such a bonus.

DEMONSTRATION PROBLEM—Withdrawal of a Partner

Remind students that a partner generally cannot withdraw without permission of the remaining partners, nor can a partner be forced to withdraw by the other partners. When a partner does withdraw from a partnership, he or she may either sell his or her interest in the partnership to another individual or sell the interest directly to the partnership. For example, assume Bruce Jordan, Ken Kohlenberg, and Dan Greene are partners in a music publishing business with capital accounts of $28,000, $42,000, and $35,000, respectively. Jordan has decided to retire. Prepare the journal entry to record Jordan's retirement under the three independent assumptions that follow.

1. Jordan sells half of his interest to Kohlenberg and half to Greene. Each partner pays $10,000.

Jordan, Capital	28,000	
Kohlenberg, Capital		14,000
Greene, Capital		14,000

2. Jordan sells his entire interest in the partnership to Bob Ruckman for $25,000.

Jordan, Capital	28,000	
Ruckman, Capital		28,000

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3. Jordan sells his interest directly to the partnership. Jordan will receive cash equal to the value of his capital account after all partnership assets are adjusted to their current market values. If the partnership does not have sufficient cash to pay Jordan, a liability may be created for the amount owed the withdrawing partner.

   The partnership currently has $17,000 in cash. The book value of its inventory is $5,000 below the current market value. The book value of its equipment is $8,000 greater than the current market value. The three partners split income or losses equally. To revalue the partnership assets:

Inventory	5,000	
Jordan, Capital	1,000	
Kohlenberg, Capital	1,000	
Greene, Capital	1,000	
Equipment		8,000

   To record Jordan's withdrawal:

Jordan, Capital ($28,000 – $1,000)	27,000	
Cash		17,000
Notes Payable		10,000

Death of Partner

You may wish to mention the steps taken when a partner dies.

1. Close the partnership accounts as of the date of death.
2. Determine and divide net income for the current period among partners' capital accounts.
3. Adjust asset accounts to current values and divide adjustments among the partners' capital accounts.
4. Close the deceased's capital account with a debit entry and credit a liability account whose balance is payable to the deceased's estate.
5. Remaining partner or partners decide to continue or liquidate the business.

OBJECTIVE 4

Describe and illustrate the accounting for liquidating a partnership.

SYNOPSIS

When a partnership goes out of business, it sells its assets, pays its liabilities, and distributes the remaining cash or assets to the partners. The four steps in this process are illustrated in Exhibit 4. In Exhibits 5 and 6, two statements of partnership liquidation are shown. This summarizes the process and shows the increases and decreases in each capital account. If the loss on realization is greater than the balance in a partner's capital account, the resulting capital debit balance represents a claim against the

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partner. If the partner pays the deficiency, the ending cash balance is then distributed among the other partners with credit balances. If the deficient partner fails to pay, the uncollected amount becomes a loss to the partnership and is divided among the remaining partners. The remaining cash is then distributed to these partners.

Key Terms and Definitions

- **Deficiency** - The debit balance in the owner's equity account of a partner.
- **Liquidation** - The winding-up process when a partnership goes out of business.
- **Realization** - The sale of assets when a partnership is being liquidated.
- **Statement of Partnership Liquidation** - A summary of the liquidation process whereby cash is distributed to the partners based on the balances in their capital accounts.

Relevant Example Exercises and Exhibits

- Exhibit 4 – Steps in Liquidating a Partnership
- Exhibit 5 – Statement of Partnership Liquidation: Gain on Realization
- Exhibit 6 – Statement of Partnership Liquidation: Loss on Realization
- Example Exercise 12-5 – Liquidating Partnerships
- Exhibit 7 – Statement of Partnership Liquidation: Loss on Realization—Capital Deficiency
- Example Exercise 12-6 – Liquidating Partnerships—Deficiency

SUGGESTED APPROACH

There are two basic scenarios when partnerships are liquidated: (1) All partners end up with a positive capital balance and receive cash or (2) one or more of the partners ends up with a negative capital balance. If a partner has a negative capital balance, that partner should contribute cash to the partnership equal to his or her deficit so that the remaining partners may receive the cash they are due. If the partner is unwilling or unable to make up this deficit, his or her deficit must be allocated to the remaining partners.

Use Handout 12-14 to review the steps in liquidating a partnership, and use the following Demonstration Problem to illustrate liquidation.

DEMONSTRATION PROBLEM—Partnership Liquidation

Mary Hills, Beth Smith, and Kathy Grove are partners in HSG Pharmaceutical Company. They decide to liquidate their partnership when the partners have capital balances of $45,000, $48,000, and $22,000, respectively. The partnership has $13,000 in cash, $128,000 of noncash assets, and $26,000 in liabilities. The noncash assets are sold for $78,000. The partners split all income/losses using a 4:3:3 ratio. (*Note:* All gains and losses in liquidation are split using the partners' income-sharing ratio.)

		Noncash		Capital		
	Cash	**Assets**	**Liabilities**	**Hills**	**Smith**	**Grove**
Beginning balance	13,000	128,000	26,000	45,000	48,000	22,000
Assets sold	+ 78,000	–128,000		–20,000	–15,000	–15,000
Balance	91,000	0	26,000	25,000	33,000	7,000
Pay liabilities	–26,000		–26,000			
Balance	65,000	0	0	25,000	33,000	7,000

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In this case, all three partners end up with a positive balance in their capital accounts. All partners will receive cash equal to their capital balances.

What if the noncash assets of HSG Pharmaceutical Company were sold for $48,000?

		Noncash			Capital	
	Cash	Assets	Liabilities	Hills	Smith	Grove
Beginning balance	13,000	128,000	26,000	45,000	48,000	22,000
Assets sold	+ 48,000	– 128,000		–32,000	–24,000	–24,000
Balance	61,000	0	26,000	13,000	24,000	–2,000
Pay liabilities	– 26,000		–26,000			
Balance	35,000	0	0	13,000	24,000	–2,000

In this case, Grove has a deficit in her capital balance. If Grove will contribute the $2,000 needed to make up her capital deficiency, the partnership will have $37,000 in cash, of which $13,000 will be distributed to Hills and $24,000 to Smith. If Grove will not contribute an additional $2,000 to the partnership, her deficit must be split between Hills and Smith in their 4:3 ratio, as follows:

		Noncash			Capital	
	Cash	Assets	Liabilities	Hills	Smith	Grove
Beginning balance	13,000	128,000	26,000	45,000	48,000	22,000
Assets sold	+ 48,000	– 128,000		–32,000	–24,000	–24,000
Balance	61,000	0	26,000	13,000	24,000	–2,000
Pay liabilities	– 26,000		–26,000			
Balance	35,000	0	0	13,000	24,000	–2,000
Deficit allocated				–1,143	– 857	2,000
Balance	35,000	0	0	11,857	23,143	0

In this case, the $35,000 cash is distributed to Hills and Smith, based on their capital balances after Grove's deficit is allocated. Point out that the most common error in partnership liquidation is the improper distribution of cash to partners. It is wise to always double-check these calculations and compare them to any liquidation procedures outlined in the partnership agreement.

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After completing this explanation, ask your students to journalize the accounting entries to record this third scenario (noncash assets sold for $48,000; Grove does not contribute cash to make up her deficit).

Solution:

Account	Debit	Credit
Cash	48,000	
Loss on Realization	80,000	
Noncash Assets		128,000
Hill, Capital	32,000	
Smith, Capital	24,000	
Grove, Capital	24,000	
Loss on Realization		80,000
Liabilities	26,000	
Cash		26,000
Hill, Capital	1,143	
Smith, Capital	857	
Grove, Capital		2,000
Hill, Capital	11,857	
Smith, Capital	23,143	
Cash		35,000

OBJECTIVE 5

Prepare the statement of partnership equity.

SYNOPSIS

At the end of the each accounting period, similar to a sole proprietorship's statement of owner's equity, a statement of partnership equity is prepared. An example of a statement of partnership equity is shown in Exhibit 8.

Key Terms and Definitions

- **Statement of Members' Equity** - A summary of the changes in each member's equity in a limited liability corporation that have occurred during a specific period of time.
- **Statement of Partnership Equity** - A summary of the changes in each partner's capital in a partnership that have occurred during a specific period of time.

Relevant Exhibit

- Exhibit 8 – Statement of Partnership Equity

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SUGGESTED APPROACH

Handout 12-3 lists the names of the equity reports for each form of business. In reality, the equity reports for proprietorships, partnerships, and limited liability companies (LLCs) are all built on the basic structure (Handout 12-4):

Capital, beginning of the year
+ Investments (also called "Capital Additions")
+ Net Income (or – Net Loss)
– Withdrawals
Capital, end of the year

Use the Group Learning Activity below to review the equity reports for proprietorships, partnerships, and LLCs.

GROUP LEARNING ACTIVITY—Equity Reports for Proprietorships, Partnerships, and LLCs

Handout 12-15 presents a statement of partnership equity for Vince Gray, owner of Woodhaven Spas. Divide your students into groups and ask them to complete the handout. It will instruct them to complete the statement of partnership equity assuming Vince has a partner. Next, the handout will instruct them to modify the statement of partnership equity, assuming the business is organized as an LLC. The goal of this activity is to point out the similarity in equity reporting for proprietorships, partnerships, and LLCs.

The solution is provided below. Note that the change from partnership to LLC will change the headings to Vince Grey, Member; Anita Carnes, Member; and Total LLC Capital. The amounts will not change.

Woodhaven Spas
Statement of Partnership Equity
For the Year Ended December 31, 20Y2

	Vince Gray, Capital	Anita Carnes, Capital	Total Partnership Capital
Balance, January 1	$120,000	$ 75,000	$195,000
Investments	15,000	7,000	22,000
Net income	87,000	22,000	109,000
Partner withdrawals	(61,000)	(13,000)	(74,000)
Balance, December 31	$161,000	$ 91,000	$252,000

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OBJECTIVE 6

Analyze and interpret employee efficiency.

SYNOPSIS

This chapter discusses the revenue per employee ratio. The performance of partnerships can be measured by the amount of net income per partner. This ratio is calculated as revenue per employee = revenue/number of employees.

Key Term and Definition

- **Revenue per Employee** - A measure of the efficiency of the business in generating revenues, which is computed as revenue divided by number of employees.

Relevant Example Exercise

- Example Exercise 12-7 – Revenue per Employee

SUGGESTED APPROACH

This ratio is often used by service-oriented enterprises to measure the average revenue on a per-employee basis. Comparisons may be made for the same company for different time periods, one company to its industry average, or one company to another company in the same industry. Remind students that comparisons across industries aren't usually useful since the operations among industries are different insofar as their use of their labor force.

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Handout 12-1

CHARACTERISTICS OF A PARTNERSHIP

1. Limited life

2. Unlimited liability

3. Co-ownership of partnership property

4. Mutual agency

5. Participation in income

6. Nontaxable entity

7. Created by contract (partnership agreement or articles of partnership)

8. Limited ability to raise capital (funds)

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Handout 12-2

Limited Liability Corporation

Characteristics similar to partnerships:

1. Multiple owners, called "members"
2. Members create an operating agreement
3. May elect for income to pass through to members' individual tax returns
4. Mutual agency if member managed

Characteristics similar to corporations:

1. Limited liability
2. Must file articles of organization with state government authorities
3. If manager managed, only authorized members may legally bind the company
4. Usually have an unlimited life

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Handout 12-3

EQUITY REPORTING

Business Form	Report
Proprietorship	Statement of Owner's Capital
Corporation	Statement of Stockholders' Equity
Partnership	Statement of Partnership Equity
Limited Liability Corporation	Statement of Members' Equity

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Handout 12-4

REPORTING CHANGES IN OWNER'S CAPITAL

Capital, beginning of the year

\+ Investments (also called "Capital Additions")

\+ Net Income (or – Net Loss)

– Withdrawals

Capital, end of the year

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PARTNERSHIP FORMATION

Gibs Landscaping
Trial Balance

Account	Debit	Credit
Cash	$ 8,500	
Accounts Receivable	12,000	
Inventory	4,000	
Equipment	43,000	
Accum. Depr.—Equipment		$17,500
Accounts Payable		5,800
Willis Gibs, Capital		44,200
	$67,500	$67,500

All of Gibs's assets and liabilities will be contributed to the partnership. Although all of the receivables appear to be collectible at this time, the partners agree to a $1,000 allowance for doubtful accounts. The partners also agree that the current market value of equipment is $24,000.

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PARTNERSHIP FORMATION

Reed Landscaping
Trial Balance

Cash	$14,000	
Accounts Receivable	20,000	
Allowance for Doubtful Accounts		$ 3,400
Inventory	5,200	
Equipment	28,000	
Accum. Depr.—Equipment		14,000
Accounts Payable		11,300
George Reed, Capital		38,500
	$67,200	$67,200

Reed has agreed to transfer all of his business assets and liabilities, except $4,000 of his cash. The partners agree that Reed's equipment has a current market value of $17,000. In addition, it is agreed that $2,000 of Reed's accounts receivable should be written off as uncollectible and a $1,600 allowance for doubtful accounts will be sufficient for future bad debts.

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Handout 12-7

PARTNERSHIP FORMATION

Journal Entries

Account	Debit	Credit
Cash	8,500	
Accounts Receivable	12,000	
Inventory	4,000	
Equipment	24,000	
Allowance for Doubtful Accounts		1,000
Accounts Payable		5,800
Willis Gibs, Capital		41,700
Cash	10,000	
Accounts Receivable	18,000	
Inventory	5,200	
Equipment	17,000	
Allowance for Doubtful Accounts		1,600
Accounts Payable		11,300
George Reed, Capital		37,300

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Handout 12-8

DIVIDING PARTNERSHIP NET INCOME OR NET LOSS

1. Give each partner his or her salary allowance.

2. Give each partner interest on his or her capital account balance.

3. Divide any remainder according to the ratio in the partnership agreement. Divide the remainder evenly if the partnership agreement does not state how it should be divided.

   Note: The remainder may be a negative amount.

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Handout 12-9

Scenario 1: The partnership agreement of Gibs and Reed Landscaping provides an $18,000 salary allowance to Willis Gibs and a $24,000 salary allowance to George Reed. Both partners are given 10% interest on their capital balances at the beginning of the year. The beginning capital balance for Gibs was $41,700 and for Reed, $37,300. Any remaining income or loss is shared equally.

Assume that the business had revenues of $130,000 and expenses of $74,000 resulting in net income of $56,000 during its first year of operations. Calculate the net income distributed to each partner.

	Gibs	**Reed**	**Total**
Salary allowance	$18,000	$24,000	$42,000
Interest allowance	4,170	3,730	7,900
Subtotal			$49,900
Remainder = $6,100			
($56,000 – $49,900)	3,050	3,050	6,100
	$25,220	$30,780	$56,000

Scenario 2: Assume that the business formed by Gibs and Reed had revenues of $130,000 and expenses of $90,000 resulting in net income of $40,000 during its first year of operations. Calculate the net income distributed to each partner.

	Gibs	**Reed**	**Total**
Salary allowance	$18,000	$24,000	$42,000
Interest allowance	4,170	3,730	7,900
Subtotal			$49,900
Remainder = –$9,900			
($40,000 – $49,900)	– 4,950	– 4,950	– 9,900
	$17,220	$22,780	$40,000

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Handout 12-9 (Continued)

Scenario 3: Assume that the Gibs/Reed partnership agreement has the following provisions:

1. Salary allowances are $20,000 for Gibs and $30,000 for Reed.

2. No interest is given on the partners' capital balances.

3. Any income/loss greater than the salary allowances is divided using a 2:3 ratio.

Revenues of $130,000 and expenses of $62,000 resulting in net income for the first year of operations was $68,000.

	Gibs	**Reed**	**Total**
Salary allowance	$20,000	$30,000	$50,000
Remainder = $18,000			
($68,000 – $50,000)			
Split 2:3 ratio			
Gibs gets 2/5	7,200		
Reed gets 3/5		10,800	18,000
	$27,200	$40,800	$68,000

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Handout 12-10

PARTNERSHIP CLOSING ENTRIES

Scenario 1: Net income = $56,000

Revenues	130,000	
Expenses		74,000
Willis Gibs, Capital		25,220
George Reed, Capital		30,780

Scenario 2: Net income = $40,000

Revenues	130,000	
Expenses		90,000
Willis Gibs, Capital		17,220
George Reed, Capital		22,780

Scenario 3: Net income = $68,000

Revenues	130,000	
Expenses		62,000
Willis Gibs, Capital		27,200
George Reed, Capital		40,800

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Handout 12-11

ADMISSION OF A NEW PARTNER

Steps if new partner purchases an interest from one or more of the current partners:

1. The partnership interest that is purchased is transferred from the capital account of the selling partner(s) to the purchasing partner(s).

2. The amount paid for the partnership interest is irrelevant as far as the accounting records are concerned.

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Handout 12-12

ADMISSION OF A NEW PARTNER

Steps if a new partner contributes assets to the partnership:

1. The partnership assets are revalued to their current market value prior to recording the new partner’s contribution. This will increase or decrease the current partner’s capital accounts.

2. Determine the total equity of the partnership after admission of the new partner by adding the new partner’s contribution to the current partner’s equity.

3. Determine the new partner’s share of the total equity by multiplying the ownership percentage of the new partner by the total equity in the partnership.

4. Compare the new partner’s equity value to the amount of his or her contribution.

   a. If the contribution is greater than the new partner’s equity, the current partners get a bonus.

   b. If the contribution is less than the new partner’s equity, the new partner gets a bonus.

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Handout 12-13

WRITING EXERCISE

1. Why are the assets contributed by each partner recorded at their current market values?

2. In what circumstances would existing partners be willing to pay a bonus to a new partner?

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Handout 12-14

STEPS IN LIQUIDATING A PARTNERSHIP

1. Any noncash assets are sold, and the resulting gains or losses are allocated to the partners' capital accounts.

2. The partnership liabilities are paid.

3. The remaining cash is distributed to the partners based on the balances in their capital accounts.

If a partner has a deficit (debit balance) in his or her capital account, one of the following occurs:

1. The partner may pay the deficiency to the partnership, allowing the other partners to receive cash equal to their capital balances.

OR

2. The deficit balance may be allocated to the other partners, reducing their capital balances and the amount of cash they will receive.

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Handout 12-15

Woodhaven Spas
Statement of Partnership Equity
For the Year Ended December 31, 20Y2

	Vince Gray, Capital		
Balance, January 1	$120,000		
Investments	15,000		
Net income	87,000		
Partner withdrawals	(61,000)		
Balance, December 31	$161,000		

Instructions:

1. Complete the above report, assuming Woodhaven Spas is organized as a partnership. Vince's partner is Anita Carnes. Anita's capital balance on January 1 was $75,000. During the year, she invested an additional $7,000 and made withdrawals of $13,000. The total company's income was $109,000; Anita's share was $22,000. If possible, make all of these changes in pencil.

2. Next, modify the above report, assuming Woodhaven Spas is organized as a limited liability corporation. If possible, make these changes in pen.

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