South Valley University
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Lectures in

ACCOUNTING FOR PARTNERSHIPS

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IN THE NAME OF ALLAH, THE MOST GRACIOUS, THE MOST MERCIFUL

THIS TEXTBOOK IS DEDICATED TO
THE MEMORY OF MY FATHER AND MY MOTHER
&
MY WIFE AND MY CHILDREN

Preface

Praise to ***Almighty ALLAH*** who gave me the strength, patience, and ability to complete this textbook.

This textbook has been written to provide student with a very comprehensive introduction to Financial Accounting regarding partnerships. Therefore, this textbook is divided into a variety of chapters intended to put the students, who study business, on the right way towards understanding financial accounting concerning partnership form of organization. Chapter one of this issue covers the nature of partnerships. Chapter two introduces to the accounting for operations of partnership. Chapter three is entitled changes in membership of the partnership.

Qena, September 2021.

CHAPTER ONE
THE NATURE OF PARTNERSHIPS

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THE NATURE OF PARTNERSHIPS

1.1 Partnerships:

A partnership is defined as an *"association of two or more persons to carry on as co-owners a business for profit"* (Baker, Lembke and King, 2005) This definition includes three distinct factors:

1. *Association of two or more persons*. The ***persons*** are usually individuals; however, they could be corporations or other partnerships.
2. *To carry on as co-owners.* A partnership is an aggregation of partners' individual rights. This means that all partners are co-owners of partnership property and are co-owners of the profits or losses of the partnership.
3. *Business for profit.* A partnership may be formed to perform any legal business' trade, profession, or other service. Nevertheless, the partnership must attempt to make a profit; hence, not-for-profit organizations, such as fraternal or

brotherly groups (societies), may not be partnership.

In practice, partnerships are the least common form of business organization, maybe because they often end of or wind up with *too many bosses*. Nevertheless, they are widely used for professional practices, such as medicine, law, and public accounting. Furthermore, partnerships also are used for many small businesses, especially those which are family-owned.

For accounting purposes, a partnership is viewed as an entity separate from the other activities of its owners. But under the law, the partnership is not ***"separate"*** from its owners. Rather, the law regards the partners as personally ***and jointly*** responsible for the activities of the business. The assets of a partnership do not belong ***"to the business***. Rather, they belong jointly to all of the partners. Unless special provisions are made, each partner has unlimited personal liability for the debts of the business. From a legal standpoint, partnerships have

limited lives. A partnership ends upon the withdrawal or death of an existing partner. Admission of a new partner terminates the ***old*** partnership and creates a new legal entity.

Nevertheless, this is only a legal distinction or difference. Most partnerships have ***continuity of existence*** extending beyond the participation of individual partners. Partnership agreements often have provisions that make the retirements of partners and the admission of new partners' ***routine events*** that do not affect the operations of the business (Meigs, et al., 1996).

1.2 Formation of a Partnership:

A chief advantage of the partnership form of entity is ease of formation. Accordingly, the agreement to form a partnership may be as informal as a handshake or as formal as a several-paged agreement typically termed the ***articles of co-partnership***. Each partner must agree to the formation agreement, and partners are strongly advised to have a formal written agreement to avoid potential problems that may arise or emerge during the operation of the business. The articles of co-partnership should include the following items (Larsen, 2000; Baker, Lembke and King, 2005):

1) The name of the partnership and the names of the partners.

2) The type of business to be conducted by the partnership and the duration of the partnership agreement.

3) The initial capital contribution of each partner and the method by which to account for future capital contributions. The procedure for valuing noncash investments and the penalties for a

partner's failure to invest and maintain the agreed amount of capital.

4) A complete specification of the profit or loss distribution, including salaries, interest on capital balances, bonuses, limits on withdrawals in anticipation of profits, and the percentages used to distribute any residual profit or loss

5) Procedures used for changes in the partnership, such as admission of new partners and the retirement of a partner.

6) Other aspects of operations the partners decide on, such as the management rights of each partner, election procedures, and accounting methods.

7) Insurance on the lives of partners, with the partnership or surviving partners named as beneficiaries.

8) Provision for liquidation of the partnership at the end of the term specified in the contract or at the death or retirement of a partner.

Each partner should sign the partnership agreement to indicate acceptance of the terms. A carefully prepared partnership agreement can eliminate many of the more common types of problems and disputes that may arise in the partnership's future operations.

1.3 Major Characteristics of Partnerships:

Actually, partnerships have several features or characteristics that distinguish them from other forms of business organizations.

1.3.1 Limited Life:

A partnership legally terminates as a business entity each time there is a change in membership. This legal termination is called ***"dissolution of the partnership."*** Most partnerships encompass provisions in their articles of copartnership for changes in membership so that the business is not interrupted. These provisions provide procedures for electing new partners and for valuing a partner's capital balance at the time of death or retirement, thus ensuring continued business operations during the period of change. The most common causes of partnership's dissolution are the death, retirement, bankruptcy, or incapacity of a partner. As mentioned in the previous sections, the admission of a new partner to the partnership legally ***dissolves*** the former partnership and establishes a new one.

1.3.2 Ease of Formation:

In contrast with a corporation, partnership may be created by an oral or a written contract between two or more persons, or may be ***implied by their conduct***. This advantage of convenience and minimum cost of formation of a partnership in some cases may be offset by certain difficulties inherent in such an informal organizational structure.

1.3.3 Co-Ownership of Partnership Assets and Earnings:

When individuals invest assets in a partnership, they retain no claim to those specific assets but acquire ownership ***equity in net assets*** of the partnership. Every member of a partnership also has an interest in partnership earnings; in fact, participation in earnings and losses is one of the tests of the existence of a partnership.

1.3.4 Agency Relationship (Mutual Agency):

As mentioned above, each partner is a co-owner of the partnership assets and liabilities. So, creditors view each partner as an agent of the partnership

capable of transacting business in the partnership's name. consequently, any partner can bind or oblige the partnership when acting within the scope of the partnership activities. for example, partner ***A*** can sign a lease in the partnership name even though the articles of co-partnership specify that only partner ***B*** may sign leases. The partnership is still bound by the lease because the other party to the lease can assume or commit mutual agency of each partner. Any legal remedy is strictly between partners ***A*** and ***B***.

Accordingly, each partner has the authority to act for the partnership and to enter into contracts on its behalf. However, acts beyond the normal scope of business operations, such as the obtaining of a bank loan by a partner, generally do not bind the partnership unless specific authority has been given to the partner to enter into such transactions.

1.4 Types of Partnerships:

It was discussed that a partnership is an unincorporated business owned by two or more *partners*. A partnership often is referred to as a **firm, enterprise, company, and so on.**

Practically and in order to satisfy the various needs of different groups of investors interested in the investment fields, different types of partnerships have been developed. The term ***partnership*** actually includes three distinct types of organizations: *general partnerships, limited partnerships, and limited liability partnerships* (Meigs, 1996; Larsen, 2000; and Baker, Lembke, and King, 2005).

1.4.1 General Partnerships:

The *general partnership* is the traditional form of partnership, in which ***all*** partners have unlimited personal liability for unpaid debts of the partnership. In a **general partnership**, each partner has rights and responsibilities similar to those of a sole proprietor. For instance, each ***general partner*** can withdraw cash and many other assets from the

business at will, except real estate, as title to real estate is held in the name of the partnership and, accordingly, cannot be sold or withdrawn by any partner at will.

Furthermore, each partner has the full ***"authority of an owner"*** to negotiate contracts binding upon the business. This concept is called *mutual agency* (الوكالة أو المسئولية المشتركة أو التبادلية). Hence, every partner also has ***unlimited personal liability*** for the debts of the firm.

Aggregating the characteristics of unlimited personal liability and mutual agency makes a *general partnership* a potentially dangerous form of business organization. For example, assume that you enter into a general partnership with Sami Ahmed. You agree to split (distribute) profits and losses ***"50-50"***. While you are on vacation, Sami commits the partnership to a contract that it simply does not have the resources to complete. Your firm's failure to complete the contract causes large financial losses to the customer. The customer sues or appeals

(يقاضي أو يرفع دعوة) your firm and is awarded a judgment of L.E.5,000,000 by the court.

Sami has few financial resources and declares personal bankruptcy (إفلاس). The holder of the judgment against your firm can hold ***you personally liable for the whole L.E.5,000,000.*** The fact that you and Sami agreed to appropriate everything ***"50-50"*** does *not* lessen or minimize your personal liability to your firm's creditors. You may have a legal claim against Sami for his half of the debt, but so what? Sami is bankrupt.

To sum up, general partnerships involve the same unlimited personal liability as sole proprietorships. Such risk is intensified, however, because you may be held financially responsible for your partner's actions, as well as for your own.

1.4.2 Partnerships That Limit Personal Liability:

The modified forms of partnerships include ***"limited"*** partnerships and ***"limited liability"*** partnerships. The purpose of these modified forms of partnerships

is to ***place limits*** upon the potential liability of individual partners.

1.4.2.1 Limited Partnerships:

A ***limited partnership (شركة التوصية البسيطة)*** has one or more *"general partners"*, and also one or more *"limited partners"*. The general partners are partners in the traditional sense or meaning, with unlimited personal liability for the debts of the business, and also the right to make managerial decisions.

The **limited partners** are basically *"passive or silent partners"*. Silent or passive partners (الشركاء الموصون) share in the profits of the business, but they don't participate actively in management and are ***not*** personally liable fore debts of the business. Thus, if the firm *"goes under"* or sinks, the losses incurred by the limited partners are ***"limited"*** to the amounts they have invested in the business.

For example, Pyramids, the professional football team, is organized as a publically owned limited partnership. This means you can easily purchase a partnership interest in the team. As one of the limited

partners, you can participate in all distributions of the team's profits. But you cannot make management decisions: You can't hire players, send in plays, or fire the head coach. On the other hand, if the Pyramids cannot pay their bills, the team's creditors won't come after you.

In the past, limited partnerships were widely used for various *"investment ventures"* (الاستثمارات المغامرة أوالاستثمار بالمضاربة) such as drilling for oil, developing real estate, or making a motion picture. These businesses often lost money-at least in the early years; if they were profitable, the profits come in later years. For such ventures, the limited partnership concept had great appeal to investors. Limited partner's financial risk was limited to the amount of their equity investment.

1.4.2.2 Limited Liability Partnerships:

A ***limited liability partnership (شركة أشخاص محدودة)*** is a relatively new form of business organization. Over the years, many professional partnerships have grown in size. Several public accounting firms, for

example, now have thousands of partners and operate in countries all over the world. Also, lawsuits against professional firms have increased greatly in number and in pound amount. To prevent these lawsuits from bankrupting *'innocent'* partners, the concept of the limited liability partnership has emerged. In this type of partnerships, each partner has unlimited personal liability for his or her ***own*** professional activities, but not for the actions of other partners. Unlike a limited partnership, all of the partners in a limited liability partnership may participate in management of the firm.

Many public accounting and other professional services now have the letters ***LLP*** after the name of their partnership. The ***LLP*** means that the partnership is a ***limited liability partnership***. The limited liability partnership provides that the partners are not personally liable for any debt, obligation, or liability that chargeable to the partnership. Also, the partners are still liable up to the amount of their

capital accounts, but their personal assets are protected from the partnership's creditors.

1.5 Accounting for the Formation of a Partnership:

The individual partners must agree to the percentage of equity that each will have in the net assets of the partnership. In general, the capital balance is determined by the proportionate share of each partner's capital contribution. For example, if ***A*** contributes 60% of the net assets in a partnership with ***B***, then ***A*** will have a 60 percent capital share and ***B*** will have a 40 percent capital share.

In recognition of intangible factors, such as a partner's special expertise or necessary business connections, however, partners may agree to any proportional division of capital. Therefore, before recording the initial capital contribution, all partners must agree on the valuation of the net assets and on each partner's capital share.

In the real world, when a partner contributes his or her capital share, he/she may introduce cash amount, cash and other assets, or a sole proprietorship (both assets and liabilities).

Illustration of Accounting for Partnership Formation:

As discussed previously, accounting in a partnership is similar to that in a sole proprietorship, except that separate capital accounts are maintained for each partner. These capital accounts show for each partner the amounts invested, the amounts withdrawn, and the appropriate share of partnership net income. Hence, each partner is provided with a history of his or her equity in the firm.

Separate drawing accounts also are maintained for each partner. These drawing accounts are debited to record all withdrawals of cash or other assets including the use of partnership funds to pay a partner's personal debts.

Illustration 1.1:

To illustrate the opening entries for a newly formed partnership, assume that on January 1, 2020, Hassan and Husain, who operate competing retail stores, decide to form a partnership by consolidating their two businesses. A capital account will be opened for each partner and credited with the agreed

valuation of the ***net assets*** (total assets less total liabilities) that the partner contributes.

Instructions:

Prepare the journal entries to open the accounts of the partnership of Hassan and Husain.

Solution

Journal entries:

Date	Description	Dr.	Cr.
2020 Jan. 1	Cash……………………..	200000	
	Accounts Receivable……	300000	
	Inventory………………..	450000	
	Accounts Payable………..		150000
	Hassan, Capital………….		800000
	To record the investment by Hassan in the partnership of Hassan and Husain.		
Jan. 1	Cash…………………..	50000	
	Inventory……………..	300000	
	Land…………………..	300000	
	Building………………	500000	
	Accounts Payable……………..		350000
	Husain Capital………………..		800000
	To record the investment by Husain in the partnership of Hassan and Husain.		

Additional Investments:

Assume that after five months of operation, the organization is in need of more cash, and the partners make additional investments of L.E.100,000 each on June 1. These additional investments are credited to the capital accounts as presented below:

2020 June 1	Cash……………. Hassan, Capital…… Husain, Capital…… To record additional investments.	200000	100000 100000

Illustration 1.2:

Alaa, a sole proprietor, has been developing software for several types of computers. The business has the following account balances as of December 31, 2019 (L.E.):

Cash………..	60000	Liabilities…..	200000
Inventory…...	140000	Alaa, Capital..	300000
Equipment….	400000		
Accumulated Depreciation: Equipment…..	(100000)		
Total	500000	***Total***	500000

Alaa needs additional technical assistance to meet the increasing sales and offers Basim an

interest in the business. Alaa and Basim agree to form a partnership. Alaa's business is audited, and its net assets are appraised. The audit and appraisal disclose that L.E.20,000 of liabilities has not been recorded, inventory has market value of L.E.180,000, and the equipment has a fair value of L.E.380,000.

On January 1, 2020, Alaa and Basim prepare and sign articles of copartnership that include all significant operating polices. Basim will contribute L.E.200,000 cash for a one-third (⅓) capital interest. The AB Partnership is to acquire all of Alaa's business and assume its debts.

Instructions:

1- Prepare the journal entry to record the initial capital contribution on the partnership's books, and the journal entry to close Alaa's business records.

2- Prepare the opening balance sheet of AB Partnership on January 1, 2020.

Solution

Calculations:

New value of Alaa's net assets = assets - liabilities = cash + inventory + equipment - liabilities.

= 60,000 + 180,000 + 380,000 - 220,000

= 620,000 - 220,000 = L.E.400,000.

1. Journal entries:

Date	Description	Dr.	Cr.
2020	Cash………………	260000	
Jan.	Inventory………..	180000	
1	Equipment……….	380000	
	Liabilities……..		220000
	Alaa, Capital…..		400000
	Basim, Capital…		200000
	Formation of AB Partnership by capital contributions of Alaa and Basim.		
	Accumulated depreciation-Equip.	100000	
Jan.	Liabilities………..	200000	
1	Alaa, Capital……..	300000	
	Cash………………		60000
	Inventory………..		140000
	Equipment……….		400000
	To close Alaa's business accounts.		

2. Opening Balance Sheet of AB Partnership:

AB Partnership Balance Sheet January 1, 2020			
Cash………..	260000	Liabilities…..	220000
Inventory…...	180000	Alaa, Capital….	400000
Equipment….	380000	Basim, Capita….	200000
Total	**820000**	***Total***	**820000**

Basic Observations from Illustration:

1) Note that the partnership is an accounting entity separate from each of the partners and that the assets and liabilities are recorded at their market values at the time of contribution. No accumulated depreciation is carried forward from the sole proprietorship to the partnership. All liabilities are recognized and recorded.

2) The partnership's capital is L.E.600,000. This is the sum of the individual partners' capital accounts and is the value of the partnership's assets less liabilities. The fundamental accounting equation-assets less liabilities equals capital- is used often in partnership accounting. Basim is to receive a one-third capital interest in the

partnership with a contribution of L.E.200,000. In this case, his capital interest equals his capital contribution.

3) Each partner's capital amount recorded does not necessarily have to equal his or her capital contribution. The partners could decide to divide the total capital equally regardless of source of the contribution. For example, although Alaa contributed L.E.400,000 of the L.E.600,000 partnership capital, he could agree to L.E.300,000 as his initial capital balance and permit Basim the remaining L.E.300,000 as a capital credit. On the surface this may not seem to be a reasonable action by Alaa, but is possible that Basim has some particularly important business experience needed by the partnership and Alaa agrees to the additional credit to Basim in recognition of his experience and skills. The key point is that the partners may allocate the capital contributions in any manner they desire. The accountant must be

sure that all partners agree to the allocation and then record it accordingly.

Key Accounting Practices in Partnerships:

In most respects, partnership accounting is similar to that in a sole proprietorship, except there are more owners. Accordingly, a separate capital account, drawing account, and current account is maintained for each partner.

Partnerships, like sole proprietorships, recognize no salaries expense for services provided to the enterprise by the partners. Amounts paid to partners are recorded by debiting the partner’s drawing account.

The statement of owner’s equity is replaced by a ***statement of partners’ equity***, which shows separately the changes in each partner’s capital account. In some cases, especially in firms with a large number of partners, this statement is condensed to show only the changes in ***total*** partners’ equity. A typical statement of partners’ equity appears below:

HASSAN AND HUSAIN
Statement of Partners' Equity
For the Year Ended December 31, 2020

	Hassan	**Husain**	**Total**
Balances, Jan. 1, 2020 L.E.	800000	800000	1600000
Add: Additional investments	50000	50000	100000
Net income for the year	150000	150000	300000
Subtotals…………………...	1000000	1000000	2000000
Less: Drawings……………	120000	80000	200000
Balance, Dec. 31, 2020	880000	920000	1800000

1.6 Questions:

CONCEPTUAL QUESTIONS:

1. What are the two factors that make ownership of an interest in a general partnership particularly risky?

a. Mutual agency and unlimited personal liability.

b. Limited life and unlimited personal liability.

c. Limited life and mutual agency.

d. Double taxation and mutual agency.

2. Which of the following types of business owners do ***not*** take an active role in the daily management of the business? (Indicate all correct answers.)

a. General partners.

b. Limited partners.

c. Sole proprietors.

d. Stockholders in a publicly owned corporation.

3. What is meant by the term ***mutual agency***?

4. Distinguish among a general partnership, a limited partnership, and a limited liability partnership.

5. Which form of partnership would be most appropriate for law practice? Explain.

EXERCISES AND PROBLEMS:

(1) A business owned by Fatah Douglas was short of cash. Douglas, therefore, decided to form a partnership with Andréa Makah, who would contribute cash to the new partnership. The assets contributed by Douglas appeared as follows in balance sheet of his business: cash, L.E.6,000; accounts receivable, L.E.349,000; inventory, L.E.450,000; and store equipment, L.E.216,000. Douglas had recorded depreciation of L.E.18,000 during his use of the store equipment in his sole proprietorship.

Douglas and Makah agreed that the accounts receivable had a fair value of L.E.331,000. They also agreed that a fair value for the inventory was its replacement cost of L.E.540,000 and that the fair value of the store equipment was L.E.190,000.

Instructions:

You are required to open the partnership accounts by making a general journal entry to record the investment by Douglas.

(2) The partnership of Effendi and Pasha was formed on January 1, 2020, when Mira Effendi and Dinah Pasha agreed to invest equal amounts and to share profit and losses equally. The investment by Effendi consists of L.E.300,000 cash and an inventory of merchandise valued at L.E.560,000.

Pasha also is to contribute a total of L.E.860,000. However, it is agreed that her contribution will consist of the following assets of her business along with the transfer to the partnership of her business liabilities. The agreed values of the various items as well as their carrying values on Pasha's records are listed below. Pasha also contributes enough cash to bring her capital account to L.E.860,000.

Investment by Pasha

Description	Balances on Pasha's Records	Agreed Value
Accounts receivable	816800	796000
Inventory	114000	128000
Office equipment-net	143000	90000
Accounts payable	248000	248000

Instructions:

a. Prepare general journal entries to record the investments of Effendi and Pasha in the new partnership.

b. Prepare the beginning balance sheet of the partnership on January 1, 2020, reflecting the above transfers to the firm.

(3) On January 1, 2020, Samira and Samar agreed to establish general partnership of L.E.700,000 as initial investments (S&S Partnership). Capital shares for Samira and Samar are L.E.400,000 and L.E.300,000, respectively. They decided to transfer their sole proprietorships to be a one new partnership. Balance sheet of each of their sole proprietorships was as follows:

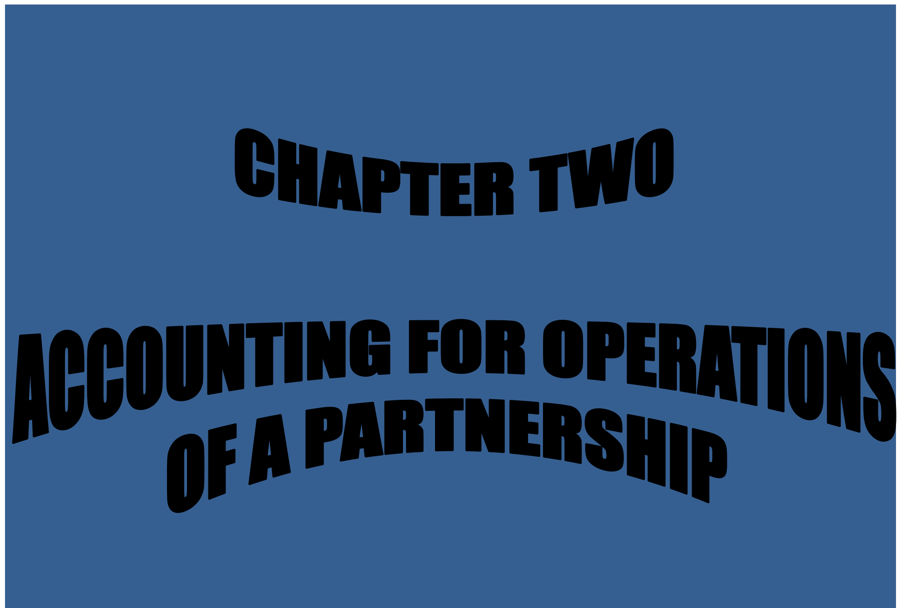
Assets **Liabilities & O. Equity**

Details	Samira	Samar	Details	Samira	Samar
Machine	105000	140000	Capital	350000	250000
Cars	167500	130000	A Payable	75000	65000
Inventory	125000	65000	Bonds		
A Receivable	52500	30000	Payable	120000	100000
Bank	95000	50000			
	545000	415000		545000	415000

They agreed to transfer all the above balances to the S&S Partnership and accepted values disclosed in the above balance sheets. They agreed also to pay or withdraw any difference between the presented net assets and the agreed shares of capitals.

Instructions:

1. Prepare the journal entry to record the initial capital contribution on the partnership's books, and the journal entry to close Samira's business records.
2. Prepare the opening balance sheet of S&S Partnership on January 1, 2020.


CHAPTER TWO
ACCOUNTING FOR OPERATIONS
OF A PARTNERSHIP

CHAPTER TWO

ACCOUNTING FOR OPERATIONS OF A PARTNERSHIP

2.1 Introduction:

Practically, like sole proprietorship, a partnership provides services or sells products in pursuit of profit. These transactions are recorded in the appropriate journals and ledger accounts. Many partnerships use accrual accounting and generally accepted accounting principles to keep their books because GAAP result in better measures of income than alternative accounting methods such as the cash basis or modified cash basis.

Partnership financial statements are prepared for the partners and occasionally for partnership creditors. Accountants often encourage the use of GAAP for financial statements purposes because the partners may then compare the partnership's financial statements with those of other business firms (Baker, Lembke, and King (2005).

2.2 Ledger Accounts for Partners:

Accounting for partnership differs from accounting for a single proprietorship or a corporation with regarding the sharing of net income and losses and the maintenance of the partners' ledger accounts. Although it could be possible to maintain partnership accounting records with only one ledger account for each partner, the common application or practice is to keep a group of accounts.

The partnership may maintain several accounts for each partner in its accounting records. These partnership accounts consist of ***(1) capital*** accounts, ***(2) drawing*** or ***personal-current-*** accounts, and ***(3)*** accounts for ***loans*** to and from partners. These ***partners' accounts*** are as follows:

2.2.1 Capital Accounts:

The initial investment of a partner, any subsequent capital contributions, profit or loss distributions, and any withdrawals of capital by the partner are ultimately recorded in the partner's capital account. The original investment by each partner is recorded

by debiting the assets invested, crediting any liabilities assumed by the partnership, and crediting partner's capital account with current fair value of the ***net assets*** invested. On occasion, a partner's capital account may have a debit balance, called a ***deficiency*** or sometimes termed a ***deficit***, which occurs because the partner's share of losses and withdrawals exceeds his or her capital contribution and share of profits. A deficiency is usually eliminated by additional capital contributions. The balance in the capital account represents the partner's share of the partnership's net assets.

2.2.2 Drawing Accounts:

Generally, partners make withdrawals of assets from the partnership during the year in anticipation of profits. A separate drawing account often is used to record the periodic withdrawals and is then closed to the partner's capital account at the end of the period. For example, the following entry is done in the H&H Partnership's books for a L.E.15,000 cash withdrawn by Hassan on May 1, 2020:

May1, 2020 Hassan Drawing Cash Withdrawal of L.E.15,000 cash be Hassan.	15000	 15000

Noncash drawings should be valued at their market values at the date of the withdrawal. A few partnerships make an exception to the rule of market value for partners' withdrawals of inventory. They record withdrawals of inventory at cost, by which not recording a gain or loss on these drawings.

2.2.3 Loans Accounts:

Partnership may look to its present partners for additional financing. This is considered a loan rather than an increase in the partner's capital account balance. This transaction is recorded by a credit to Loans Payable to Partners and generally is accompanied by the issuance of a promissory note.

Conversely, a partner may receive cash from the partnership with the intention of repaying this amount. Such a transaction may be debited to the Loans Receivable from Partners ledger account

rather than to the partner's drawing account. Loans receivable from partners are displayed as asset in the partnership balance sheet and loans payable to partners are displayed as liabilities.

Any loans between a partner and the partnership should always be accompanied by proper loan documentation. Unless all partners agree otherwise, the partnership is obligated to pay interest on the loan to the individual partner for loan payable. On the contrary, interest is ***not*** required to be paid on capital investments unless the partnership agreement states that capital interest is to be paid. The partnership records interest on loans payable as an operating expense. On the other hand, the interest income is recognized on the partnership's income statement concerning loans receivable. The following journal entry is made to record a L.E.20,000, 10%, one-year loan from Husain to the partnership on July 1, 2020:

July 1, 2020		
Cash	20000	
Loan Payable to Husain		20000
Sign loan agreement with partner Husain.		

The loan payable to Husain is recorded in the partnership's balance sheet. A loan from a partner is a related-party transaction for which separate footnote disclosure is required, and it must be reported as a separate balance sheet item, not included with other liabilities.

If a substantial unsecured loan has been made by a partnership to a partner and repayment appears doubtful, it is appropriate to offset the receivable against the partner's capital account balance.

2.2.4 Partners' Current Account:

In practice, partners' capital accounts can be maintained either on ***fixed capital system,*** or ***fluctuating (changing) capital system.***

Fixed Capital System:

In case of a fixed capital system, there are two accounts for each partner:

a) Partner's Capital Account.

b) Partner's Current Account

The capital account for each partner remains year by year at the figure of capital put into the firm by the partners. The partner's capital account is credited

with the original amount of capital introduced by the partner into the business. It is to be credited subsequently with extra capital introduced by the partner or debited with the amount of capital permanently withdrawn by the partner. No other adjustments are made in this account.

The partner's current account is maintained for making all entries relating to interest, share of profit, drawings, etc. Accordingly, the profits, interest on capital and the salaries to which the partner may be entitled are then credited to a separate current account for the partner, and the drawings and interest on drawings are debited to it. The balance of the current account at the end of each financial year will then represent the amount of undrawn (or withdrawn) profits. A credit balance will be undrawn profits, while a debit balance will be drawings in excess of the profits to which the partner was entitled. The balance in this account will go on fluctuating but the balance of the capital account will remain fixed.

Fluctuating Capital System:

In case of fluctuating capital system, there is only one account for each partner. This account is termed as capital account. All entries relating to initial capital, drawings, interest, profit etc. are made in this account. The balance in the capital account, therefore, goes on fluctuating.

2.3 Allocation Profit or Loss to Partners:

In the business world, a wide range of ***profit distribution plans*** is found. Some partnerships have straightforward distribution plans; others have extremely complex ones. It is the accountant's responsibility to distribute the profit or loss according to the partnership agreement regardless of how simple or complex that agreement is. A profit distribution is similar to dividends for corporation: These distributions ***should not be included in the income statement (or profit & loss account)*** regardless of how the profit is distributed. Profit distributions are recorded directly into the partner's personal account (whether capital or current account), not as expense items.

The many possible plans for sharing of net income or loss among partners of a partnership may include the following categories:

(1) Equally, or in some other ratio.

(2) In the ratio of partners' capital account balances on a particular date, or in the ratio of

average capital account balances during the year.

(3) Allowing interest on partners' capital account balances and dividing the remaining net income or loss in a specified ratio.

(4) Allowing salaries to partners and dividing the resultant net income or loss in a specified ratio.

(5) Bonus to managing partner based on income.

(6) Allowing salaries to partners, allowing interest on capital account balances, and dividing the remaining net income or loss in a specified ratio.

The alternative income-sharing plans emphasize that the value of personal services rendered by individual partners may vary widely, as may the amounts of capital invested by each partner. The amount and quality of managerial services rendered and the amount of capital invested often are important factors in the success or failure of a partnership. Therefore, provisions may be made for salaries to partners and interest on their respective

capital account balances as a preliminary step in the division of income or loss. Any remaining income or loss then may be distributed in a specified ratio.

Another factor affecting the success of a partnership may be that one of the partners has large personal financial resources, thus giving the partnership a strong credit rating. Similarly, partners who are well known in a profession or an industry may contribute importantly to the success of the partnership even though they may not participate actively in the operations of the partnership. These two factors may be incorporated in the income-sharing plan by carful selection of the ratio in which any remaining net income or loss is divided (Larsen, 2000).

Most partnerships use one or more of the following distribution methods:

1. Preselected ratio.

2. Interest on capital balances.

3. Salaries to partners.

4. Bonuses to partners.

Preselected Ratio:

Preselected ratios are usually the result of negotiations between the partners. Ratios for profit distributions may be based on the percentage of total partnership capital, time and effort invested in the partnership, or a variety of other factors. Smaller partnerships often split or distribute profits evenly among the partners. Furthermore, some partnerships have different ratios if the firm suffers a loss rather than earns a profit. The partnership form of business allows a wide selection of profit distribution ratios to meet the partner's individual desires.

For example, suppose the capitals were Ali L.E.200,000 and Peter L.E.100,000, many people would share the profits in the ratio of two-thirds to one-third, even though the work to be done by each partner is similar. A look at the division of the first few years' profits on such a basis would be:

Years	**One L.E.**	**Two L.E.**	**Three L.E.**	**Four L.E.**	**Five L.E.**	**Total L.E.**
Net profits	36000	48000	60000	60000	72000	
Shared:						
Ali ⅔	24000	32000	40000	40000	48000	184000
Peter ⅓	12000	16000	20000	20000	24000	92000

Ali would receive L.E.184,000, or L.E.92,000 more than Peter. Equitably the difference between the two shares of profit in this case, as the duties of the partners are the same, should be adequate to compensate Ali for contributing extra capital into the firm. It is obvious that L.E.92,000 extra profits is far more than adequate for this purpose. Consider too the position of capital ratio sharing of profits if one partner put in L.E.9,900,000 and the other put in L.E.100,000 as capital. To overcome the difficulty of compensating for the investment of extra capital, the concept of interest on capital was introduced or devised.

Interest on Capital Balances:

Distributing partnership income based on interest on capital balances recognizes the contribution of the partners' capital investments to the partnership's profit-generating capacity. This interest on capital is not an expense of the partnership; it is a distribution of profits. If the work to be done by each partner is of equal value but the capital contributed is unequal, it

is equitable to grant interest on the partners' capitals. This interest is treated as a deduction prior to the calculation of profits and their distribution according to the profit-sharing ratio.

The rate of interest is a matter of agreement between the partners, but it should theoretically equal the return which they would have received if they had invested the capital elsewhere. Taking Ali & Peter again, but sharing the profits equally after charging 5% annual interest on capital, the appropriation of profits would become:

Years	One L.E.	Two L.E.	Three L.E.	Four L.E.	Five L.E.	Total L.E.
Net profits	36000	48000	60000	60000	72000	
Interest on capitals						
Ali	10000	10000	10000	10000	10000	50000
Peter	5000	5000	5000	5000	5000	25000
Shared:						
Ali 1/2	10500	16500	22500	22500	28500	100500
Peter 1/2	10500	16500	22500	22500	28500	100500

Summary	***Ali***	***Peter***
Interest of capital	L.E. 50,000	25,000
Balance of profits	100,500	100,500
	150,500	125,500

Ali has thus received L.E.25,000 more than Peter, this being adequate return (in the partners' estimation) for having invested an extra L.E.100,000 in the firm for five years.

Salaries or Bonuses to Partners:

If one or more of the partners' services are important to the partnership, the profit distribution agreement may provide for salaries or bonuses. For example, one partner may have more responsibility or tasks than the others. As a reward for this, rather than change the profit and loss sharing ratio, he/she may have a salary which is deducted before sharing the balance of profits. Again, ***these salaries paid to partners are a form of profit distribution, not an expense of the partnership.***

Interest on Drawings:

It will obviously be in the best interests of the business if cash is withdrawn from the partnership by the partners in accordance with the two basic principles of (Wood, 1993):

a. As little as possible.

b. As late as possible.

The more cash that is left in the business the more expansion can be financed. To deter or prevent the partners from taking out cash, partners can be charged interest on each withdrawal, calculated from the date of withdrawal to the end of the financial year. The amount charged to them helps to swell or inflate the profits distributable between the partners. Suppose that Ali and Peter have decided to charge interest on drawings at 5% annually, and that their yearend was 31 December. The following drawings are made:

Drawings		Ali Interest	L.E.
1 January	L.E.1,000	1000 × 5% × 12 months =	50
1 March	2,400	2400 × 5% × 10 months =	100
1 May	1,200	1200 × 5% × 8 months =	40
1 July	2,400	2400 × 5% × 6 months =	60
1 October	800	800 × 5% × 3 months =	10
		Interest charged to Ali =	260

Drawings		Peter Interest	L.E.
1 January	L.E. 600	600 × 5% × 12 months =	30
1 August	4,800	4800 × 5% × 5 months =	100
1 December	2,400	2400 × 5% × 1 months =	10
		Interest charged to Peter =	140

The amount of profit may be arrived at after making adjustments for interest on capital, interest on drawings, and salaries to partners. The profit or

loss distribution is recorded with a closing entry at the end of each period. The revenue and expenses are closed into an income summary account. In the following examples, an income summary account is used, the balance of which is net income or net loss after the revenue and expense accounts are closed and before the income or loss is distributed to the partners' personal accounts.

The entries for each one of the distribution items will be as follows:

Items	Description	Dr	Cr
1. Interest on Capital	Profit and Loss Appropriation Account	xx	
	Partners' Current or Capital Accounts		xx
2. Interest on Drawings	Partners' Current or Capital Accounts	xx	
	P & L Appropriation or Distribution a/c		xx
3. Salaries to Partners	P & L Appropriation or Distribution a/c	xx	
	Partners' Current or Capital Accounts		xx
4. Bonuses to Partners	P & L Appropriation or Distribution a/c	xx	
	Partners' Current or Capital Accounts		xx
5. Distribution of net profit or net loss	P & L Appropriation or Distribution a/c	xx	
	Partners' Current or Capital Accounts		xx
	In case of loss the entry will be reversed.		

<u>Illustration 2.1:</u>

During 2020, the A&B Partnership earns L.E.90,000 of revenue and incurs L.E.70,000 in expenses, leaving a profit of L.E.20,000 for the year. Amine

maintains a capital balance of L.E.40,000 during the year, but Baker's capital investment varies during the year as follows:

Date	Debit	Credit	Balance
January 1			L.E.20000
May 1	L.E.6000		14000
September 1		L.E.1000	15000
November 1	2000		13000
December 31			13000

The debits of L.E.6,000 and L.E.2,000 are recorded in Baker's drawing account; the additional investment is credited to his capital account.

Calculating Profit Sharing Ratio:

The partners agree to share profits or losses in the ratio of 60% to Amine and 40% to Baker (this ratio is specified as 3:2). The following schedule illustrates how the net income is distributed using a 3:2 profit sharing ratio:

	Amine	Baker	Total
Profit sharing percentage	60%	40%	100%
Net income			L.E.20,000
Allocate 60:40	L.E.12,000	L.E.8,000	(20,000)
Total	L.E.12,000	L.E.8,000	L.E. 0000

This schedule shows how net income is distributed to the partners' capital accounts. The actual appropriation is accomplished by closing the ***Income Summary*** account. Additionally, the drawing accounts are closed to the personal accounts (capital or current accounts) at the end of the period.

Date	Description	Dr	Cr
2020 Dec. 31	Baker, Capital…………..	8000	
	Baker, Drawings………		8000
	Close Baker's drawing account.		
	Revenue…………………	90000	
	Expenses…………….		70000
	Income Summary……		20000
	Close revenue and expenses.		
	Income Summary………..	20000	
	Amine, Capital (or Current a/c)		12000
	Baker, Capital (or Current a/c)		8000
	Distribute profit in accordance with partnership agreement.		

Calculating Interest on Capital Balances:

As stated earlier, the articles of copartnership may provide for interest to be credited on the partners' capital balances as part of the distribution of profits. The rate of interest is often a stated percentage. Again, interest calculated on partners' capital is not

an expense of operating the business. The calculation is made after net income is determined in order to decide how appropriate the income. Special caution must be exercised whenever interest on capital balances is encompassed in the profit appropriation plan. For instance, the amount of the distribution can be significantly different depending on whether the interest is calculated on opening capital balances, closing balances, or average capital balances for the period.

Most terms for interest on capital determine that a weighted-average capital should be used. This method explicitly recognizes the time span for which each capital level is maintained during the period. Accordingly, Baker's weighted-average capital balance for 2020 is calculated as follows:

Date	Debit	Credit	Balance	Months Maintained	Months Times (×) Pound Balance
Jan. 1			20000	4	L.E. 80000
May 1	6000		14000	4	56000
Sep. 1		1000	15000	2	30000
Nov. 1	2000		13000	2	26000
Total				12	L.E.192000
Average capital (192000 ÷ 12 months)					L.E. 16000

If Amine and Baker agreed to allow interest of 15% on the weighted-average capital balances with any remaining profit to be divided in the 60:40 ratio, the appropriation of the L.E.20,000 profit would be calculated as follows:

	Amine	Baker	Total
Profit sharing percentage	60%	40%	100%
Average capital	L.E.40000	L.E.16000	
Net income			L.E.20000
Interest on average			
Capital (15 %)	L.E. 6000	L.E. 2400	(8400)
Residual income			L.E.11600
Allocate 60:40	L.E. 6960	L.E. 4640	(11600)
Total	L.E. 12960	L.E. 7040	L.E.0000

Calculating Salaries:

As stated earlier, salaries to partners are often included as part of the profit appropriation plan to recognize and reward for differing amounts of personal services provided by partners to firm. A general concept of partnership accounting is that salaries to partners are not operating expenses but are part of the profit distribution plan. This approach or concept is closely related to the proprietary

concept of owner's equity. According to the proprietary theory, the proprietor invests capital and personal services in pursuit of income. The earnings are a result of those two investments.

Logically, the same idea applies to the partnership form of organization. Some partners invest capital while others invest personal time. Those who invest capital are typically compensated with interest on their capital balances; those who invest personal time are rewarded with salaries. Nevertheless, both interest and salaries are a result of the respective investments and are used not in the determination of income but in the determination of the proportion or division of income to credit to each partner's personal account (capital or current account).

On the other hand, an interesting question arises if the partnership experiences losses. Can salaries to the partners during the year be treated as a distribution of profits? Although any amounts actually paid to partners during the year are really drawings made in anticipation of profits, the agreed salary

amounts usually are added to the loss and that total is then distributed to the partners' capital or current accounts.

To examine partnership salaries, assume that the partnership agreement provides for salaries of L.E.4,000 to Amine and L.E.10,000 to Baker. Any residual is to be distributed in the profit and loss-sharing ratio of 60:40 percent. The profit distribution is computed as below:

	Amine	Baker	Total
Profit percentage	60%	40%	100%
Net income			L.E.20000
Salary	L.E.4000	L.E.10000	(14000)
Residual income			L.E. 6000
Allocate 60:40	L.E.3600	L.E. 2400	(6000)
Total	L.E.7600	L.E.12400	L.E. 0000

Calculating Bonuses:

Sometimes, bonuses are used as a means of providing additional compensation to partners who have provided services to the partnership. Bonuses are typically stated as a percentage of income either before or after the bonus. Sometimes the partnership agreement requires a minimum income to be earned before a bonus is calculated. The bonus is easily

calculated by deriving and solving an equation. For instance, a bonus of 10% of income in excess of L.E.10,000 is to be credited to Baker's personal account before appropriating the remaining profit.

Case (1): The bonus is computed as a percentage of income ***before*** subtracting the bonus. Accordingly, the bonus is calculated as follows:

Bonus = X% (NI - MIN)

Where: *X%* = the bonus percentage.

NI = net income before bonus.

MIN = minimum amount of income before bonus.

Bonus = 10% (20000 - 10000) = L.E.1,000.

Case (2): The bonus is calculated as percentage of income ***after*** subtracting the bonus. Accordingly the bonus is computed as follows:

Bonus = *X%* (NI - MIN - Bonus)

= 10% (20,000 - 10,000 - Bonus)

= 10% (10,000 - Bonus)

= 1000 - .10 Bonus

1.10 Bonus = 1000

Bonus = $\frac{1000x10}{11}$ = L.E.910.

The distribution of net income based on ***Case (2)*** is calculated as follows:

	Amine	Baker	Total
Profit percentage	60%	40%	100%
Net income			L.E.20000
Bonus to partner		L.E. 910	(910)
Residual income			L.E.19090
Allocate 60:40	L.E.11454	L.E.7636	(19090)
Total	L.E.11454	L.E.8546	L.E.0000

Multiple Bases of Profit Allocation:

In the real world, a partnership agreement may provide a combination of several allocation procedures to be used to distribute profit. For example, the profit and loss agreement of the A&B Partnership specifies the following allocation method:

1. Interest of 15% on weighted-average capital balances.

2. Salaries of L.E.4,000 for Amine and L.E.10,000 for Baker.

3. A bonus of 10% to be paid to Baker on partnership income exceeding L.E.10,000 before

subtracting the bonus, partners' salaries, and interest on capital balances.

4. Any residual to be allocated in the ratio of 60% to Amine and 40% to baker.

The partnership agreement should also contain a provision to determine the allocation process in the event that partnership income is not sufficient to satisfy all allocation procedures. Some partnerships specify a profit distribution to be followed to whatever extent is possible. Most agreements specify that the entire process is to be completed and any residual is to be allocated in the profit and loss ratio as illustrated in the following schedule:

	Amine	**Baker**	**Total**
Profit percentage	60%	40%	100%
Average capital	L.E.40000	L.E.16000	
Net income			L.E.20000
Step 1:			
Interest on average			
Capital (15 %)	L.E. 6000	L.E. 2400	(8400)
Residual after step 1			L.E.11600
Step 2:			
Salary	4000	10000	(14000)
Deficiency after step 2			(2400)
Step 3:			
Bonus		1000	(1000)
Deficiency after step 3			(3400)

Step 4:			
Allocate 60:40	(2040)	(1360)	3400
Total	L.E. 7960	L.E.12040	L.E. 0000

In this case, the first two distribution steps created a deficiency. The A & B partnership agreement provided that the entire profit allocation process must be completed and any deficiency distributed in the profit and loss ratio. A partnership agreement could specify that the profit distribution process stop at any point in the event of any operating loss or the creation of a deficiency.

Illustration 2.2:

Ant & Bee Partnership has a net income of L.E.300,000 for the year ended December 31, 2020, the first year of operations. The partnership contract provides that each partner may withdraw L.E.5,000 cash on the last day of each month; both partners did so during 2020. the drawings are recorded by debits to the partners' drawing accounts and are not a factor in the division of net income or loss; all other withdrawals, investments, and net income or loss are entered directly in the partners' capital accounts.

Partner Ant invested L.E.400,000 on January 1, 2020, and an additional L.E.100,000 on April 1. Partner Bee invested L.E.800,000 on January 1, and withdrew L.E.50,000 on July 1. These transactions and events are summarised in the following Capital, Drawings, and Income Summary ledger accounts:

Ant, Capital

		2020	
		Jan. 1	400,000
		Apr. 1	100,000

Bee, Capital

2020		2020	
July 1	50,000	Jan. 1	800,000

Ant, Drawing

2020			
Jan.-Dec.	60,000		

Bee, Drawing

2020			
Jan.-Dec.	60,000		

Income Summary

		2020	
		Dec. 1	300,000

Allocation of Earnings Equally:

The net income of L.E.300,000 for Ant & Bee Partnership is transferred by a closing entry on December 31, 2020, from the Income Summary

ledger account to the partners' capital accounts, and also the drawing accounts are closed to the partners' capital accounts, by the following journal entries:

Date	Description	Dr	Cr
2020 Dec. 31	Income Summary…..	300,000	
	Ant, Capital…….		150,000
	Bee, Capital……		150,000
	To record allocation of net income for 2020.		
	Ant, Capital………..	60,000	
	Bee, Capital………..	60,000	
	Ant, Drawing…….		60,000
	Bee, Drawing…….		60,000
	To close drawing accounts		

After the drawing accounts are closed, the balances of the partners' capital accounts show the ownership equity of each partner on December 31, 2020. If Ant & Bee Partnership has a net loss of, for example, L.E.200,000 during the year ended December 31, 2020, the Income Summary ledger account would have a debit balance of L.E.200,000. This loss would be transferred to the partners' capital accounts-or current accounts- by a debit to each

capital account for L.E.100,000 and a credit to the Income Summary account for L.E.200,000.

Allocation of Earnings in Ratio of Partners' Capital Account Balances:

Allocation of partnership net income in proportion to the capital invested by each partner is most likely to be found in partnerships in which substantial investment is the principal ingredient for success. To avoid controversy, it essential that the partnership contract specify whether the income-sharing ratio is based on ***(1)*** the original capital investments, ***(2)*** the capital account balances at the beginning of each year, ***(3)*** the balances at the end of each year (before the distribution of net income or loss) or ***(4)*** the average balances during each year.

Assume that the partnership contract of Ant & Bee Partnership stipulates for division of net income in the ratio of ***original capital investments***. The net income of L.E.300,000 for 2020 is distributed as follows:

Ant = 300,000 × $\frac{400,000}{1,200,000}$ = L.E.100,000.

Bee = 300,000 × $\frac{800,000}{1,200,000}$ = L.E.200,000.

Assume that the net income is allocated in ratio of capital account balances at the ***end of the year*** (before drawings and the distribution of net income), the net income of L.E.300,000 for 2020 is divided as follows:

Ant = 300,000 × $\frac{500{,}000}{1{,}200{,}000}$ = L.E.120,000.

Bee = 300,000 × $\frac{750{,}000}{1{,}200{,}000}$ = L.E.180,000.

2.4 Partnership Financial Statements:

For accounting purposes, a partnership is a separate reporting entity. If the sales, stock and expenses of partnership were exactly the same as that of a sole trader, then the trading and profit and loss account (income statement) would be identical with that as prepared for the sole trader. Nevertheless, a partnership would have an extra section shown under the profit and loss account. This section is called the ***Profit and Loss Appropriation Account***, and it is in this account that the distribution of profits is shown.

The three financial statements-income statement (or trading and profit and loss account), balance sheet, and statement of cash flows-typically are prepared for the partnership at the end of each reporting period. In addition to the three principal financial statements, a ***statement of partners' capital (equity)*** is usually prepared to show the changes in the partners' capital accounts for the period.

Income Statement:

Sometimes explanations of the distribution of net income (or loss) among partners may be included in the partnership's income statement or in a note to the financial statements. Such information is referred to as the ***division of net income section*** of the income statement. Accordingly, the income statement for a partnership differs from that of a sole proprietorship in only one respect: a final section may be added to show the allocation of the net income among the partners, as illustrated below for the partnership of Basil & Waal, for the year ended December 31, 2020:

BASIL AND WAAL INCOME STATEMENT For the Year Ended December 31, 2020		
Sales……………………… L.E.		1,200,000
Cost of goods sold…………		800,000)
Gross profit on sales……….		400,000
Operating expenses:		
Selling expenses………….	200,000	
General & Administrative expenses	80,000	280,000
Net income………………..		***120,000***
Division of net income:		
To Basil (50%)………….	60,000	
To Waal (50%)………….	60,000	120,000

Statement of Partners' Capital:

Partners and other users of partnership financial statements generally want a complete explanation or picture of the changes in the partners' capital accounts each year. To meet this requirement, a ***statement of partners' capital*** is prepared. For example, the statement of partners' capital for the A&B Partnership for 2020 is a follows:

A & B PARTNERSHIP Statement of Partners' Capital For the Year Ended December 31, 2020			
	Amine	Baker	Total
Balance, January 1, 2020	L.E.40000	20000	60000
Add: Additional investment		1000	1000
Net income distribution	7960	12040	20000
	47960	33040	81000
Less: Withdrawal		(8000)	(8000)
Balance, December 31, 2020	L.E.47960	25040	73000

Illustration 2.3:

Beginning balances in the partners' capital accounts were Adam, L.E.160,000, and Eve, L.E.40,000. At year-end, the Income Summary account showed a credit balance of L.E.96,000, representing the net income for the year. The net income will be distributed in the light of the following assumptions:

1. Salaries to Partners, with Remainder in a Fixed Ratio:

Because partners often contribute different amounts of personal services, partnership agreements often provide for partners' salaries as a factor in the distribution of profits. For example, assume that Adam and Eve agree to annual salary allowances of L.E.12,000 for Adam and L.E.60,000 for Eve. These salaries, which total L.E.72,000 per year, are agreed upon by the partners in advance. Of course, the net income of the business is ***not*** likely to be exactly L.E.72,000 in a given year. Accordingly, the profit-and-loss sharing agreement should also determine a fixed ratio for allocating any profit or loss remaining after giving consideration to the agreed-upon salary allowances. It is assumed that Adam and Eve agree to divide any remaining profit or loss equally.

The appropriation of the L.E.96,000 in partnership net income between Adam and Eve is illustrated in the following schedule. The first procedure is to divide to each partner his or her agreed-upon salary allowance. This procedure allocates L.E.72,000 of

the partnership net income. the residual L.E.24,000 is then distributed in the agreed-upon fixed ratio (50-50).

Allocation of Partnership Net Income

Description	**Adam**	**Eve**	**Net Income**
Net income to be allocated			96,000
Salary allowance to partners	12,000	60,000	(72,000)
Remaining income after salary allowances			24,000
Allocated in a fixed ratio:			
Adam (50%)…….	12,000		
Eve (50%)……….		12,000	(24,000)
Total share to each partner	24,000	72,000	00000

The amount of cash or other assets that a partner withdraws from the partnership may be greater than or less than the partner's salary allowance. Even if a partner decides to withdraw an amount of cash equal to his or her "salary allowance," the withdrawal should be recorded by debiting the partner's drawing account, ***not by debiting an expense account.*** *Salary allowances to partners should not be recorded as expenses of the business.*

2. Interest Allowances on Partners Capital, with Remainder in a Fixed Ratio:

For example, assume that Adam and Eve agree that both partners are to be allowed interest at ***15%*** on their beginning capital balances, with any remaining profit or loss to be distributed equally. Net income to be divided is L.E.96,000, and the opening capital balances are Adam, ***L.E.160,000***, and Eve, ***L.E.40,000.***

Allocation of Partnership Net Income

Description	**Adam**	**Eve**	**Net Income**
Net income to be allocated			96,000
Interest allowances on opening capital:			
Adam (160,000 × 15%)…	24,000		
Eve (40,000 × 15%)…		6,000	
Total allocated as interest allowances………..			(30,000)
Remaining income after interest allowances			66,000
Allocated in a fixed ratio:			
Adam (50%)…….	33,000		
Eve (50%)……….		33,000	(66,000)
Total share to each partner	57,000	39,000	00000

3. *Salary Allowances, Interest on Capital, and Remainder in a Fixed Ratio:*

Allocation of Partnership Net Income			
Description	**Adam**	**Eve**	**Net Income**
Net income to be allocated			96,000
Salary allowances to partners	12,000	60,000	(72,000)
Income after salary allowances			24,000
Interest allowances on opening capital:			
Adam (160,000 × 10%)…	16,000		
Eve (40,000 × 10%)…		4,000	
Total allocated as interest allowances………..			(20,000)
Remaining income after salary and interest allowances….			4,000
Allocated in a fixed ratio:			
Adam (50%)…….	2,000		
Eve (50%)……….		2,000	(4,000)
Total share to each partner	30,000	66,000	-0-

4. Authorized Salary and Interest Allowance in Excess of Net Income:

Suppose that the net income had been only L.E.30,000. If the partnership agreement provides for salaries and interest on invested capital, these provisions are to be followed even though the net income for the year is ***less*** than the total of the authorized salaries and interest. If the net income of

the partnership of Adam and Eve amounted to only L.E.30,000, this amount would be allocated as shown below:

Allocation of Partnership Net Income

Description	**Adam**	**Eve**	**Net Income**
Net income to be allocated			30,000
Salary allowances to partners	12,000	60,000	(72,000)
Residual loss after salary allowances…………….			(42,000)
Interest allowances on beginning capital:			
Adam (160,000 × 10%)…	16,000		
Eve (40,000 × 10%)…		4,000	
Total allocated as interest allowances………..			(20,000)
Residual loss after salary and interest allowances….			(62,000)
Allocated in a fixed ratio:			
Adam (50%)…….	(31,000)		
Eve (50%)……….		(31,000)	62,000
Total share to each partner	(3,000)	33,000	-0-

2.5 Questions:

(1) The partnership agreement of Jud and Hood has the following provision:

a. The partners are to earn 8% interest on the average capital.

b. Jud and Hood are to earn salaries of L.E.35,000 and L.E.25,000, respectively.

c. Any remaining income or loss is to be divided between Jud and Hood in a 60-40 ratio.

d. Jud's average capital is L.E.100,000, and Hood's is L.E.60,000.

Instructions:

Prepare an income distribution schedule assuming the income of the partnership is ***(1)*** L.E.100,000 and ***(2)*** L.E.40,000.

(2) West and East are partners. Their capital accounts during 2020 were as follows:

West, Capital

Aug. 1	12,000	Jan. 1	60,000
		Apr. 1	16,000
		Oct. 31	12,000

East, Capital

March. 1	18,000	Jan. 1	100,000
		July. 1	14,000
		Oct. 1	10,000

Partnership net income is L.E.100,000 for the year. The partnership agreement provides for the division of income as follows:

1. Each partners is to be credited 8% interest on his or her average capital.

2. Any residual income or loss is to be divided equally.

Instructions:

Prepare an income appropriation plan.

(3) The income statement for the Apple & Orange Partnership for the year ended December 31, 2020, follows:

APPLE & ORANGE PARTNERSHIP Income Statement For the Year Ended December 31, 2020	
Net Sales	L.E. 600,000
Cost of Goods Sold	(380,000)
Gross Margin	L.E. 220,000
Operating Expenses	(60,000)
Net Income	L.E. 160,000

Additional Information for 2020:

1. Apple began the year with a capital balance of L.E.81,600.

2. Orange began the year with a capital balance of L.E.224,000.

3. On April 1, Apple invested an additional L.E.30,000 into the partnership.

4. On August 1, Orange invested an additional L.E.40,000 into the business the partnership.

5. Throughout 2020, each partner withdrew L.E.800 per week in anticipation of partnership net income. The partners agreed that these withdrawals are not to be included in the computation of average capital balances for the purposes of income distributions.

Apple and Orange have agreed to distribute partnership net income according to the following plan:

	Apple	Orange
1. Interest on average capital balances	6%	6%
2. Bonus on net income before the bonus but after interest on average capital balances	10%	
3. Salaries	L.E.50,000	L.E.60,000

4. Residual (if positive)	70%	30%
Residual (if negative)	50%	50%

Instructions:

1. Prepare a schedule that presents the division of partnership net income for 2020. Show supporting calculations in good form. Round to the nearest pound.
2. Prepare the statement of partners' capital at December 31, 2020, supposing that fluctuating capital method is adopted.
4. How would your answer to part ***1*** change if all the provisions of the income distribution plan were the same except that the salaries were L.E.60,000 to Apple and L.E.70,000 to Orange?

(4) Sunday and Friday, both of whom are CPAs, form a partnership, with Sunday investing L.E.200,000 and Friday, L.E.160,000. They agree to share net income as follows:

1. Salary allowances of L.E.160,000 to Sunday and L.E.120,000 to Friday.

2. Interest allowances at 15% of beginning capital account balances.

3. Any partnership earnings in excess of the amount required to cover the interest and salary allowances to be divided 60% to Sunday and 40% to Friday.

The partnership net income for the first year of operations amounted to L.E.494,000 before interest and salary allowances.

Instructions:

Show how this L.E.494,000 should be divided between the two partners. Use a three-column schedule. List on separate lines the amounts of interest, salaries, and the residual amount divided.

CHAPTER THREE

CHANGES IN MEMBERSHIP OF THE PARTNERSHIP

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CHANGES IN MEMBERSHIP OF THE PARTNERSHIP

3.1 Introduction:

A partner's interest often is considered a share in the partnership that may be transferred, much as shares of a corporation's capital stock are transferred among stockholders, without disturbing the continuity of the partnership. Changes in the ownership of a partnership raise a number of accounting and managerial issues. Among these issues are the setting of terms for admission of a new partner, the possible revaluation of existing partnership assets, the development of a new plan for the allocation of net income or loss, and the determination of the amount to be paid to a retiring partner.

Of course, new partners are often a primary source of additional capital or needed business expertise. The legal structure of a partnership requires that the ***admission of a new partner*** be subject to the unanimous approval of the present

partners. Additionally, public announcements are typically made about new partner admission so that third parties transacting business with the partnership are aware of the partnership change.

3.2 Admission of a New Partner:

When a new partner is admitted to a firm of two or three partners, it is appropriate to adjust the partnership accounting records to restate the carrying amounts of assets and liabilities to current fair values before a new partner is admitted.

3.2.1 New Partner Purchases an Interest:

An individual may acquire a partnership interest directly from one or more of the partners. In such cases, the event is recorded by establishing a capital account for the new partner and decreasing the capital account balances of the selling partners by the same amount. No assets are received by the partnership; the transfer of ownership is a private transaction between two or more partners. In other words, in this type of transaction, cash or other assets are exchanged outside the partnership, and the only entry necessary on the partnership's records is a reclassification of the total capital of the partnership.

A concept used with some frequency is book value. The ***book value of a partnership*** is simply the total amount of the capital, which is also the difference between total assets and total liabilities. Book value is essential because it serves as a basis for asset revaluations or goodwill recognition.

Illustration 3.1:

After operations and partners' withdrawals during 2018 and 2019, A & B Partnership has a book value of L.E.300,000 and profit percentages on January 1, 2020, as follows:

	Capital Balance	***Profit Percentage***
A	L.E.200,000	60
B	100,000	40
Total	L.E.300,000	100

The following information describes the case:

a. On January 1, 2020, A and B invite C to become a partner in their business. The resulting partnership will be called ABC Partnership.

b. C purchases a one-fourth interest in the partnership capital directly from A and B for a total cost of L.E.90,000, paying L.E.59,000 to A and L.E.31,000 to B. C will have a capital credit of L.E.75,000 (L.E.300,000 × 25%) in a proportionate reclassification from A and B's capital accounts.

c. C will be entitled to a 25% interest in the profits or losses of the partnership. The remaining 75% interest will be allocated between A and B in their old profit ratio of 60:40 percent. The resulting profit and loss percentages after the admission of C flow:

Partner	***Profit Percentage***
A	45 (75% of .60)
B	30 (75% of .40)
C	25
Total	100

In this illustration, C's 25% share of partnership profits or losses is the same as his/her one-fourth capital interest. These two percentage shares do not have to be the same. Of course, a partner's capital

interest may change over time because of profit distributions, withdrawals (fluctuating capital method), or additional investments in capital. Additionally, C could have acquired his/her entire capital interest directly from either partner. It is not necessary that a new partner directly purchasing an interest do so in a proportionate reclassification from each of the prior partners.

On the other hand, the transaction is between C and the individual partners and is not reflected on the partnership's records. The only entry in this case is to reclassify the partnership capital. Both A and B provide one-fourth of their capital to C, as follows:

January 1, 2020	A, Capital B, Capital C, Capital Reclassify capital to new partner: From A: L.E.50,000 = 200,000 × 25% From B: L.E.25,000 = 100,000 × 25%.	50,000 25,000	 75,000

Furthermore, in this case the capital credit to C is only L.E.75,000, although L.E.90,000 is paid for the

one-fourth interest. The L.E.90,000 payment implies that the fair value of the partnership is L.E.360,000, calculated as follows:

L.E.90,000 = fair value × $\frac{25}{100}$

Fair value = 90,000 × $\frac{100}{25}$ = L.E.360,000.

The partnership's book value is L.E.300,000 before C's investment. The payment of L.E.90,000 is made directly to the individual partners, and it does not become part of the partnership's assets. The L.E.60,000 difference between the partnership's fair value and its new book value could be due to understated assets or to unrecognized ***goodwill***.

A and B could use the evidence from C's acquisition to revalue the partnership's assets and fully reflect the changes in values that have taken place before the admission of C. Failure to do so could result in C's sharing proportionately in the increases in value when the increases are realized. For instance, if the partnership has land that is understated or undervalued by L.E.60,000 that it

sells after C is admitted to the partnership, C will share in the gain on the sale according to the profit ratio. To avoid this possible situation, some partnerships revaluate the assets at the time a new partner is admitted even if the new partner purchases the partnership interest directly from the present partners. In such situation, A and B could recognize the increase in the value of the land immediately before the admission of C and properly divide the increase to their capital accounts in their 60:40 profit ratios, as below:

January 1, 2020	Land A, Capital B, Capital Revaluation of land before admission of new partner.	60,000	 36,000 24,000

Note that the partnership's total resulting capital is L.E.360,000 (L.E.300,000 prior plus the L.E.60,000 revaluation). The transfer of a one-fourth capital to C is recorded as follows:

January 1, 2020	A, Capital B, Capital C, Capital Reclassify capital to new partner: From A: L.E.59,000 = 236,000 × 25% From B: L.E.31,000 = 124,000 × 25%. L.E.90,000 = 360,000 × 25%.	59,000 31,000	 90,000

3.2.2 New Partner Invests in Partnership:

A new partner may gain admission to acquire a share of the partnership by investing in the business. Accordingly, the total assets of the partnership and partners' capital will increase. For example, assume that Wally and Yasser are partners in a partnership. They share net profit or loss equally and that each has a capital account balance of L.E.300,000. Assume also that the book value of the partnership assets is approximately equal to current fair values and that Zaid has land that might be used for expansion of partnership operations. Wally and Yasser agree to admit zaid to the partnership by investment of the land; net profit or losses of the new

firm are to be shared equally. The land had cost Zaid L.E.250,000, but has a current fair value of L.E.400,000. The admission of Zaid is recorded by the partnership as follows:

Land Zaid, Capital To record admission of Zaid to partnership.	400,000	 400,000

Zaid has a capital account balance of L.E.400,000 and hence owns a 40% [L.E.400,000 ÷ (L.E.300,000 + L.E.300,000 + L.E.400,000) = 0.40] interest in the net assets of the partnership. The fact that the three partners share net income and losses equally does not require that their capital account balances be equal.

Practically, when a new partner invests in a partnership, three cases can be observed:

<u>First Case:</u> The new partner's investment equals the partner's proportion (share) of the partnership's carrying amount (book value).

<u>Second Case:</u> The investment is for ***more*** than the new partner's proportion of the partnership's book

value. In such a case, there is an indicator that the partnership's prior (before admission of a new partner) net assets are understated (undervalued) on the books or that unrecorded goodwill exists.

Third Case: The investment is for ***less*** than the new partner's share of the partnership's book value. Such case suggests that the partnership's prior net assets are overstated (overvalued) on its accounting records or that the new partner may be contributing good will in addition to other assets.

The preceding discussion can be summarized as follows:

Overview of Accounting for Admission of a New Partner (Baker, Lembke and King, 2005)

Step 1: Compare Proportionate Book Value and Investment of New Partner	***Step 2: Alternative Methods to Account for Admission***	***Key Observations***
Investment cost > book value (Second Case)	*a.* Revalue net assets up to market value and allocate to prior partners. *b.* Record unrecognized goodwill and allocate to prior	• Prior partners receive asset valuation increase, goodwill, or bonus indicated by the excess of new partner's investment over

	partners. *c.* Assign bonus to prior partners.	book value of the capital share initially assignable to new partner. • Recording asset valuation increase or prior partners' goodwill increases total resulting partnership capital.
Investment cost = book value (First Case)	*a.* No revaluations, bonus, or goodwill.	• No additional allocations necessary because new partner will receive a capital share equal to the amount invested. • Total resulting partnership capital equals prior partners' capital plus investment of new partner.
Investment cost < book value (Third Case)	*a.* Revalue net assets down to market value and allocate to prior partners. *b.* Recognize goodwill brought in by new partner. *c.* Assign	• Prior partners are assigned the reduction of asset values occurring before admission of the new partner. Alternatively, new partner is assigned goodwill

	bonus to new partner.	or bonus as part of admission incentive or reward. • Recording asset valuation decrease reduces total resulting capital, while recording new partner's goodwill increases total resulting capital.

Illustration 3.2:

The January 1, 2020, capital of A & B Partnership is L.E.300,000. A's balance is L.E.200,000, and B's balance is L.E.100,000. A and B share profits in ratio of 60:40. C is invested into the partnership. C will have a one-fourth capital interest and a 25% share of profits. A and B will share the remaining 75% of profits in ratio of 60:40, resulting in A having a 45% share of any profits and B having a 30% share.

***First Case:* Investment Equals Proportion of the Partnership's Book Value**

The total book value of the partnership before the acceptance of the new partner is L.E.300,000, and

the new partner, C, is buying a one-fourth capital interest for L.E.100,000.

The amount of a new partner's investment is usually the result of negotiations between the prior partners and the prospective partner. The new partner's investment is then a function of the percentage of partnership capital being acquired. As such, C must think that the L.E.100,000 investment required is a fair price for a one-fourth interest in the resulting partnership; otherwise, he/she would not make the investment decision.

After the amount of investment is agreed on, it is possible to compute the new partner's proportionate book value. For a L.E.100,000 investment, C will have a one-fourth interest in the partnership, as calculated below:

Investment in partnership	L.E.100,000
New partner's proportionate book value:	
(L.E.300,000 + L.E.100,000) × 25%	(100,000)
Difference (investment = book value)	L.E. -0-

Since the amount of the investment (L.E.100,000) equals the new partner's 25% proportionate book

value (L.E.100,000 = L.E.400,000 × 0.25), there is an implication that the net assets are fairly valued. Total resulting capital equals the prior partners' capital (L.E.300,000) plus the new partner's tangible investment (L.E.100,000). Note that the capital credit assigned to the new partner is his or her share of the total resulting capital of the partnership after his/her admission as partner. The entry on the partnership records is:

January 1, 2020	Cash C, Capital Admission of C for one-fourth interest upon investment of L.E.100,000.	100,000	 100,000

The following schedule shows the key concepts in the First Case:

Details	Prior Capital	New Partner's Tangible Investment	New Partner's Proportion of Partnership's Book Value (25%)	Total Resulting Capital	New Partner's Share of Total Resulting Capital (25%)
First Case New partner's investment equals proportionate book value No revaluations, bonus, or goodwill	300,000	100,000	100,000	400,000	100,000

<u>Second Case:</u> New Partner's Investment More than Proportion of the Partnership's Book Value

In some occasions, a new partner may invest more in an existing partnership than his or her proportionate share of the partnership's book value. This means that the partner perceives some value in the partnership that the accounting records do not reflect. For instance, C invests L.E.110,000 for a one-fourth capital interest in the ABC Partnership. The first step is to compare the new partner's investment with the new partner's proportionate book value, as follows:

Investment in partnership	L.E.110,000
New partner's proportionate book value:	
(L.E.300,000 + L.E.110,000) × 25%	(102,500)
Difference (investment > book value)	L.E. 7,500

C has invested L.E.110,000 for interest with a book value of L.E.102,500, thus paying an excess of L.E.7,500 over the present book value.

Commonly, an excess of investment over the respective book value of the partnership interest implies that the partnership's prior net assets are undervalued or that the partnership has some unrecorded goodwill. Three alternative accounting treatments exist in this situation:

1. ***Revalue assets upward.*** Under this alternative:
   - ***a.*** Asset book values are increased to their market values.
   - ***b.*** The prior partners' capital accounts are increased for their respective shares of the increase in the book values of the assets.
   - ***c.*** The partnership's total resulting capital reflects the prior capital balances plus the amount of

asset revaluation plus the new partner's investment.

2. ***Record unrecognized goodwill.*** With this method:
   - ***a.*** Unrecognized goodwill is recorded.
   - ***b.*** The prior partners' capital accounts are increased for their respective shares of the goodwill.
   - ***c.*** The partnership's total resulting capital reflects the prior capital balances plus the goodwill recognized plus the new partner's investment.
3. ***Use bonus method.*** In essence, the bonus method is a transfer of capital balances among the partners. This method is used when the partners do not wish to record adjustments in asset accounts or recognize goodwill. Under this method:
   - ***a.*** The prior partners' capital accounts are increased for their respective shares of the bonus paid by the new partner.

b. The partnership's total resulting capital reflects the prior capital balances plus the new partner's investment.

Illustration 3.3 (Revaluation of Assets Approach):

Using information provided in Illustration 3.3, assume that C paid a L.E.7,500 excess (L.E.110,000 minus L.E.102,500) over his/her proportionate book value because the partnership owns land with a book value of L.E.40,000 but a recent appraisal indicates that the land has a market value of L.E.70,000. The prior partners decide to use the admission of the new partner to recognize the increase in the land's value and to assign this increase to the capital accounts of the prior partners. The increase in land value is allocated to partners' capital accounts in the ***profit and loss ratio*** that ***existed during the time of increase.*** A's capital is increased by L.E.18,000 (60% of the L.E.30,000 increase), and B's capital is increased byL.E.12,000 (40% of the L.E.30,000). The partnership passes the following journal entry for the revaluation of the land:

Land…………………………….	30,000	
A, Capital…………………….		18,000
B, Capital…………………….		12,000
Revalue partnership land to market value.		

C's L.E.110,000 investment brings the partnership's total resulting capital to L.E.440,000, as follows:

Prior capital of AB Partnership	L.E.300,000
Revaluation of land to market value	30,000
C's investment	110,000
Total resulting capital of ABC Partnership	L.E.440,000

C is acquiring a one-fourth interest in the total resulting capital of the ABC Partnership. His/her capital credit, after revaluating the land, is computed as follows:

New partner's share of total resulting capital = (L.E.300,000 + 30,000 + 110,000) × 25% = L.E.110,000.

The journal entry to record the acceptance of C into the partnership follows:

January 1, 2020	Cash C, Capital Admission of C for one-fourth capital interest in ABC Partnership.	110,000	110,000

When the land is eventually sold, C will participate in the gain or loss calculated on the basis of new L.E.70,000 book value, which is the land's market value at the time of his/her admission into the partnership. The entire increase in the land value before C's admission belongs to the prior partners.

Illustration 3.4 (Goodwill Recognition):

In a profitable and well-established organization, the existing partners may require that a portion of the investment by a new partner be allocated to them as a bonus or that goodwill be recognized and credited to the existing partners. The new partner may accept such terms because of the benefits to be gained when he/she becomes a member of an enterprise with high earning power. Therefore, a new partner may be paying an excess amount because of

unrecognized goodwill, evidenced by the partnership's high profitability. Some partnerships use the change in membership as an opportunity to record unrecognized goodwill created by the existing partners. Recording unrecognized goodwill is allowed for partnership accounting because of the need to establish appropriate capital equity among the partners.

As a general practice, the amount of goodwill is specified by negotiations between the prior or old and prospective or new partners and is built on estimates of future earnings. For example, and based on the above illustration, the old and new partners may agree that, due to the prior partners' efforts, the partnership has superior or outstanding earnings potential and that L.E.30,000 of goodwill should be recorded to recognize this fact. The new partner's negotiated investment cost will be based partly on the earnings potential of the partnership. Alternatively, goodwill may be estimated from the amount of the new partner's investment. In this case,

the new partner C is investing L.E.110,000 for a one-fourth interest; therefore, he/she must believe the total resulting partnership capital is L.E.440,000 (L.E.110,000 × 4). The estimated goodwill is L.E.30,000:

Step 1

25% of estimated total resulting capital	L.E.110,000
Estimated total resulting capital (110,000 ÷ 0.25)	440,000

Step 2

Estimated total resulting capital	440,000
Total net assets not including goodwill (300,000 prior plus 110,000 invested by C)	(410,000)
Estimated goodwill	L.E.30,000

Another method to view the creation of goodwill at the time of a new partner's admission is to use a T-account form for the partnership's balance sheet. Any additional net assets, such as recognizing goodwill, must be balanced with additional capital, as follows:

BALANCE SHEET

Prior to admission of new partner C, Net assets	300,000	Partners' capital	300,000
New partner's cash investment, Cash	110,000	New tangible capital	110,000
Capital prior to recognizing goodwill	410,000		410,000
Estimated new goodwill	30,000	Capital from goodwill	30,000
Total resulting capital, Net assets	**440,000**	Total resulting capital	**440,000**

As soon as the new ABC Partnership's total resulting capital is estimated (L.E.440,000), the new goodwill (L.E.30,000) is the balance sheet difference between the tangible capital (L.E.410,000), which includes the new partner's cash investment and the estimated total resulting capital of the ABC Partnership (L.E.440,000).

The unrecorded goodwill is recorded, and the old partners' capital accounts are credited for the increase in assets. The adjustments to the capital accounts are in the profit and loss ratio that existed during the periods the goodwill was developed (before the admission of a new partner). This increased A's capital by 60% of the goodwill and B's

capital by 40%. The journal entries to record goodwill and the admission of C, are as below:

Goodwill……………………… A, Capital………………….. B, Capital………………….. Recognize unrecorded goodwill.	30,000	 18,000 12,000
Cash………………………….. C, Capital………………… Admission of C to partnership for a one-fourth capital interest: L.E.440,000 × 25%.	110,000	 110,000

Another reason for recording goodwill is that the new partner may want his or her capital balance to equal the amount of investment contributed. The investment is based on the market value of the partnership, and for this equality to happen; the partnership must restate its prior net assets to their fair values. It is necessary to know that the L.E.110,000 credit to C's capital account is one-fourth of the total resulting capital of ABC Partnership of L.E.440,000 as follows:

New partner's share of total resulting capital = (L.E.300,000+ 30,000+ 110,000)× 25% = L.E.110,000.

In future years, any essential loss of goodwill will be charged against partnership earnings before net income is allocated to the partners. Consequently, C's future profit division may be affected by the goodwill recognized at the time of his or her admission into the partnership.

Illustration 3.5 (Bonus Method):

In some cases, partnerships may be reluctant to recognizing asset revaluations or unrecorded goodwill when a new partner is admitted. Instead, they record a portion of the new partner's contribution or investment as a bonus to the existing partners to align or settle the capital balances properly at the time of the new partner's admission. In this case, refer to the prior illustrations, the L.E.7,500 excess paid by C is a bonus allocated to the old partners in their profit and loss ratio of 60% to A and 40% to B. ABC Partnership's total resulting capital consists of L.E.300,000 prior or existing capital of A and B plus the L.E.110,000 investment of C. Accordingly, no additional capital is recognized by

revaluing assets. The value of the capital credit acquired by the new partner is accounted for as:

New partner's share of the total resulting capital = (L.E.300,000 + L.E.110,000) × 25%=L.E.102,500.

The journal entry to record the admission of C under the bonus method is as follows:

Cash………………………………	110,000	
A, Capital……………………		4,500
B, Capital……………………		3,000
C, Capital……………………		102,500
Admission of C with bonus t A and B.		

The following schedule presents the key concepts in the Second Case:

Details	**Prior Capital**	**New Partner's Tangible Investment**	**New Partner's Proportion of Partnership's Book Value (25%)**	**Total Resulting Capital**	**New Partner's Share of Total Resulting Capital (25%)**
Second Case New partner's investment greater than proportionate book value 1. Revalue	300,000	110,000	102,500		

assets by increasing land L.E.30,000				440,000	110,000
2. Recognize L.E.30,000 goodwill for old partners				440,000	110,000
3. Bonus of L.E.7,500 to old partners				410,000	102,500

Illustration 3.6 (Bonus Method):

Assume that in Cola and Dola Partnership, the two partners share net income and losses equally and have capital account balances of L.E.450,000 each. The carrying amounts (book values) of the partnership net assets approximate current fair values. The partners agree to admit Emma to a one-third interest in capital and a one-third share in net income or losses for a cash investment of L.E.600,000. The net assets of the new firm amount to L.E.1,500,000 (450,000 + 450,000 + 600,000). The following journal entry gives Emma a one-third interest in capital and credits the L.E.100,000 ***bonus*** (600,000 - 500,000 = 100,000) equally to Cola and Dola according to their prior agreement to share income and losses equally:

Cash…............................	600,000	
Cola, Capital (100,000 ×½)		50,000
Dola, Capital (100,000 ×½)		50,000
Emma, Capital (1,500,000 ×⅓)		500,000
To record investment by Emma for a one-third interest in capital, with bonus of L.E.100,000 allocated equally between Cola and Dola.		

Illustration 3.7 (Goodwill Recognition):

In the foregoing illustration, Emma invested L.E.600,000 but received a capital account balance of only L.E.500,000, representing a one-third interest in the net assets of the firm. Emma might prefer that the full amount invested, L.E.600,000, be credited to Emma's capital account. This might be done while still allotting or assigning Emma a one-third interest if ***goodwill*** is recognized by the partnership, with the offsetting credit allocated equally between the two existing partners. If Emma is to be given a one-third interest represented by a capital account balance of L.E.600,000, the indicated total capital of the partnership is L.E.1,800,000 (600,000 × 3 = L.E.1,800,000), and the total capital of Cola and Dola

must equal L.E.1,200,000 (1,800,000 ×⅔ = L.E.1,200,000). Because their present combined capital account balances amount to L.E.900,000, a write-up (an increase) of L.E.300,000 in the net assets of the partnership is recorded as follows:

Cash……………………………	600,000	
Goodwill (1,200,000 - 900,000)	300,000	
Cola, Capital (300,000 ×½)		150,000
Dola, Capital (300,000 ×½)		150,000
Emma, Capital……………		600,000
To record investment by Emma for a one-third interest in capital, with credit offsetting goodwill of L.E.300,000 allocated equally between Cola and Dola.		

***Third Case:* New Partner's Investment Less than Proportion of the Partnership's Book Value**

A new partner may be admitted to a partnership because it needs cash or because the new partner has valuable skills and business relationships or contacts. To ensure the admission of the new partner, the present firm may offer the new partner a larger equity in net assets than the amount invested by the new partner.

Therefore, it is possible that a new partner may pay less than his or her proportionate share of the partnership's book value. For instance, C invests L.E.80,000 for a one-fourth capital interest in the ABC Partnership (refer to the prior illustrations). The first step is to compare the new partner's investment with new partner's proportionate book value, as follows:

Investment in Partnership	*L.E.80,000*
New partner's proportionate book value:	
(300,000 + 80,000) × 25%	*(95,000)*
Difference (investment < book value)	*(15,000)*

The fact that C's investment is less than the book value of a one-fourth interest in the partnership indicates that the partnership has overvalued assets or the prior partners recognize that C is contributing additional value in the form of expertise or skills he/she possesses that are needed by the partnership. In this case, C is investing L.E.80,000 in cash and an additional amount that may be viewed as goodwill.

3.3 Retirement of a Partner from the Partnership:

From the legal standpoint, when a partner retires or withdraws from a partnership, the partnership is dissolved, but the remaining partners may wish to continue operating the firm. The articles of copartnership (agreement or contract) must determine the procedures to be followed by the partnership to insure that the agreement of the partners is carried out.

The key accounting issue is the proper measurement of the retiring partner's capital account. This sometimes requires a determination of the partnership's fair value when the partner retires, including the computation of the partnership income since the end of the last fiscal period. A partner retiring from a partnership usually receives cash or other assets from the partnership. It is also possible that a retiring partner might arrange for the sale of partnership interest to one or more of the continuing partners or to an outsider.

Accounting Problems on Retirement of a Partner:

The accounting problems in the event of retirement of a partner can be summarized as follows:

(1)Adjustment for Goodwill.

(2)Revaluation of assets and liabilities.

(3)Adjustments regarding Reserves and other unallocated profits.

(4)Payment to the retiring partner.

(1) Goodwill:

The retiring partner will be entitled to his share of goodwill in the business. The problem of goodwill can be handled in the following two different methods:

a. Where goodwill account is already appearing in the accounting records:

- In such a case if goodwill is soundly valued, no further adjustment will be needed. The amount has already been credited to all the partners including the retiring one.
- In case goodwill is not properly valued, an adjusting entry will be required only for the

difference. For example, A, B and C are three partners sharing profits and losses in the ratio of 2: 2: 1. The goodwill is appearing in the records at L.E.100,000. C retires and on the date of his retirement, the goodwill is valued at L.E.150,000. The following journal entry will be made for L.E.50,000.

Particulars	Dr.	Cr.
Goodwill Account……….	50,000	
A's Capital Account….		20,000
B's Capital Account….		20,000
C's Capital Account….		10,000
Adjusting for goodwill on retirement of C.		

b. Where goodwill account is not appearing in the accounting records. There could be several alternatives:

- Goodwill account may be raised in the books:

Particulars	Dr.	Cr.
Goodwill Account	xxx	
Old Partners' Capital Accounts		xxx
The amount of goodwill credited to old partners including the retiring partner in the old profit sharing ratio.		

- In case continuing partners decide not to continue with the goodwill account, it may be written off:

Continuing Partners' Capital Accounts Goodwill Account	xxx	 xxx

- Entry may be made only with the share of goodwill of the retiring partner:

Goodwill Account (only with the share of the retiring partner) Retired Partner's Capital Account	xxx	 xxx

- The share of goodwill of the retiring partner may be adjusted in the accounts of the continuing partners without raising a goodwill account:

Continuing Partners' Capital Accounts (in the ratio in which they gain on retirement) Retired Partner's Capital Account	xxx	 xxx

Illustration 3.8:

A, B and C are partners in a partnership and they share profits and losses in the ratio of 2:2:1. C retires from the firm and on this date the value of firm's goodwill (for which no account appears in the accounting records) was determined at L.E.50,000.

Instructions:

You are required to make proper journal entries for each of the following cases:

1. When goodwill account is to be raised in the books.
2. When the goodwill account raised is subsequently written off.
3. When only C's share is to be recorded.
4. When C's share is to be adjusted into accounts of A and B without raising a goodwill account in the firm's books.

Solution

1.	Goodwill a/c…………	50,000	
	A's Capital a/c……		20,000
	B's Capital a/c……		20,000
	C's Capital a/c……		10,000
	Goodwill account is opened in the books.		
2.a	Goodwill a/c…………	50,000	
	A's Capital a/c……		20,000
	B's Capital a/c……		20,000
	C's Capital a/c……		10,000
2.b	Goodwill account is opened in the books.		
	A's Capital a/c……	25,000	
	B's Capital a/c……	25,000	
	Goodwill a/c…..		50,000
3.	Goodwill which was raised or recorded now is written off in the new profit sharing ratio.		
	Goodwill a/c………	10,000	
	C's Capital a/c…….		10,000

4.	Recording C's share of goodwill.		
	A's Capital a/c....... B's Capital a/c........ C's Capital a/c..... Debiting A and B capital accounts with C's share of goodwill in the ratio of their gain on C's retirement.	5,000 5,000	 10,000

(2) Revaluation of Assets and Liabilities:

The revaluation of assets and liabilities will be dealt with in detail in Section 3.4 of the current chapter.

(3) Reserves and Other Unallocated Profits:

The amount of reserves or undistributed profits in the accounting records of a business should be allocated among all the partners in their existing profit sharing ratio. The journal entry to do this will be as follows:

Reserves or Profit & Loss Account Partners' Capital Accounts	xxx	 xxx

If it is desired that only retiring partner should be credited with his/her share in reserves or undistributed profit, the following journal entry will be made:

Reserves or Profit & Loss Account Retiring Partner' Capital Account Only with his or her share.	xxx	 xxx

The balance of reserves or unallocated profits will continue to appear in the balance sheet after such retirement.

In case it is desired that the retiring partner should be given the benefit of reserves or undistributed profits without distributing such reserves or undistributed profits, the following journal entry will be done:

Continuing Partners' Capital Accounts Retiring Partner' Capital Account Only with his or her share.	xxx	 xxx

Illustration 3.9:

A, B and C, are partners in a firm sharing profits and losses in the ratio of 2:2:1. C Retires from the partnership. The General Reserve amounts L.E.50,000 on the date of C's retirement. A and B agree to share the future profits in the ratio of 3:2, respectively.

Instructions:

You are required to make the necessary journal entries for allocation of General Reserve if:

1. The General Reserve is not allowed to be maintained in the books.

2. The General Reserve is maintained only at amount remaining after giving C his or her share.

3. The General Reserve is allowed to be kept at the full amount.

Solution

1.	General Reserve a/c............ A's Capital a/c............... B's Capital a/c............... C's Capital a/c............... General Reserve is allocated among the partners.	50,000	 20,000 20,000 10,000
2.	General Reserve a/c............ C's Capital a/c............... C's share in the General Reserve credited to his or her capital account.	10,000	 10,000
3.	A's Capital a/c......... C's Capital a/c....... A debited with C's share of General Reserve because A only will gain or benefit on account of C's retirement.	10,000	 10,000

(4) Payment to Retiring Partner:

In essence, the amount due to the retiring partner will be paid as per terms of the partnership agreement or as otherwise mutually agreed. When the amount

payable to the retiring partner is specified, it will be transferred to his/her account (
Retired Partner Account or Loan etc), by the following journal entry:

Retiring Partner's Capital Account	xxx	
Retiring Partner's (or Loan) Account		xxx

When the continuing partners agree to bring cash to pay off the retiring partner, the entries will be as follows:

Cash or Bank Account	xxx	
Continuing Partners' Capital Accounts		xxx
For cash brought in by the continuing partners in the agreed ratio to pay off the retiring partner.		
Retiring Partner's Capital (or Loan) Account	xxx	
Cash or Bank Account		xxx
For cash paid to the retiring partner.		

In case the continuing partners decide to pay the retiring partner in their individual money according to their profit sharing ratio, the entry will be as follows:

Retiring Partner's Capital (or Loan) Account	xxx	
Continuing Partners' Capital Accounts		xxx

Illustration 3.10 (Bonus to Continuing Partners):

Assume that the three partners of Mohamed, Noh & Adam Partnership share net income or losses equally, and that each has a capital account balance of L.E.600,000. Noh retires from the partnership and receives L.E.500,000. The journal entry to record Noh's retirement follows:

Noh, Capital…………………..	600,000	
Cash………………………..		500,000
Mohamed, Capital (100,000 ×½)		50,000
Adam, Capital (100,000 ×½)		50,000
To record retirement of Partner Noh for an amount less than carrying amount of Noh's equity, with a bonus to continuing partners.		

3.4 Revaluation of Partnership's Assets and Liabilities:

3.4.1 The Need for Revaluation:

Usually, when a firm is sold, and the sale price of the assets exceeds their book values, there will be a profit on the sale. This realized profit will be shared between the partners in their profit and loss sharing ratios. On the contrary, any loss on sale would be shared in the same way. This means that whatever one of the following happens:

- A new partner is admitted;
- An old partner leaves (retires from) the firm;
- The partners change profit and loss sharing ratios;

The assets and liabilities will have to be revalued.

Of course, if this were not done, the new partner admitted would benefit from increases in value before he joined the firm, without having to pay anything for it. In the same way, if the value of assets had decreased or fallen before he had joined the firm, and no revaluation took place, he would share that loss of value without any adjustment being made

for it. Partners who leave or where there is a change to the profit and loss sharing ratios would also either gain or lose, without payments or allowances for such gains or losses.

3.4.2 Profit or Loss on Revaluation:

It is important that there should be a revaluation with a change of partners or a change in profit sharing ratio. If the revaluation shows no difference in assets values, no additional action is needed. Such situation will not happen very often, especially if assets include lands and buildings. Such assets are normally shown at cost, but this is very rarely the actual value after the land or buildings have been owned for a few years.

Illustration 3.11:

The balance sheet of W & Y Partnership as at 31 December 2020, who shared net income and losses in ratios W two-thirds Y one-third, is as follows:

Balance Sheet as at December 31, 2020

Premises at cost	65,000	Capitals: W	70,000
Fixtures (net)	15,000	Y	50,000
Stock	20,000		
Debtors	12,000		
Bank	8,000		
	120,000		**120,000**

From January 1, 2021, the profit and loss sharing ratios are to be altered to W one-half; Y one-half. Also, on January 1, the assets are revalued to be: Premises L.E.90,000, Fixtures L.E.11,000. Other assets remained at the same values.

Instructions:

Prepare the required accounts to show the assets at revalued amounts.

Solution:

Revaluation Profit and Loss Account

Assets reduced in value:		Assets increased in value:	
Fixtures	4,000	Premises	25,000
Profit on revaluation credited to Capital accounts:			
W 14,000			
Y 7,000	21,000		
	25,000		**25,000**

Premises Account

Balance b/d	65,000	Balance c/d	90,000
Revaluation: Increase	25,000		
	90,000		**90,000**

Fixtures Account

Balance b/d	15,000	Revaluation:	4,000
		Decrease	11,000
	15,000		**15,000**

W's Capital Account

Balance c/d	84,000	Balance b/d	70,000
		Revaluation: Share of profit	14,000
	84,000		**84,000**

Y's Capital Account

Balance c/d	57,000	Balance b/d	50,000
		Revaluation: Share of profit	7,000
	57,000		**57,000**

Illustration 3.12:

A, B and C partners in a business sharing profits in the ratio of 3:2:1. Their balance sheet on December 31, 2020 is as below:

ABC PARTNERSHIP
Balance Sheet as on December 31, 2020

Cash	50,000	Sundry Creditors	100,000
Sundry Debtors	100,000	Loan from D	200,000
Stock	200,000	Capital:	
Plant	500,000	A	200,000
		B	200,000
		C	150,000
Total	*850,000*	*Total*	*850,000*

C retires on January 1, 2021. The following arrangement is agreed upon:

1. The value of the firm's goodwill is L.E. 150,000. C's share of the goodwill is to be adjusted in the capital accounts of A and B.

2. The assets are revalued as follows (L.E.): Stock 250,000 and Plant 520,000.

3. A provision for bad debts is to be created of 10% on debtors.

4. The amount due to C is to be transferred to a loan account in his/her name.

Instructions:

You are required to prepare the Revaluation Profit and Loss Account, Partners' Capital Accounts, and the Balance Sheet of the firm.

Solution
Revaluation Profit and Loss Account

Provision for bad debts	10,000	Stock	50,000
Capital Accounts:		Plant	20,000
A 30,000			
B 20,000			
C 10,000	60,000		
	70,000		**70,000**

Capital Account

Details	A	B	C	Details	A	B	C
C's Capital (GW)	15000	10000		Balance b/d	200000	200000	150000
Balance c/d	215000	210000		Revaluation P & L a/c	30000	20000	10000
C's Loan a/c			185000	A & B Cap. a/c (GW)			25000
	230000	220000	185000		230000	220000	185000

AB PARTNERSHIP
Balance Sheet as on January 1, 2021

Cash	50,000	Sundry Creditors	100,000
Debtors 100,000		Loan from D	200,000
- Provision (10,000)	90,000	Loan from C	185,000
Stock	250,000	Capital:	
Plant	520,000	A	215,000
		B	210,000
Total	*910,000*	*Total*	*910,000*

3.5 Questions:

(1) In the ABC Partnership, the capital balances of A, B and C, who share income in the ratio of 6:3:1, are: A, L.E.240,000, B, L.E.120,000, and C, L.E.40,000.

Instructions:

a. If no goodwill or bonus is recorded, how much must D invest for a one-fourth interest?

b. Prepare journal entries for the admission of D if he/she invests L.E.80,000 for a one-fifth interest, and goodwill is recorded.

c. Prepare journal entries for the admission of D if he/she invests L.E.200,000 for a 20% interest, and total capital will be L.E.600,000.

(2) J and K, partners in the J&K Partnership, have capital balances of L.E.100,000 and L.E.40,000 and share income in a ratio of 4:1, respectively. L is to be admitted into the partnership with a 20% interest in the business.

Instructions:

Record L's admission for each of the following independent situations:

1. L invests L.E.60,000, and goodwill is to be recorded.
2. L invests L.E.60,000. Total capital is to be L.E.200,000.
3. L purchases the 20% interest by paying J L.E.22,000 and K L.E.11,000. L is assigned 20% of each of J's and K's capital accounts.
4. L invests L.E.32,000. Total capital is to be L.E.172,000.
5. L invests L.E.32,000, and goodwill is to be recorded.

(3) In the LMK Partnership, L's capital is L.E.40,000, M's is L.E.50,000, and K's is L.E.30,000. They share income in a 4:1:1 ratio, respectively. K is retiring from the partnership.

Instructions:

Prepare journal entries to record K's withdrawal according to each of the following independent assumptions:

1. K is paid L.E.38,000, and no goodwill is recorded.

2. K is paid L.E.42,000, and only his share of the goodwill is recorded.
3. K is paid L.E.35,000, and all implied goodwill is recorded

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(4) On January 1, 2021, Eid decides to retire from the partnership of Cole, Dad, and Eid, who share profits and losses in the ratio of 3:2:1, respectively. The following condensed balance sheets present the account balances immediately before and, for six independent cases, after Eid's retirement:

Accounts	Bal. prior to Eid's Ret.	Balances after Eid's Retirement					
		Case 1	Case 2	Case 3	Case 4	Case 5	Case 6
Assets: L.E.							
Cash	**90000**	**10000**	**16000**	**25000**	**16000**	**50000**	**90000**
Other Assets	**200000**	**200000**	**200000**	**200000**	**200000**	**220000**	**200000**
Goodwill	**10000**	**10000**	**14000**	**10000**	**34000**	**10000**	**10000**
Total Assets	**300000**	**220000**	**230000**	**235000**	**250000**	**280000**	**300000**
Liabilities and Capital							
Liabilities	**60000**	**60000**	**60000**	**60000**	**60000**	**60000**	**60000**
Cole, Capital	**80000**	**74000**	**80000**	**83000**	**92000**	**110000**	**80000**
Dad, Capital	**90000**	**86000**	**90000**	**92000**	**98000**	**110000**	**160000**
Eid, Capital	**70000**	**-0-**	**-0-**	**-0-**	**-0-**	**-0-**	**-0-**
Total Liabilities and Capital	**300000**	**220000**	**230000**	**235000**	**250000**	**280000**	**300000**

Instructions:

Prepare the necessary journal entries to record Eid's retirement from the partnership for each of the six independent cases.

(5) Doha and Mai sell electronic equipment and supplies through their partnership. They wish to expand their computer lines and decide to admit Walla to the partnership. Doha's capital is L.E.200,000, Mai's capital is L.E.160,000, and they share income in a ratio of 3:2, respectively.

Instructions:

Record Walla's admission for each of the following independent situations:

a. Walla directly purchases half of Mai's investment in the partnership for L.E.90,000.

b. Walla invests the amount needed to give her a one-third interest in the capital of the partnership if no goodwill or bonus is recorded.

c. Walla invests L.E.110,000 for a one-fourth interest. Goodwill is to be recorded.

d. Doha and Mai agree that some of the inventory is obsolete. The inventory account is decreased before Walla is admitted. Walla invests L.E.100,000 for a one-fourth interest.

e. Walla directly purchases a one-fourth interest by paying Doha L.E.80,000 and Mai L.E.60,000. The land account is increased before Walla is admitted.

f. Walla invests L.E.80,000 for a one-fifth interest in the total capital of L.E.440,000.

g. Walla invests L.E.100,000 for a one-fifth interest. Goodwill is to be recorded.

(6) The following condensed balance sheet is presented for the partnership of Duck, Emi, and Opera, who share profits and losses in the ratio of 4:3:3, respectively.

Cash….L.E.	40,000	Accounts Payable	150,000
Other Assets	710,000	Duck, Capital	260,000
		Emi, Capital	180,000
		Opera, Capital	160,000
Total Assets	750,000	Total Li. & Cap.	750,000

Assume that the partnership decides to admit Suzan as a new partner with a one-fourth interest.

Instructions:

For each of the following independent cases, determine the amount that Suzan must contribute in cash or other assets.

1- No goodwill or bonus is to be recorded.

2- Goodwill of L.E.30,000 is to be recorded and allocated to the prior partners.

3- A bonus of L.E.24,000 is to be paid by Suzan and distributed to the prior partners.

4- The prior partners, Duck, Emi, and Opera, agree to give Suzan L.E.10,000 of goodwill upon admission to the partnership

5- Other assets are revalued for an increase of L.E.20,000, and goodwill of L.E.40,000 is recognized and allocated to the existing partners at the time of the admission of Suzan.

6- The partners agree that total resulting capital should be L.E.820,000 and no goodwill should be recognized.

7- Other assets are revalued down by L.E.20,000 and a bonus of L.E.40,000 is paid to Suzan at the time of admission.

(7) The partnership of Ahmed, Jack, and Said has been in business for 30 years. On December 31, 2020, Said decided to retire from the partnership. The partnership balance sheet declared the following capital balances for each partner at December 31, 2020:

Ahmed, Capital	L.E.150,000
Jack, Capital	200,000
Said, Capital	120,000

The partners distribute partnership income and loss in the ratio of 20:30:50.

Instructions:

Record Said's withdrawal under each of the following situations.

a. Jack acquired Said's capital interest for L.E.150,000 in a personal transaction. Partnership assets were not revalued, and partnership goodwill was not recognized.

b. Assume the same facts as in part *a except* that partnership goodwill applicable to the entire business was recognized by the partnership.

a. Said received L.E.180,000 of partnership cash upon retirement. Capital of the partnership after Said's retirement was L.E.290,000.

b. Said received L.E.60,000 of cash and partnership land with a fair value of L.E.120,000. The carrying amount of the land on the partnership books was L.E.100,000. Capital of the partnership after Said's retirement was L.E.310,000.

c. Said received L.E.150,000 of partnership cash upon retirement. The partnership recorded the portion of goodwill attributable to Said.

d. Assume the same facts as in part *e except* that partnership goodwill attributable to all the partners was recorded.

e. Due to limited cash in the partnership, Said received land with a fair value of L.E.100,000 and a note payable for L.E.50,000. The carrying amount of the land on the partnership books was

L.E.60,000. Capital of the partnership after Said's retirement was L.E.360,000.

(8) A and B are partners in a partnership, sharing profits and losses equally. The following is the B/S of their partnership as on December 31, 2020.

Assets			**Liabilities**		
Cash		50000	Creditors		200000
Inventory		125000	Bank Loan		125000
Debtors	65000				
Less: Provision			Capital:		
for D. Debts	15000	50000	A	375000	
Land		385000	B	375000	750000
Machine		285000			
Equipment		145000			
Goodwill		35000			
		1075000			1075000

On January1, 2021, C admitted to the partnership according to the following:

a. Partnership's assets are revalued as follows (L.E.): Goodwill 85,000, Land 335,000, Machine 385,000, Equipment 125,000, Debtors 60,000, provision for doubtful debts 10%, and Creditors 192,500.

b. C directly purchases a one-half-capital interest from A and B for an amount of L.E.329,250, which will be personally paid to A and B, after recording revaluation results. Profits and losses will be shared equally after C's admission to the partnership.

Instructions:

Record C's admission to the partnership, prepare the Revaluation Profit and Loss Account, Partners' Capital Accounts, and prepare the partnership's balance sheet upon the admission of C, as on January 1, 2021.

(9) The partnership of Ahmed, Borai, and Cool has been in business for 25 years, sharing profits and losses equally. The partnership balance sheet at July 31, 2021 follows:

Assets			**Liabilities**		
Bank		**150000**	**Creditors**		**35000**
Debtors	**150000**				
***Less*: Provision**			**Capital:**		
for D. Debts	**20000**	**130000**	**Ahmed**	**140000**	
Inventory		**90000**	**Borai**	**140000**	
Cars		**50000**	**Cool**	**140000**	**420000**
Equipment		**80000**	**General Reserve**		**45000**
		500000			**500000**

On July 31, 2021, partner Cool decided to retire from the partnership. On that date, the following information is provided:

a. Partnership's assets and liabilities are revalued as follows (L.E.): Cars 35,000, Equipment 75,000, provision for doubtful debts 25,000, and Inventory 100,000.

b. Partners Ahmed and Borai decided to purchase Cool's capital interest equally.

Instructions:

Record Cool's retirement from the partnership, prepare the Revaluation Profit and Loss Account, Partners' Capital Accounts, and prepare the partnership's balance sheet upon the retirement of Cool, as on July 31, 2021, under each of the following cases:

- The remaining partners pay for the retired partner from their individual fund in the partnership's bank account.
- The remaining partners pay for the retiring one from their individual funds outside the partnership.

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