CHAPTER 12

# ACCOUNTING FOR PARTNERSHIPS AND LIMITED LIABILITY COMPANIES

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# Chapter Introduction

Businesses may be organized as:

- Proprietorships
- Partnerships
- Limited liability companies
- Corporations

**Each form differs in**

- Number of owners
- Owner liability
- Management authority
- Continuity
- Capital structure
- Equity accounting

# Why This Chapter Matters

Partnership accounting must address questions such as:

- How are partners' investments recorded?
- How is income divided?
- How are withdrawals recorded?
- What happens when a new partner joins?
- How is a withdrawing partner paid?
- What happens when a partnership is liquidated?
- Who absorbs a capital deficiency?

# Opening Business Case — AgentBlaze, LLC

The 23rd edition opens the chapter with AgentBlaze, LLC.

The case illustrates a business owned by members who combine:

- Skills
- Capital
- Business responsibilities
- Rights to income
- Exposure to business risk

The chapter uses the case to introduce partnerships and limited liability companies.

# Central Accounting Question

*How should an organization account for the investments, income shares, withdrawals, ownership changes and final settlement of a business owned by two or more persons?*

# Learning Objectives

By the end of this chapter, students will be able to:

- Compare proprietorships, partnerships and limited liability companies.
- Explain the characteristics of a partnership.
- Record the formation of a partnership.
- Divide partnership income or loss.
- Prepare a statement of partnership equity.
- Account for the admission of a partner.
- Account for the withdrawal or death of a partner.
- Explain the liquidation process.
- Allocate gains and losses during liquidation.
- Account for a partner's capital deficiency.
- Identify common liquidation errors.
- Analyze revenue per employee or professional staff.

# Chapter Roadmap

| Part | Topic | Part | Topic |
|---|---|---|---|
| 1 | Forms of business organization | 7 | Statement of partnership equity |
| 2 | Partnership characteristics | 8 | Admission of a new partner |
| 3 | Limited liability companies | 9 | Withdrawal and death of a partner |
| 4 | Partnership formation | 10 | Partnership liquidation |
| 5 | Division of income and loss | 11 | Capital deficiency |
| 6 | Partnership withdrawals | 12 | Financial analysis |

# Opening Reflection

Two individuals establish a consulting business.

- One contributes ETB 500,000 cash
- The other contributes equipment worth ETB 400,000 and a related liability of ETB 100,000

## Questions

- What capital amount should be credited to each partner?
- Should historical cost or agreed value be used?
- How should future income be divided?
- What happens when one partner later leaves?

SECTION 1

# Forms of Business Organization

- Ownership forms
- Proprietorships
- Partnerships
- Characteristics and agreements

# Major Ownership Forms

| Form | Typical Ownership |
|---|---:|
| Proprietorship | One owner |
| Partnership | Two or more partners |
| Limited liability company | One or more members |
| Corporation | Shareholders |

# Proprietorship

A proprietorship is a business owned by one individual.

The proprietor normally:

- Provides the capital
- Manages the business
- Receives the profit
- Bears the business risk
- Reports one owner's capital account

# Proprietorship Advantages and Limitations

## Advantages

- Easy to establish
- Direct owner control
- Simple equity accounting
- Flexible decision-making

## Limitations

- Limited access to capital
- Dependence on one owner
- Limited continuity
- Owner may have unlimited personal liability

# Partnership

A partnership is an association of two or more persons who agree to own and operate a business together.

Partners may contribute:

- Cash
- Property
- Expertise
- Labour
- Business relationships
- Other agreed resources

# Main Partnership Characteristics

Common characteristics include:

- Two or more owners
- Voluntary association
- Partnership agreement
- Co-ownership of business assets
- Sharing of income and loss
- Mutual management responsibilities
- Separate capital accounts
- Limited continuity when ownership changes

# Mutual Agency

Mutual agency means that a partner may act as an agent of the partnership.

Actions taken within authorized business activities may:

- Bind the partnership
- Create liabilities
- Affect other partners
- Commit partnership resources

## Control Requirement

The partnership agreement should clearly define each partner's authority.

# Unlimited Liability

In a general partnership, partners may be personally responsible for partnership debts when partnership assets are insufficient.

## Implication

A partner's financial exposure may exceed the amount invested.

## Important

Liability rules depend on the legal form and applicable jurisdiction.

# Partnership Advantages

- Combines financial resources
- Combines professional skills
- Supports specialization
- Expands management capacity
- May be easier to form than a corporation
- Allows flexible income-sharing arrangements

# Partnership Limitations

- Possible unlimited liability
- Potential disagreement among partners
- Mutual agency risk
- Limited continuity
- Difficulty transferring ownership
- Need to divide income and decision-making authority

# Partnership Agreement

A partnership agreement should address:

- Partner contributions
- Ownership interests
- Income-and-loss sharing
- Management authority
- Partner salaries and interest allowances
- Withdrawal rights
- Admission of new partners
- Settlement upon death
- Dispute-resolution procedures
- Liquidation procedures

# Importance of a Written Agreement

A written agreement reduces uncertainty regarding:

- Financial rights
- Management responsibilities
- Compensation
- Decision-making
- Ownership changes
- Dissolution

**Key Principle**

A partnership should not rely only on informal verbal understandings.

SECTION 2

# Limited Liability Companies

- LLC characteristics
- Operating agreement
- Equity accounting
- Comparisons

# Limited Liability Company

A limited liability company, or LLC, combines selected features commonly associated with:

- Partnerships
- Corporations

Its owners are normally called:

**MEMBERS**

# LLC Characteristics

An LLC may provide:

- Limited liability for members
- Flexible management arrangements
- Multiple ownership interests
- Separate member capital accounts
- Allocation of income according to an operating agreement
- Greater continuity than a traditional partnership

# LLC Operating Agreement

An operating agreement may specify:

- Member investments
- Ownership percentages
- Voting rights
- Management responsibility
- Income distribution
- Member withdrawals
- Admission of new members
- Transfer of ownership
- Dissolution procedures

# Equity Accounting for an LLC

LLC equity may be maintained using separate accounts such as:

- Member A, Capital
- Member B, Capital
- Member A, Drawing
- Member B, Drawing

The accounting procedures may therefore resemble partnership accounting.

# Partnership versus LLC

| Partnership | Limited Liability Company |
| --- | ---: |
| Owners are partners | Owners are members |
| General partners may have unlimited liability | Members generally have limited liability |
| Partnership agreement | Operating agreement |
| Separate partner capital accounts | Separate member capital accounts |
| Ownership change may dissolve partnership | Continuity depends on agreement and law |

# Comparison of Ownership Forms

| Feature | Proprietorship | Partnership | LLC |
|---|---:|---:|---:|
| Number of owners | One | Two or more | One or more |
| Owner title | Proprietor | Partner | Member |
| Limited liability | Normally no | Normally no for general partners | Generally yes |
| Equity accounts | One capital account | Separate partner accounts | Separate member accounts |
| Income allocation | Entirely to owner | By agreement | By operating agreement |

# Jurisdictional Application Note

The textbook's LLC discussion reflects a United States business form.

**For classroom application**

- Use the textbook accounting principles.
- Do not assume that the LLC name has the same legal meaning in every country.
- Apply the legal registration, taxation and liability rules of the relevant jurisdiction.

SECTION 3

# Forming a Partnership

- Entity principle
- Recording contributions
- Agreed values
- Formation documentation

# Partnership Accounting Entity

Although partners own the partnership, the partnership's accounting records are maintained separately from the personal records of the partners.

## Business Entity Principle

Only partnership assets, liabilities, income and expenses are recorded in the partnership accounts.

# Recording Partner Contributions

When a partnership is formed:

- Cash is recorded at the amount contributed.
- Non-cash assets are recorded at agreed values.
- Liabilities assumed by the partnership are recorded.
- Each partner receives a separate capital account.

# Contribution of Cash

Amanuel contributes ETB 300,000 cash.

| Account | Debit | Credit |
| --- | ---: | ---: |
| Cash | 300,000 | |
| Amanuel, Capital | | 300,000 |

# Contribution of Non-Cash Assets

A partner may contribute:

- Land
- Buildings
- Equipment
- Vehicles
- Inventory
- Receivables
- Other agreed assets

The assets are generally recorded at agreed current values at the date of contribution.

# Fair Value versus Partner's Book Value

An asset may have:

- A historical cost in the partner's personal records
- Accumulated depreciation
- A different agreed value at contribution

The partnership records the asset at the amount agreed by the partners — not the contributing partner's old carrying amount.

# Liability Assumed by Partnership

When the partnership assumes a liability related to a contributed asset:

```
Partner's Capital Credit = Agreed Asset Value – Liability Assumed
```

# Contribution Example — Amanuel

Amanuel contributes:

- Cash: ETB 300,000
- Equipment valued at ETB 240,000
- Equipment liability assumed: ETB 40,000

## Capital Credit

$$300{,}000 + 240{,}000 - 40{,}000 = \text{ETB } 500{,}000$$

# Entry for Amanuel's Contribution

| Account | Debit | Credit |
|---|---:|---:|
| Cash | 300,000 | |
| Equipment | 240,000 | |
| Equipment Loan Payable | | 40,000 |
| Amanuel, Capital | | 500,000 |

# Contribution Example — Hana

Hana contributes:

- Cash: ETB 200,000
- Land valued at ETB 400,000

## Capital Credit

```
200,000 + 400,000 = ETB 600,000
```

# Entry for Hana's Contribution

| Account | Debit | Credit |
|---|---:|---:|
| Cash | 200,000 | |
| Land | 400,000 | |
| Hana, Capital | | 600,000 |

# Partnership Balances after Formation

### Assets

| Asset | ETB |
|---|---|
| Cash | 500,000 |
| Equipment | 240,000 |
| Land | 400,000 |
| **Total Assets** | **1,140,000** |

### Liabilities and Capital

| Item | ETB |
|---|---|
| Equipment Loan Payable | 40,000 |
| Amanuel, Capital | 500,000 |
| Hana, Capital | 600,000 |
| **Total** | **1,140,000** |

# Ownership Percentage versus Capital Balance

A partner's capital balance does not automatically determine:

- Voting rights
- Management authority
- Profit-sharing percentage
- Loss-sharing percentage
- Final ownership rights

These matters should be defined in the partnership agreement.

# Partnership Formation Costs

Costs incurred to establish the business may include:

- Legal fees
- Registration costs
- Professional fees
- Initial advertising
- Administrative setup costs

Their accounting treatment should follow applicable reporting standards and the nature of the expenditure.

# Formation Documentation

The accounting file should include:

- Signed partnership agreement
- Evidence of cash contributions
- Asset-valuation documents
- Ownership documents
- Liability-transfer agreements
- Opening inventory lists
- Initial capital calculations

# Formation Activity

A partner contributes:

- Vehicle agreed value: ETB 500,000
- Vehicle loan assumed: ETB 120,000
- Cash: ETB 80,000

## Capital Credit

$$500{,}000 - 120{,}000 + 80{,}000 = \text{ETB } 460{,}000$$

SECTION 4

# Dividing Partnership Income

- Sharing methods
- Salary and interest allowances
- Allocation sequence
- Losses

# Income-Sharing Principle

Partnership net income or net loss is allocated to the partners according to the partnership agreement.

The allocation may be based on:

- Equal shares
- Fixed percentages
- Capital balances
- Salary allowances
- Interest allowances
- A combination of methods

# When the Agreement Is Silent

When an agreement does not specify how income or loss should be divided, the applicable legal rule may require equal allocation.

### Recommended Practice

The income-and-loss-sharing method should always be stated explicitly in the partnership agreement.

# Equal Division

A partnership earns ETB 300,000. Two partners share income equally.

$$300{,}000 \div 2 = \text{ETB } 150{,}000$$

Each partner receives ETB 150,000.

# Income-Allocation Entry

| Account | Debit | Credit |
|---|---:|---:|
| Income Summary | 300,000 | |
| Partner A, Capital | | 150,000 |
| Partner B, Capital | | 150,000 |

# Fixed-Ratio Division

Net income may be divided using an agreed ratio, for example 60 : 40.

If net income is ETB 300,000:

```
Partner A:  300,000 × 60% = ETB 180,000
Partner B:  300,000 × 40% = ETB 120,000
```

# Salary Allowances

A partnership agreement may provide salary allowances to recognize differences in:

- Time devoted to the business
- Management responsibility
- Technical expertise
- Business-development duties

**Important**

A partner's salary allowance is not a salary expense.

# Why Partner Salaries Are Not Expenses

Partners are owners, not ordinary employees of the partnership for this allocation purpose.

Therefore, a salary allowance:

- Does not reduce partnership net income
- Is used only to divide net income
- Is credited to the partner's capital account

# Interest Allowances

Interest allowances may recognize differences in capital invested.

The allowance may be based on:

- Beginning capital
- Average capital
- Agreed capital
- Another amount specified in the agreement

**Important**

Interest allowances are not interest expenses.

# Income-Allocation Sequence

A common allocation sequence is:

- Salary allowances
- Interest allowances
- Remaining income or loss
- Allocation of the remainder using an agreed ratio

# Comprehensive Allocation Agreement

Amanuel and Hana agree to divide income as follows:

- Amanuel salary allowance: ETB 120,000
- Hana salary allowance: ETB 90,000
- Interest: 10% of beginning capital
- Remaining income: 60% to Amanuel and 40% to Hana

**Beginning capital and net income**

- Amanuel: ETB 500,000
- Hana: ETB 600,000
- Net income: ETB 400,000

# Step 1 — Salary Allowances

| Partner | Salary Allowance |
|---|---:|
| Amanuel | ETB 120,000 |
| Hana | 90,000 |
| **Total** | **210,000** |

# Step 2 — Interest Allowances

```
Amanuel:  500,000 × 10% = ETB 50,000
Hana:      600,000 × 10% = ETB 60,000
```

## Total Interest Allowances

```
ETB 110,000
```

# Step 3 — Remaining Income

| Item | ETB |
|---|---:|
| Net income | 400,000 |
| Less salary allowances | (210,000) |
| Less interest allowances | (110,000) |
| Remaining income | 80,000 |

**400,000 − 210,000 − 110,000 = ETB 80,000**

# Step 4 — Allocate the Remainder

```
Amanuel:  80,000 × 60% = ETB 48,000
Hana:      80,000 × 40% = ETB 32,000
```

# Final Income Allocation

| Allocation | Amanuel | Hana | Total |
|---|---:|---:|---:|
| Salary allowance | 120,000 | 90,000 | 210,000 |
| Interest allowance | 50,000 | 60,000 | 110,000 |
| Remaining income | 48,000 | 32,000 | 80,000 |
| **Income share** | **218,000** | **182,000** | **400,000** |

# Income-Allocation Entry

| Account | Debit | Credit |
|---|---:|---:|
| Income Summary | 400,000 | |
| Amanuel, Capital | | 218,000 |
| Hana, Capital | | 182,000 |

# Allowances Exceed Net Income

Salary and interest allowances may exceed net income. When this occurs:

- Apply the salary allowances.
- Apply the interest allowances.
- Treat the remaining amount as a negative remainder.
- Allocate the negative remainder according to the agreed ratio.

# Low-Income Example

| Item | ETB |
|---|---:|
| Net income | 200,000 |
| **Total salary and interest allowances** | **(320,000)** |
| Negative remainder | (120,000) |

```
210,000 + 110,000 = ETB 320,000
200,000 – 320,000 = –ETB 120,000
```

# Allocate the Negative Remainder

```
Amanuel:  120,000 × 60% = ETB 72,000
Hana:      120,000 × 40% = ETB 48,000
```

# Final Allocation of ETB 200,000

| Allocation | Amanuel | Hana |
|---|---:|---:|
| Salary allowance | 120,000 | 90,000 |
| Interest allowance | 50,000 | 60,000 |
| Negative remainder | (72,000) | (48,000) |
| **Income share** | **98,000** | **102,000** |

**98,000 + 102,000 = ETB 200,000**

# Partnership Net Loss

A net loss is allocated using the loss-sharing method stated in the agreement.

If the partners share losses 60 : 40 and the net loss is ETB 150,000:

```
Amanuel:  150,000 × 60% = ETB 90,000
Hana:      150,000 × 40% = ETB 60,000
```

# Loss-Allocation Entry

| Account | Debit | Credit |
|---|---:|---:|
| Amanuel, Capital | 90,000 | |
| Hana, Capital | 60,000 | |
| Income Summary | | 150,000 |

A net loss reduces the partners' capital accounts.

SECTION 5

# Partner Withdrawals

- Drawing accounts
- Closing entries
- Capital rollforward

# Partner Withdrawals

A partner may withdraw cash or other assets for personal use.

Withdrawals:

- Are not business expenses
- Do not reduce net income
- Reduce the partner's equity
- Are recorded in a drawing account during the period

# Recording a Withdrawal

Amanuel withdraws ETB 30,000.

| Account | Debit | Credit |
|---|---:|---:|
| Amanuel, Drawing | 30,000 | |
| Cash | | 30,000 |

# Closing Drawing Accounts

At period-end:

| Account | Debit | Credit |
|---|---:|---:|
| Amanuel, Capital | 30,000 | |
| Amanuel, Drawing | | 30,000 |

Each partner's drawing account is closed separately.

# Capital Rollforward Formula

```
Ending Capital
= Beginning Capital
+ Additional Investments
+ Share of Net Income
– Share of Net Loss
– Withdrawals
```

# Knowledge Check

A partner has:

- Beginning capital: ETB 400,000
- Additional investment: ETB 50,000
- Income share: ETB 120,000
- Withdrawals: ETB 70,000

$$400{,}000 + 50{,}000 + 120{,}000 - 70{,}000 = \text{ETB } 500{,}000$$

SECTION 6

# Statement of Partnership Equity

- Purpose and format
- Building the statement
- Balance-sheet presentation

# Purpose of the Statement

The statement of partnership equity explains the changes in each partner's capital account during the period.

It reports:

- Beginning capital
- Additional investments
- Income or loss allocation
- Withdrawals
- Ending capital

The statement of partnership equity is a separate section in the 23rd-edition chapter.

# Statement Format

**Business Name**

**Statement of Partnership Equity**

**For the Year Ended December 31, 2026**

| Item | Partner A | Partner B | Total |
|---|---:|---:|---:|
| Beginning capital | — | — | — |
| Additional investments | — | — | — |
| Net income allocation | — | — | — |
| Withdrawals | — | — | — |
| **Ending capital** | **—** | **—** | **—** |

# Beginning Capital and Investments

| Item | Amanuel | Hana | Total |
|---|---:|---:|---:|
| Beginning capital | 500,000 | 600,000 | 1,100,000 |
| Additional investments | 20,000 | — | 20,000 |
| **Subtotal** | **520,000** | **600,000** | **1,120,000** |

# Add Income Shares

| Item | Amanuel | Hana | Total |
|---|---:|---:|---:|
| **Subtotal** | **520,000** | **600,000** | **1,120,000** |
| Share of net income | 218,000 | 182,000 | 400,000 |
| **Subtotal** | **738,000** | **782,000** | **1,520,000** |

# Deduct Withdrawals

| Item | Amanuel | Hana | Total |
|---|---:|---:|---:|
| **Subtotal** | **738,000** | **782,000** | **1,520,000** |
| Withdrawals | (80,000) | (70,000) | (150,000) |
| **Ending capital** | **658,000** | **712,000** | **1,370,000** |

# Balance-Sheet Equity Section

## Partnership Equity

| Item | ETB |
|---|---:|
| Amanuel, Capital | 658,000 |
| Hana, Capital | 712,000 |
| **Total Partnership Equity** | **1,370,000** |

# Statement of Members' Equity

An LLC may prepare a similar statement showing:

- Beginning member capital
- Member investments
- Allocated income or loss
- Member distributions
- Ending member capital

SECTION 7

# Admission of a New Partner

- Purchase of an interest
- Investment in the partnership
- Bonus method
- Revaluation

# Partner Admission

A new partner may be admitted through:

- Purchase of an interest from an existing partner
- Investment directly in the partnership

Admission normally requires the consent specified in the partnership agreement.

# Purchase from an Existing Partner

When a new partner purchases an interest directly from an existing partner:

- The transaction is between the individuals.
- Partnership cash is not affected.
- Total partnership capital does not change.
- Capital is transferred between partner accounts.

# Purchase Example

Hana sells ETB 150,000 of her capital interest to Sami. Sami personally pays Hana ETB 200,000.

## Partnership Entry

| Account | Debit | Credit |
|---|---:|---:|
| Hana, Capital | 150,000 | |
| Sami, Capital | | 150,000 |

# Why the ETB 200,000 Is Not Recorded

The partnership does not record the ETB 200,000 because:

- The payment is made directly to Hana.
- The partnership does not receive the cash.
- Partnership assets do not change.
- Only the ownership of capital changes.

# Investment in the Partnership

A new partner may contribute cash or other assets directly to the partnership.

The partnership then:

- Records the contributed asset
- Credits the new partner's capital
- May recognize a bonus under the admission agreement

# Investment Equal to Capital Credit

| Item | ETB |
|---|---:|
| Existing capital | 800,000 |
| Sami contributes | 200,000 |
| **Total capital after admission** | **1,000,000** |

A 20% capital interest equals:

$$1{,}000{,}000 \times 20\% = \text{ETB } 200{,}000$$

# Admission Entry without Bonus

| Account | Debit | Credit |
|---|---:|---:|
| Cash | 200,000 | |
| Sami, Capital | | 200,000 |

# Bonus Method

A bonus arises when the new partner's credited capital differs from the amount invested.

## Capital Credit Greater than Investment

Bonus to the new partner.

## Capital Credit Less than Investment

Bonus to the existing partners.

# Bonus to the New Partner

| Item | ETB |
|---|---:|
| Existing partners' capital | 800,000 |
| Sami contributes | 200,000 |
| **Total capital** | **1,000,000** |

**Agreed interest: 25% × 1,000,000 = ETB 250,000**
**Bonus to Sami: 250,000 – 200,000 = ETB 50,000**

# Allocate Bonus to New Partner

Existing partners share income 60 : 40.

```
Amanuel's capital reduction:  50,000 × 60% = ETB 30,000
Hana's capital reduction:      50,000 × 40% = ETB 20,000
```

# Entry for Bonus to New Partner

| Account | Debit | Credit |
|---|---|---|
| Cash | 200,000 | |
| Amanuel, Capital | 30,000 | |
| Hana, Capital | 20,000 | |
| Sami, Capital | | 250,000 |

# Bonus to Existing Partners

| Item | ETB |
|---|---:|
| Existing capital | 800,000 |
| Sami contributes | 300,000 |
| **Total capital after contribution** | **1,100,000** |

**Agreed 20% interest: 1,100,000 × 20% = ETB 220,000**
**Bonus to existing partners: 300,000 – 220,000 = ETB 80,000**

# Allocate Bonus to Existing Partners

Existing partners share income 60 : 40.

```
Amanuel:  80,000 × 60% = ETB 48,000
Hana:     80,000 × 40% = ETB 32,000
```

# Entry for Bonus to Existing Partners

| Account | Debit | Credit |
| --- | ---: | ---: |
| Cash | 300,000 | |
| Sami, Capital | | 220,000 |
| Amanuel, Capital | | 48,000 |
| Hana, Capital | | 32,000 |

# Asset Revaluation before Admission

Before admitting a new partner, existing partners may agree that recorded asset amounts do not reflect current agreed values.

Any agreed increase or decrease is allocated to existing partners according to their income-sharing ratio before the new partner is admitted.

# Revaluation Example

| Item | ETB |
| --- | ---: |
| Land book value | 200,000 |
| Agreed value | 320,000 |
| Increase | 120,000 |

Existing partners share 60 : 40.

# Revaluation Entry

| Account | Debit | Credit |
|---|---:|---:|
| Land | 120,000 | |
| Amanuel, Capital | | 72,000 |
| Hana, Capital | | 48,000 |

The new partner is admitted after the existing partners receive the revaluation adjustment.

# Admission Controls

Before admitting a new partner:

- Approve the admission according to the agreement.
- Determine the new income-sharing ratio.
- Verify contributed assets.
- Review asset valuations.
- Update the partnership agreement.
- Document the bonus or revaluation method.
- Update all capital accounts.

SECTION 8

# Withdrawal and Death of a Partner

- Sale to remaining partners
- Payment from partnership assets
- Bonuses
- Settlement with an estate

# Partner Withdrawal

A partner may withdraw through:

- Sale of an interest to other partners
- Payment from partnership assets

The accounting depends on who provides the settlement payment.

# Sale to Remaining Partners

When a withdrawing partner sells directly to the remaining partners:

- Partnership assets do not change.
- Total partnership capital does not change.
- The withdrawing partner's capital is transferred.
- Personal payments are not recorded by the partnership.

# Direct-Sale Example

Sami's capital balance is ETB 180,000. Amanuel and Hana purchase the interest equally.

| Account | Debit | Credit |
|---|---:|---:|
| Sami, Capital | 180,000 | |
| Amanuel, Capital | | 90,000 |
| Hana, Capital | | 90,000 |

# Payment from Partnership Assets

When the partnership pays the withdrawing partner:

- Cash decreases.
- The withdrawing partner's capital is eliminated.
- A bonus may arise when payment differs from capital.

# Payment Equal to Capital

Sami's capital is ETB 180,000 and cash paid is ETB 180,000.

| Account | Debit | Credit |
|---|---:|---:|
| Sami, Capital | 180,000 | |
| Cash | | 180,000 |

# Payment Greater than Capital

| Item | ETB |
|---|---:|
| Sami's capital | 180,000 |
| Cash paid | 210,000 |
| Bonus to Sami | 30,000 |

$$210{,}000 - 180{,}000 = \text{ETB } 30{,}000$$

# Allocate Bonus to Withdrawing Partner

Remaining partners share income 60 : 40.

```
Amanuel:  30,000 × 60% = ETB 18,000
Hana:      30,000 × 40% = ETB 12,000
```

| Account | Debit | Credit |
|---|---:|---:|
| Sami, Capital | 180,000 | |
| Amanuel, Capital | 18,000 | |
| Hana, Capital | 12,000 | |
| Cash | | 210,000 |

# Payment Less than Capital

| Item | ETB |
|---|---|
| Sami's capital | 180,000 |
| Cash paid | 150,000 |
| Bonus to remaining partners | 30,000 |

**180,000 – 150,000 = ETB 30,000**

# Entry for Bonus to Remaining Partners

| Account | Debit | Credit |
|---|---:|---:|
| Sami, Capital | 180,000 | |
| Cash | | 150,000 |
| Amanuel, Capital | | 18,000 |
| Hana, Capital | | 12,000 |

# Death of a Partner

The death of a partner normally requires:

- Closing the accounting records to the date of death
- Determining the deceased partner's income or loss share
- Updating the capital account
- Valuing partnership interests as agreed
- Settling with the partner's estate

Death of a partner is specifically included in the chapter's ownership-change section.

# Settlement with the Estate

Settlement may involve:

- Cash payment
- Transfer of assets
- Issuance of a note payable
- Purchase by remaining partners
- Continuation under a revised agreement

The procedure should follow the partnership agreement and applicable law.

SECTION 9

# Liquidating a Partnership

- Realization
- Gains and losses
- Capital deficiency
- Financial analysis

# What Is Partnership Liquidation?

Liquidation is the process of:

- Discontinuing partnership operations
- Selling non-cash assets
- Paying liabilities
- Allocating realization gains or losses
- Distributing remaining cash
- Closing partner capital accounts

# Main Liquidation Steps

- Sell non-cash assets.
- Record gain or loss on realization.
- Allocate the gain or loss to partners.
- Pay partnership liabilities.
- Resolve capital deficiencies.
- Distribute remaining cash according to final capital balances.

# Statement of Partnership Liquidation

A statement of partnership liquidation summarizes changes in:

- Cash
- Non-cash assets
- Liabilities
- Each partner's capital

It provides a transparent record of the liquidation process.

# Gain on Realization Example

Before liquidation:

| Item | ETB |
|---|---:|
| Cash | 100,000 |
| Non-cash assets | 900,000 |
| Liabilities | 200,000 |
| Amanuel, Capital | 480,000 |
| Hana, Capital | 320,000 |

Income-sharing ratio is 60 : 40. Non-cash assets are sold for ETB 960,000.

# Record Gain on Realization

```
Gain:  960,000 – 900,000 = ETB 60,000
```

## Allocation

```
Amanuel:  60,000 × 60% = ETB 36,000
Hana:      60,000 × 40% = ETB 24,000
```

# Realization Entry and Updated Capital

| Account | Debit | Credit |
|---|---:|---:|
| Cash | 960,000 | |
| Non-Cash Assets | | 900,000 |
| Amanuel, Capital | | 36,000 |
| Hana, Capital | | 24,000 |

| Partner | Capital |
|---|---:|
| Amanuel | ETB 516,000 |
| Hana | 344,000 |
| **Total** | **860,000** |

# Liability Settlement and Final Distribution

## Pay Liabilities

| Account | Debit | Credit |
|---|---:|---:|
| Liabilities | 200,000 | |
| Cash | | 200,000 |

## Final Cash Distribution

| Account | Debit | Credit |
|---|---:|---:|
| Amanuel, Capital | 516,000 | |
| Hana, Capital | 344,000 | |
| Cash | | 860,000 |

# Loss on Realization

Using the same opening balances, assume non-cash assets are sold for ETB 700,000.

```
900,000 − 700,000 = ETB 200,000 loss
```

## Allocate the Loss

```
Amanuel:  200,000 × 60% = ETB 120,000
Hana:      200,000 × 40% = ETB 80,000
```

# Updated Capital after the Loss

| Partner | Before Loss | Loss Share | Final Capital |
|---|---:|---:|---:|
| Amanuel | 480,000 | (120,000) | 360,000 |
| Hana | 320,000 | (80,000) | 240,000 |

After paying ETB 200,000 of liabilities, the remaining ETB 600,000 cash is distributed according to these final capital balances.

# Capital Deficiency

A capital deficiency occurs when a partner's capital account has a debit balance after realization losses are allocated.

Example capital balances after a large loss:

| Partner | Capital |
|---|---:|
| Partner A | ETB 200,000 |
| Partner B | 20,000 |
| Partner C | (20,000) |

Partner C should contribute ETB 20,000 to eliminate the deficiency.

# Partner Unable to Pay the Deficiency

When a deficient partner cannot contribute the required cash:

- The deficiency is treated as a loss to the remaining partners.
- It is allocated according to their income-and-loss-sharing ratio.
- The final cash distribution is based on adjusted capital balances.

The 23rd edition added an illustration emphasizing a partner's failure to pay a capital deficiency.

# Common Liquidation Errors

- Distributing cash before all liabilities are settled
- Ignoring estimated liquidation expenses
- Paying partners according to income-sharing ratios rather than capital balances
- Failing to allocate realization gains or losses
- Ignoring a partner's capital deficiency
- Distributing disputed amounts prematurely
- Failing to retain sufficient cash for unknown obligations

# Financial Analysis — Revenue per Employee

```
Revenue per Employee = Revenue ÷ Number of Employees
```

The chapter includes financial-analysis exercises involving Deloitte & Touche and Office-Brite Cleaning Services, LLC.

# Office-Brite Example

| Year | Revenue | Employees | Revenue per Employee |
|---|---:|---:|---:|
| 2009 | $38,500,000 | 350 | $110,000 |
| 2008 | $33,750,000 | 250 | $135,000 |

### Interpretation

Revenue increased, but revenue per employee decreased from approximately $135,000 to $110,000. This may indicate that employee growth occurred faster than revenue growth.

COMPREHENSIVE EXERCISE

# Muna and Robel Partnership

- Formation
- Income allocation
- Ending capital

# Comprehensive Exercise — Facts

### Contributions

- Muna contributes ETB 400,000 cash.
- Robel contributes equipment valued at ETB 500,000.
- The partnership assumes an ETB 100,000 liability on the equipment.

### Income Agreement

- Muna salary allowance: ETB 80,000
- Robel salary allowance: ETB 100,000
- Interest: 10% of beginning capital
- Remaining income: 40% to Muna and 60% to Robel
- Net income: ETB 300,000
- Muna withdrawals: ETB 50,000
- Robel withdrawals: ETB 60,000

# Formation Entries

### Muna

| Account | Debit | Credit |
|---|---:|---:|
| Cash | 400,000 | |
| Muna, Capital | | 400,000 |

### Robel

```
500,000 – 100,000 = ETB 400,000 capital
```

| Account | Debit | Credit |
|---|---:|---:|
| Equipment | 500,000 | |
| Equipment Loan Payable | | 100,000 |
| Robel, Capital | | 400,000 |

# Income Allocation — Allowances

## Salary Allowances

```
80,000 + 100,000 = ETB 180,000
```

## Interest Allowances

```
Muna:   400,000 × 10% = ETB 40,000
Robel:  400,000 × 10% = ETB 40,000
   Total interest = ETB 80,000
```

# Income Allocation — Remainder

$$300{,}000 - 180{,}000 - 80{,}000 = \text{ETB } 40{,}000$$

Muna: 40,000 × 40% = ETB 16,000
Robel: 40,000 × 60% = ETB 24,000

# Final Income Shares

| Allocation | Muna | Robel |
|---|---:|---:|
| Salary allowance | 80,000 | 100,000 |
| Interest allowance | 40,000 | 40,000 |
| Remaining income | 16,000 | 24,000 |
| **Net income share** | **136,000** | **164,000** |

# Ending Capital

```
Muna:   400,000 + 136,000 – 50,000 = ETB 486,000
Robel:  400,000 + 164,000 – 60,000 = ETB 504,000
```

## Total Partnership Equity

```
486,000 + 504,000 = ETB 990,000
```

# Chapter Summary — Organization and Formation

- A proprietorship has one owner.
- A partnership has two or more co-owners.
- An LLC generally provides limited liability to its members.
- A partnership agreement defines financial and management rights.
- Partners maintain separate capital and drawing accounts.
- Contributed assets are recorded at agreed values.
- Liabilities assumed reduce the contributing partner's capital credit.

# Chapter Summary — Income and Ownership Changes

- Partnership income and loss are divided according to agreement.
- Partner salary and interest allowances are not business expenses.
- The statement of partnership equity explains changes in capital.
- A partner may be admitted through purchase or direct investment.
- Admission may involve revaluation or a bonus.
- A withdrawing partner may sell an interest or receive partnership assets.
- Death is accounted for as an ownership withdrawal and settlement.

# Chapter Summary — Liquidation and Analysis

- Liquidation requires realization of assets, payment of liabilities and distribution of remaining cash.
- Realization gains and losses are allocated using the income-sharing ratio.
- Final cash is distributed according to positive capital balances.
- A deficient partner should contribute enough to eliminate the deficiency.
- An unpaid deficiency is allocated to the remaining partners.
- Revenue per employee measures the relationship between revenue and staffing.

# The Partnership Accounting Cycle

1. Form the Partnership →
2. Record Partner Contributions →
3. Operate the Business
4. Determine Net Income or Loss →
5. Allocate Income or Loss →
6. Record Withdrawals
7. Prepare the Statement of Partnership Equity →
8. Account for Ownership Changes →
9. Liquidate When Necessary

# Key Message

*Partnership accounting is built around separate capital accountability: every investment, income allocation, withdrawal, ownership change and liquidation settlement must be assigned fairly and accurately to the affected partners.*

Questions and Discussion

# THANK YOU

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