Accounting for Partnerships

1. Topics that require attention:
   a. Adjusting values of assets when control transactions occur.
   b. Keeping track of partnership assets and shares.

Rule: Prices/exchanges involving control transactions ought to reflect economic values. Book values before and after transactions need not reflect economic values.

This discrepancy is at the heart of all the important issues that we will run into later in corporate forms as well, so we deal with it in the simpler setting of partnerships.

Basically, asset values can differ from book values in three important ways:

Assets may have:
(1) increased in value
(2) decreased in value or
(3) created but never recorded (goodwill).
In the simplest case of entry, the incoming partner will want asset base to be reduced by (1) while continuing partners will want to be paid for (2) and (3).

However the firm may not want to write up assets (various reasons including lenders’ wishes, tax complications etc.).

Two principal ways to handle entry:
- Bonus Method (writedowns required but no writeups allowed)
- Goodwill method (writeups allowed as well)

Suppose at the time of admission of new partner, one asset has gone down in value and one has gone up.

Under the bonus method we proceed as follows:

**Step 1** Write down the first asset and assign the loss to the existing partners in their old profit sharing ratios. (Note here the use of the profit & loss % rather than the capital %). **Ignore all gains** for this step (this is key to the bonus method).
- E 14–1: no assets have lost value. Step is moot.
Step 2  Compute the book value of the assets of the partnership after the contribution of the new partner. Compute the new partner’s share of that book value using his capital share %.

- E 14–1: BV of partnership assets = $900,000 + $250,000. Tyler’s share: 20% of $1,150,000 = $230,000.

Step 3  Compute the bonus to continuing partners as BV of new partner’s contribution (usually the FMV of the contributed items) – new partner’s share computed in Step 2.

- E 14–1: Bonus is $20,000 ($250,000–$230,000).

Note: If this number is negative, either new partner gets a bonus or assets have lost value and must be written down.

Step 4  Allocate bonus to continuing partners in their profit sharing ratios.

- E 14–1: Riley: $12,000 (60%), Smith: $8,000 (40%).

<table>
<thead>
<tr>
<th>Dr. Assets brought in</th>
<th>FMV</th>
<th>Cr. Continuing partners</th>
<th>Bonus</th>
<th>New partner</th>
<th>Share</th>
</tr>
</thead>
</table>

(this assume bonus for continuing partners, make suitable changes for new partner bonus – what will those be?).
Goodwill method.

**Step 1** Compute total capital of new partnership:
[New partner contribution ÷ New partner capital share %]
- E14-1: $250,000 ÷ 20% = $1,250,000

**Step 2** Compute bonus to old or new partners:
Total capital from Step 1 - FMV of new partner contribution - BV of original assets = Net bonus
- E14-1: $1,250,000-$250,000-$900,000 = $100,000

Note: net bonus may involve both unrecognized appreciation or depreciation of assets AND unrecognized goodwill of original or new partner.

**Step 3:** Credit the net bonus to partners to whom it is due in their old profit-sharing proportions.
- E14-1: Riley: $60,000 (60%), Smith $40,000 (40%)

Buying into a partnership

Buying directly from a partner
- In the partnership books, move old partner balance to new partner. Do nothing else.
- New partner pays old partner privately.
Buying a share from the partnership
- Partner pays in consideration to firm
- Firm assets increase
- Compute what must be paid in to acquire the necessary share of the grossed-up partnership assets.
- Credit part of consideration paid by new partner to original partners as bonus if bonus method used.
- Revalue assets and credit goodwill to original partners if goodwill method used. Credit the consideration paid in to new partner account.

Withdrawal
Selling a share back to the partnership
- Bonus method: allow a bonus to exiting partner or continuing partners depending on facts. Split bonus between continuing partners based on their old proportions.
  - E 14-5: Split between G%S 45/65 and 20/65.

- Goodwill method: Recognize goodwill paid to retiring partner or to entire entity. Goodwill computation as before.