

ACCOUNTING FOR PARTNERSHIPS

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The financial needs of a rapidly growing sole proprietorship often overwhelm its borrowing capacity. Additional ownership represents one solution. A business with \$80,000 in existing capital may bring in additional ownership with \$20,000 cash, bringing total capital to \$100,000. Whether the new ownership receives 20% of the total capital (\$20,000 divided by \$100,000) depends upon the bargaining power of the participants. A very profitable company may award only 10%-15% interest while a less profitable company may be required to award 25% - 30% interest, or even more.

Sometimes new partners buy capital in a partnership from the individual partners and not the partnership. When this happens only the change in capital is recorded in the partnership records. There are many options available for the distribution of income to partners. Partners may receive interest on their capital investment. If they work for the partnership, they may receive a salary (which is charged to withdrawals) and a bonus. Unless stated otherwise, any remainder would be shared equally.

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I. ENTRY OF NEW PARTNER AND DIVISION OF INCOME

NEW PARTNER PAYS A BONUS

Peter Smith became a partner of Darin's Music Emporium on January 1, of year 2. He invested \$20,000 cash and received one-eighth interest (12.5%). Darin's capital was \$60,000.

DETERMINING NEW PARTNER'S CAPITAL			
Capital, Darin Jones	\$60,000	Jan. 1 Cash	DR. 20,000
Additional Investment	<u>20,000</u>	Capital, Darin Jones	CR. 10,000
Total Partnership Equity	<u>\$80,000</u>	Capital, Peter Smith (.125) (\$80,000)	10,000
Peter Smith receives (.125) (\$80,000) = \$10,000		To record entry of Peter Smith with 12.5% interest.	
Darin Jones receives a bonus of \$10,000			

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DIVISION OF YEAR TWO'S INCOME

Darin Jones and Peter Smith were to receive salaries of \$44,000 and \$22,000 respectively. After the distribution of salaries, any positive or negative balance would be distributed according to their 7:1 capital ratios with Darin receiving seven-eighths and Peter, one-eighth. Year 2's income was \$106,000.

DISTRIBUTING INCOME			
Year 2's Income:			\$106,000
Salary Distribution:	Darin Jones \$44,000	Peter Smith \$22,000	<u>66,000</u>
Balance to be distributed.			<u>\$40,000</u>
Capital Ratio Distribution:			
Darin Jones (.875) (\$40,000) =	35,000		
Peter Smith (.125) (\$40,000) =		<u>5,000</u>	<u>40,000</u>
Balance to be Distributed			0
Distributed to each Partner.	\$79,000	\$27,000	\$106,000

Dec. 31	Income Summary	106,000	
	Capital, Darin Jones		79,000
	Capital, Peter Smith		27,000
	To distribute Year 2 earnings.		

NOTE: Partnerships often pay salaries and interest on invested capital even when there is a loss or income is not high enough to cover these items. When this occurs, these distributions result in a negative amount which must then be subtracted from partners' capital according to existing income distribution policies.

NEW PARTNER RECEIVES A BONUS

On January 2 of Year 3 a new store opened, the capital for which had been provided by Karen O'Neil who invested \$36,000 for a 25% interest in the company. Darin Jones and Peter Smith had capital balances on January 2 of Year 3 of \$105,000 and \$15,000 respectively.

DETERMINING NEW PARTNERS' CAPITAL			
Capital, Darin Jones	= \$105,000	Jan. 2 Cash	DR. 36,000.00
Capital, Peter Smith	= 15,000	Capital, Darin Jones	2,625.00
Additional Capital	<u>36,000</u>	Capital, Peter Smith	375.00
Total Capital	<u>\$156,000</u>	Capital, Karen O'Neil	39,000
Karen O'Neil received (25%) (\$156,000) =	\$39,000.00	To record the entry of Karen O'Neil with a 25% interest.	
Darin Jones gives up (.875) (\$3,000) =	(\$ 2,625.00)		
Peter Smith gives up (.125) (\$3,000) =	(\$ 375.00)		

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