Appendix  Admission and Withdrawal of Partners

The chapter explained how the basic accounting for a partnership works. We now look at how to account for a common occurrence in partnerships—the addition or withdrawal of a partner.

Admission of a Partner

**STUDY OBJECTIVE 6**

Explain the effects of the entries when a new partner is admitted.

The admission of a new partner results in the **legal dissolution** of the existing partnership and the beginning of a new one. From an economic standpoint, however, the admission of a new partner (or partners) may be of minor significance in the continuity of the business. For example, in large public accounting or law firms, partners are admitted annually without any change in operating policies. To recognize the economic effects, it is necessary only to open a **capital account for each new partner**. In the entries illustrated in this appendix, we assume that the accounting records of the predecessor firm will continue to be used by the new partnership.

A new partner may be admitted either by (1) purchasing the interest of one or more existing partners or (2) investing assets in the partnership, as shown in Illustration 12A-1. The former affects only the capital accounts of the partners who are parties to the transaction. The latter increases both net assets and total capital of the partnership.

**Illustration 12A-1**  Procedures in adding partners

1. **Purchase of a Partner's Interest**

2. **Investment of Assets in Partnership**

**Purchase of a Partner's Interest**
HELPFUL HINT

In a purchase of an interest, the partnership is not a participant in the transaction. In this transaction, the new partner contributes no cash to the partnership.

The **admission of a partner by purchase of an interest** is a personal transaction between one or more existing partners and the new partner. Each party acts as an individual separate from the partnership entity. The individuals involved negotiate the price paid. It may be equal to or different from the capital equity acquired. The purchase price passes directly from the new partner to the partners who are giving up part or all of their ownership claims.

Any money or other consideration exchanged is the personal property of the participants and **not** the property of the partnership. Upon purchase of an interest, the new partner acquires each selling partner's capital interest and income ratio.

Accounting for the purchase of an interest is straightforward. The partnership records only the changes in partners' capital. **Partners' capital accounts are debited for any ownership claims sold.** At the same time, the new partner's capital account is credited for the capital equity purchased. Total assets, total liabilities, and total capital remain unchanged, as do all individual asset and liability accounts.

To illustrate, assume that L. Carson agrees to pay $10,000 each to C. Ames and D. Barker for \(\frac{1}{3}\) (one-third) of their interest in the Ames–Barker partnership. At the time of the admission of Carson, each partner has a $30,000 capital balance. Both partners, therefore, give up $10,000 of their capital equity. The entry to record the admission of Carson is:

\[
\begin{align*}
C. \text{ Ames, Capital} & \quad 10,000 \\
D. \text{ Barker, Capital} & \quad 10,000 \\
L. \text{ Carson, Capital} & \quad 20,000
\end{align*}
\]

(To record admission of Carson by purchase)

The effect of this transaction on net assets and partners' capital is shown below.

<table>
<thead>
<tr>
<th>Net Assets</th>
<th>C. Ames, Capital</th>
<th>D. Barker, Capital</th>
<th>L. Carson, Capital</th>
</tr>
</thead>
<tbody>
<tr>
<td>60,000</td>
<td>10,000</td>
<td>30,000</td>
<td>20,000</td>
</tr>
<tr>
<td>Bal. 20,000</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

**Illustration 12A-2  Ledger balances after purchase of a partner's interest**

Note that net assets remain unchanged at $60,000, and each partner has a $20,000 capital balance. Ames and Barker continue as partners in the firm, but the capital interest of each has changed. The cash paid by Carson goes directly to the individual partners and not to the partnership.

**Regardless of the amount paid by Carson for the one-third interest, the entry is exactly the same.** If Carson pays $12,000 each to Ames and Barker for one-third of the partnership, the partnership still makes the entry shown on the bottom of page 533.

**Investment of Assets in a Partnership**

The admission of a partner by an investment of assets is a transaction between the new partner and the partnership. Often referred to simply as **admission by investment**, the transaction increases both the net assets and total capital of the partnership.
Admission and Withdrawal of Partners

Assume, for example, that instead of purchasing an interest, Carson invests $30,000 in cash in the Ames–Barker partnership for a \( \frac{3}{3} \) capital interest. In such a case, the entry is:

\[
\begin{array}{lcr}
\text{Cash} & 30,000 \\
\text{L. Carson, Capital} & 30,000 \\
\end{array}
\]

(To record admission of Carson by investment)

The effects of this transaction on the partnership accounts would be:

<table>
<thead>
<tr>
<th>Net Assets</th>
<th>C. Ames, Capital</th>
<th>D. Barker, Capital</th>
<th>L. Carson, Capital</th>
</tr>
</thead>
<tbody>
<tr>
<td>60,000</td>
<td>30,000</td>
<td>30,000</td>
<td>30,000</td>
</tr>
<tr>
<td>30,000</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Bal.</td>
<td>90,000</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Illustration 12A-3  Ledger balances after investment of assets

Note that both net assets and total capital have increased by $30,000.

Remember that Carson's one-third capital interest might not result in a one-third income ratio. The new partnership agreement should specify Carson's income ratio, and it may or may not be equal to the one-third capital interest.

The comparison of the net assets and capital balances in Illustration 12A-4 shows the different effects of the purchase of an interest and admission by investment.

<table>
<thead>
<tr>
<th>Purchase of an Interest</th>
<th>Admission by Investment</th>
</tr>
</thead>
<tbody>
<tr>
<td>Net Assets</td>
<td>$60,000</td>
</tr>
<tr>
<td>Capital</td>
<td></td>
</tr>
<tr>
<td>C. Ames</td>
<td>$20,000</td>
</tr>
<tr>
<td>D. Barker</td>
<td>20,000</td>
</tr>
<tr>
<td>L. Carson</td>
<td>20,000</td>
</tr>
<tr>
<td>Total capital</td>
<td>$60,000</td>
</tr>
</tbody>
</table>

Illustration 12A-4  Comparison of purchase of an interest and admission by investment

When a new partner purchases an interest, the total net assets and total capital of the partnership do not change. When a partner is admitted by investment, both the total net assets and the total capital change.

In the case of admission by investment, further complications occur when the new partner's investment differs from the capital equity acquired. When those amounts are not the same, the difference is considered a bonus either to (1) the existing (old) partners or (2) the new partner.

Bonus to Old Partners. For both personal and business reasons, the existing partners may be unwilling to admit a new partner without receiving a bonus. In an established firm, existing partners may insist on a bonus as compensation for the work they have put into the company over the years. Two accounting factors underlie the business reason: First, total partners' capital equals the book value of the recorded net assets of the partnership. When the new partner is admitted, the fair market values of assets such as land and buildings may be higher than their book values. The bonus will help make up the difference between fair market value and book value. Second, when the partnership has been profitable, goodwill may exist. But, the partnership balance sheet does not report goodwill. In such cases, the new partner is usually willing to pay the bonus to become a partner.
A bonus to old partners results when the new partner's investment in the firm is greater than the capital credit on the date of admittance. The bonus results in an increase in the capital balances of the old partners. The partnership allocates the bonus to them on the basis of their income ratios before the admission of the new partner.

To illustrate, assume that the Bart–Cohen partnership, owned by Sam Bart and Tom Cohen, has total capital of $120,000. Lea Eden acquires a 25% ownership (capital) interest in the partnership by making a cash investment of $80,000. The procedure for determining Eden's capital credit and the bonus to the old partners is as follows.

1. **Determine the total capital of the new partnership:** Add the new partner's investment to the total capital of the old partnership. In this case the total capital of the new firm is $200,000, computed as follows.

   \[
   \begin{array}{ccc}
   \text{Total capital of existing partnership} & \$120,000 \\
   \text{Investment by new partner, Eden} & \$80,000 \\
   \text{Total capital of new partnership} & \$200,000 \\
   \end{array}
   \]

2. **Determine the new partner's capital credit:** Multiply the total capital of the new partnership by the new partner's ownership interest. Eden's capital credit is $50,000 ($200,000 × 25%).

3. **Determine the amount of bonus:** Subtract the new partner's capital credit from the new partner's investment. The bonus in this case is $30,000 ($80,000 - $50,000).

4. **Allocate the bonus to the old partners on the basis of their income ratios:** Assuming the ratios are Bart 60%, and Cohen 40%, the allocation is: Bart $18,000 ($30,000 × 60%) and Cohen $12,000 ($30,000 × 40%).

The entry to record the admission of Eden is:

\[
\begin{align*}
\text{Cash} & \quad 80,000 \\
\text{Sam Bart, Capital} & \quad 18,000 \\
\text{Tom Cohen, Capital} & \quad 12,000 \\
\text{Lea Eden, Capital} & \quad 50,000 \\
\hline
\text{(To record admission of Eden and bonus to old partners)} &
\end{align*}
\]

**Bonus to New Partner.** A bonus to a new partner results when the new partner's investment in the firm is less than his or her capital credit. This may occur when the new partner possesses resources or special attributes that the partnership wants. For example, the new partner may be able to supply cash that the firm urgently needs for expansion or to meet maturing debts. Or the new partner may be a recognized expert or authority in a relevant field. Thus, an
A bonus to a new partner results in a **decrease in the capital balances of the old partners.** The **amount of the decrease for each partner is based on the income ratios before the admission of the new partner.** To illustrate, assume that Lea Eden invests $20,000 in cash for a 25% ownership interest in the Bart–Cohen partnership. The computations for Eden's capital credit and the bonus are as follows, using the four procedures described in the preceding section.

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Total capital of Bart–Cohen partnership</td>
<td>$120,000</td>
</tr>
<tr>
<td>Investment by new partner, Eden</td>
<td>20,000</td>
</tr>
<tr>
<td>Total capital of new partnership</td>
<td>$140,000</td>
</tr>
<tr>
<td>2. <strong>Eden's capital credit</strong> (25% × $140,000)</td>
<td><strong>$35,000</strong></td>
</tr>
<tr>
<td>3. <strong>Bonus to Eden</strong> ($35,000 – $20,000)</td>
<td><strong>$15,000</strong></td>
</tr>
<tr>
<td>4. Allocation of bonus to old partners:</td>
<td></td>
</tr>
<tr>
<td>Bart ($15,000 × 60%)</td>
<td>$9,000</td>
</tr>
<tr>
<td>Cohen ($15,000 × 40%)</td>
<td>6,000</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>$15,000</strong></td>
</tr>
</tbody>
</table>

**Illustration 12A-5  Computation of capital credit and bonus to new partner**

The partnership records the admission of Eden as follows:

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>20,000</td>
</tr>
<tr>
<td>Sam Bart, Capital</td>
<td>9,000</td>
</tr>
<tr>
<td>Tom Cohen, Capital</td>
<td>6,000</td>
</tr>
<tr>
<td>Lea Eden, Capital</td>
<td>35,000</td>
</tr>
<tr>
<td>(To record Eden's admission and bonus)</td>
<td></td>
</tr>
</tbody>
</table>

\[
A = L + OE \\
+20,000 \\
-9,000 \\
-6,000 \\
+35,000 \\
\]

**Cash Flows**

+20,000

**Withdrawal of a Partner**
Now let's look at the opposite situation—the withdrawal of a partner. A partner may withdraw from a partnership **voluntarily**, by selling his or her equity in the firm. Or, he or she may withdraw **involuntarily**, by reaching mandatory retirement age or by dying. The withdrawal of a partner, like the admission of a partner, legally dissolves the partnership. The legal effects may be recognized by dissolving the firm. However, it is customary to record only the economic effects of the partner's withdrawal, while the firm continues to operate and reorganizes itself legally.

As indicated earlier, the partnership agreement should specify the terms of withdrawal. As Illustration 12A-6 shows, the withdrawal of a partner may be accomplished by (1) payment from partners' personal assets or (2) payment from partnership assets. The former affects only the partners' capital accounts. The latter decreases total net assets and total capital of the partnership.

**Illustration 12A-6  Procedures in partnership withdrawal**

**Payment from Partners' Personal Assets**

Withdrawal by payment from partners' personal assets is a personal transaction between the partners. **It is the direct opposite of admitting a new partner who purchases a partner's interest.** The remaining partners pay the retiring partner directly from their personal assets. **Partnership assets are not involved in any way, and total capital does not change.** The effect on the partnership is limited to changes in the partners' capital balances.

To illustrate, assume that partners Morz, Nead, and Odom have capital balances of $25,000, $15,000, and $10,000, respectively. Morz and Nead agree to buy out Odom's interest. Each of them agrees to pay Odom $8,000 in exchange for one-half of Odom's total interest of $10,000. The entry to record the withdrawal is:
Admission and Withdrawal of Partners

J. Odom, Capital 10,000
A. Morz, Capital 5,000
M. Nead, Capital 5,000

(To record purchase of Odom's interest)

The effect of this entry on the partnership accounts is shown below.

Illustration 12A-7

<table>
<thead>
<tr>
<th>A = L + OE</th>
</tr>
</thead>
<tbody>
<tr>
<td>− 10,000</td>
</tr>
<tr>
<td>+ 5,000</td>
</tr>
<tr>
<td>+ 5,000</td>
</tr>
</tbody>
</table>

Cash Flows
no effect

The effect of this entry on the partnership accounts is shown below.

<table>
<thead>
<tr>
<th>Net Assets</th>
<th>A. Morz, Capital</th>
<th>M. Nead, Capital</th>
<th>J. Odom, Capital</th>
</tr>
</thead>
<tbody>
<tr>
<td>50,000</td>
<td>25,000</td>
<td>15,000</td>
<td>10,000</td>
</tr>
<tr>
<td>5,000</td>
<td>5,000</td>
<td>10,000</td>
<td></td>
</tr>
<tr>
<td>Bal. 30,000</td>
<td>Bal. 20,000</td>
<td>Bal. 10,000</td>
<td></td>
</tr>
</tbody>
</table>

Illustration 12A-7  Ledger balances after payment from partners' personal assets

Note that net assets and total capital remain the same at $50,000.

What about the $16,000 paid to Odom? You've probably noted that it is not recorded. The entry debited Odom's capital only for $10,000, not for the $16,000 that she received. Similarly, both Morz and Nead credit their capital accounts for only $5,000, not for the $8,000 they each paid.

After Odom's withdrawal, Morz and Nead will share net income or net loss equally unless they specifically indicate another income ratio in the partnership agreement.

Payment from Partnership Assets

Withdrawal by payment from partnership assets is a transaction that involves the partnership. Both partnership net assets and total capital decrease as a result. Using partnership assets to pay for a withdrawing partner's interest is the reverse of admitting a partner through the investment of assets in the partnership.

Many partnership agreements provide that the amount paid should be based on the fair market value of the assets at the time of the partner's withdrawal. When this basis is required, some maintain that any differences between recorded asset balances and their fair market values should be (1) recorded by an adjusting entry, and (2) allocated to all partners on the basis of their income ratios. This position has serious flaws. Recording the revaluations violates the cost principle, which requires that assets be stated at original cost. It also is a departure from the going-concern assumption, which assumes the entity will continue indefinitely. The terms of the partnership contract should not dictate the accounting for this event.

In accounting for a withdrawal by payment from partnership assets, the partnership should not record asset revaluations. Instead, it should consider any difference between the amount paid and the withdrawing partner's capital balance as a bonus to the retiring partner or to the remaining partners.
Admission and Withdrawal of Partners

Bonus to Retiring Partner. A partnership may pay a bonus to a retiring partner when:

1. The fair market value of partnership assets is more than their book value,
2. There is unrecorded goodwill resulting from the partnership's superior earnings record, or
3. The remaining partners are eager to remove the partner from the firm.

The partnership deducts the bonus from the remaining partners' capital balances on the basis of their income ratios at the time of the withdrawal.

To illustrate, assume that the following capital balances exist in the RST partnership: Roman $50,000, Sand $30,000, and Terk $20,000. The partners share income in the ratio of 3 : 2 : 1, respectively. Terk retires from the partnership and receives a cash payment of $25,000 from the firm. The procedure for determining the bonus to the retiring partner and the allocation of the bonus to the remaining partners is as follows.

HELPFUL HINT

Compare this entry to the one on page 539.

1. **Determine the amount of the bonus**: Subtract the retiring partner's capital balance from the cash paid by the partnership. The bonus in this case is $5,000 ($25,000 - $20,000).
2. **Allocate the bonus to the remaining partners on the basis of their income ratios**: The ratios of Roman and Sand are 3 : 2. Thus, the allocation of the $5,000 bonus is: Roman $3,000 ($5,000 × 3/5) and Sand $2,000 ($5,000 × 2/5).

The partnership records the withdrawal of Terk as follows.

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>B. Terk, Capital</td>
<td>20,000</td>
</tr>
<tr>
<td>F. Roman, Capital</td>
<td>3,000</td>
</tr>
<tr>
<td>D. Sand, Capital</td>
<td>2,000</td>
</tr>
<tr>
<td>Cash</td>
<td>25,000</td>
</tr>
</tbody>
</table>

(To record withdrawal of and bonus to Terk)

The remaining partners, Roman and Sand, will recover the bonus given to Terk as the partnership sells or uses the undervalued assets.

Bonus to Remaining Partners. The retiring partner may give a bonus to the remaining partners when:
Admission and Withdrawal of Partners

1. Recorded assets are overvalued,
2. The partnership has a poor earnings record, or
3. The partner is eager to leave the partnership.

In such cases, the cash paid to the retiring partner will be less than the retiring partner's capital balance. The partnership allocates (credits) the bonus to the capital accounts of the remaining partners on the basis of their income ratios.

To illustrate, assume (instead of the example above) that the partnership pays Terk only $16,000 for her $20,000 equity when she withdraws from the partnership. In that case:

1. The bonus to remaining partners is $4,000 ($20,000 - $16,000).
2. The allocation of the $4,000 bonus is: Roman $2,400 ($4,000 × 3/5) and Sand $1,600 ($4,000 × 2/5).

**HELPFUL HINT**

Compare this entry to the one on page 538.

Under these circumstances, the entry to record the withdrawal is:

\[
\begin{align*}
B. \text{Terk, Capital} & \quad 20,000 \\
F. \text{Roman, Capital} & \quad 2,400 \\
D. \text{Sand, Capital} & \quad 1,600 \\
\text{Cash} & \quad 16,000 \\
\end{align*}
\]

(To record withdrawal of Terk and bonus to remaining partners)

\[
\begin{align*}
A &= L + OE \\
&= -20,000 + 2,400 + 1,600 - 16,000 \\
&= -16,000 \\
\end{align*}
\]

**Cash Flows**

\[
-16,000
\]

Note that if Sand had withdrawn from the partnership, Roman and Terk would divide any bonus on the basis of their income ratio, which is 3 : 1 or 75% and 25%.

Death of a Partner

The death of a partner dissolves the partnership. But partnership agreements usually contain a provision for the surviving partners to continue operations. When a partner dies, it usually is necessary to determine the partner's equity at the date of death. This is done by (1) determining the net income or loss for the year to date, (2) closing the books, and (3) preparing financial statements. The partnership agreement may also require an independent audit of the
Admission and Withdrawal of Partners

financial statements and a revaluation of assets by an appraisal firm.

The surviving partners may agree to purchase the deceased partner's equity from their personal assets. Or they may use partnership assets to settle with the deceased partner's estate. In both instances, the entries to record the withdrawal of the partner are similar to those presented earlier.

To facilitate payment from partnership assets, some partnerships obtain life insurance policies on each partner, with the partnership named as the beneficiary. The partnership then uses the proceeds from the insurance policy on the deceased partner to settle with the estate.

Summary of Study Objective for Appendix

6. Explain the effects of the entries when a new partner is admitted. The entry to record the admittance of a new partner by purchase of a partner's interest affects only partners' capital accounts. The entries to record the admittance by investment of assets in the partnership (a) increase both net assets and total capital and (b) may result in recognition of a bonus to either the old partners or the new partner.

7. Describe the effects of the entries when a partner withdraws from the firm. The entry to record a withdrawal from the firm when the partners pay from their personal assets affects only partners' capital accounts. The entry to record a withdrawal when payment is made from partnership assets (a) decreases net assets and total capital and (b) may result in recognizing a bonus either to the retiring partner or the remaining partners.