



# **ADVANCED FINANCIAL ACCOUNTING AND REPORTING**

**AFAR03**

**PARTNERSHIP DISSOLUTION**

**HANDOUT**

## INTEGRATED REVIEW II: ADVANCED FINANCIAL ACCOUNTING AND REPORTING

### MODULE 3: PARTNERSHIP DISSOLUTION

#### I. NOTES

1. Dissolution is the changes in the ownership structure among partners in the partnership. Dissolution does not mean termination of partnership business.
2. Over time, changes occur in the makeup of a partnership because of death or retirement or because of the admission of new partners. Such changes dissolve the existing partnership, although the business frequently continues uninterrupted through a newly formed partnership. If, for example, a new partner is admitted by the acquisition of a present interest, the capital balances can simply be reclassified to reflect the change in ownership. As an alternative, the purchase price may be viewed as evidence of the underlying value of the organization as a whole. Based on this calculation, asset and liability balances are adjusted to fair value, and any residual goodwill is recognized.
3. Admission into an existing partnership also can be achieved by a direct capital contribution from the new partner. Because of the parties' negotiations, the amount invested will not always agree with the beginning capital balance attributed to the new partner. The bonus method resolves this conflict by simply reclassifying the various capital accounts to align the balances with specified totals and percentages. No revaluation is carried out under this approach. Conversely, according to the goodwill method, all asset and liability accounts are adjusted first to fair value. The price the new partner paid is used to compute an implied value for the partnership, and any excess over fair value is recorded as goodwill.
4. The composition of a partnership also can undergo changes because of the death or retirement of a partner. Individuals may decide to withdraw. Such changes legally dissolve the partnership, although business operations frequently continue under the remaining partners' ownership. In compensating the departing partner, the final asset distribution may differ from the ending capital balance. This disparity can, again, be accounted for by means of the bonus method, which adjusts the remaining capital accounts to absorb the bonus. The goodwill approach by which all assets and liabilities are restated to fair value with any goodwill being recognized also can be applied. Finally, a hybrid method revalues the assets and liabilities but ignores goodwill. Under this last approach, any amount paid to the departing partner in excess of the newly adjusted capital balance is accounted for by means of the bonus method.

#### II. STRAIGHT PROBLEMS (DEMONSTRATION PROBLEMS)

**PROBLEM 1** (*Admission by purchase of interest*). Assume that after operations and partners' withdrawals during 20x2 and 20x3, DE Partnership has a book value of P120,000 and profit and loss ratio percentage on January 1, 20x4 as follows:

Particulars	Capital balances	P&L Percentage
D	P72,000	70
E	<u>P48,000</u>	30
Total	P120,000	100

On this date, F is admitted to the partnership.

Required: Prepare journal entries to record the admission of F, assuming there is a purchase of interest from all partners. This situation gives rise to three assumptions:

- a. Purchase at book value. F purchases a one-fourth ( $\frac{1}{4}$ ) interest in the firm. One-fourth of each partners' capital is to be transferred to the new partner. F pays the partners P30,000
- b. Purchase at more than book value. F purchased one-fourth of D's interest for P21,600 and one-fourth of E's interest for P14,400, making payment directly to D and E. The new partner will have a  $\frac{1}{4}$  profit and loss ratio and the old partners continue to use their old profit and loss ratio.
  - b.1 Bonus approach
  - b.2 Revaluation (goodwill) approach
- c. Purchase at less than book value. F purchased one-fourth of D's and E's interest by paying P26,400 directly to D and E. The new partner will have a  $\frac{1}{4}$  profit and loss ratio and the old partners continue to use their old profit and loss ratio.
  - c.1 Bonus approach
  - c.2 Revaluation (goodwill) approach
- d. What are the capital balances of the partners immediately after admission?

**PROBLEM 2 (Admission by investment).** B and C have been operating a tax accounting service as a partnership for five years. Their current capital balances are P92,000 and P88,000, respectively, and they share profits and losses in a 60:40 ratio. Because of the growth in their tax business, they decide that they need a new partner. D is admitted to the partnership after which the partners agree to share profits and losses 40% to B, 35% to C and 25% to D.

Required: Prepare the necessary journal entries to admit D in each of the following independent conditions. If the information is such that the bonus and revaluation (goodwill) methods are appropriate, record the admission using both methods.

1. D invests P90,000 in cash and receives a one-third capital interest.
2. D invests P120,000 cash for a 45% capital interest. Total capital after his admission is to be P300,000.
3. D agrees to invests P120,000 cash for a one-third capital interest, but will not accept a capital credit less than his investment.
4. D invests P40,000 cash for a one-fourth capital interest. The partners agree that assets and the firm as a whole should not be revaluated.
5. D invests P35,000 cash for a one-fifth capital interest. The partners agree that total capital after admission of D should be P225,000.
6. D invests land in the partnership as a site for a new office building. The land, which originally cost D P90,000, now has a current market value of P150,000. D is admitted with a one-third capital interest.
7. D is admitted to the partnership by purchasing a 30% capital interest from each partner. A payment of P35,000 is made outside the partnership and is split between B and C.

**PROBLEM 3 (Withdrawal of a Partner).** Assume the following data on January 1, 20x4 for KLM Partnership

Assets		Liabilities and Capital	
Cash	P60,000	Liabilities	P12,000
Non-cash assets	48,000	K, capital (30%)	36,000
Loan receivable – K	6,000	L, capital (50%)	48,000
		M, capital (20%)	18,000
Total	P114,000	Total	P114,000

The percentage in parentheses after partners' capital balances represent their respective interest in profits and losses. On May 1, 20x4, K retires from the partnership. The net income of the partnership to date of retirement amounted to P24,000. The partnership paid cash to the retiring partner also on the retirement date.

Required:

1. Determine the total interest of K, L and M immediately before the retirement of K.
2. Prepare journal entries to record the retirement of K, assuming:
  - a. Payment at Book Value (Settlement price is equal to the interest of retiring partner). The partnership paid K P37,200
  - b. Payment at More than book value (Settlement price is greater than the interest of retiring partner). The partnership paid K P42,000. Included in the non-cash assets is an inventory costing P7,200 with a fair value of P12,000. The remaining partners continue to use their old profit and loss ratio.
    - b.1 Bonus approach
    - b.2 Revaluation (goodwill) approach
  - c. Payment at Less than book value (Settlement price is less than the interest of retiring partner). The partnership paid K P31,200
    - c.1 Bonus approach
    - c.2 Revaluation approach

**PROBLEM 4 (Incorporation of a Partnership).** The balance sheet of S and T, Ltd. On April 30, 20x4 are as follows:

Assets		Liabilities and Capital	
Cash	P8,700	Notes payable	P10,000
Accounts receivable	13,250	Accounts payable	9,800
Inventories	21,760	S, Capital	25,110
Equipment	32,400	T, Capital	20,000
Less: Accum Depreciation	(11,200)		
Total	P64,910	Total	P64,910

The partnership was converted to S and T Corporation with new accounting records. S and T received a total of 10,000 shares of P1 par common stock in exchange for the net assets of the partnership. The accounting records of the partnership had been maintained in accordance with generally accepted accounting principles, except that an allowance for doubtful accounts of P800 had not been provided. The

current fair value of inventories and equipment were P28,000 and P35,000 respectively. S and T shared net income and losses in a 3:2 ratio, respectively.

Required: Prepare journal entries for S and T Corporation on April 30, 20x4 to record the transfer of net assets from the partnership and the issuance of common stock to the partners.

END