Chapter 2 Partnerships: Organization and Operation

True/False Questions

1. A limited liability partnership is a taxable entity under federal income tax laws.

   Answer: False

2. The balances of limited liability partners' drawing ledger accounts are closed to the partners' capital accounts at the end of an accounting period.

   Answer: True

3. The Interest Expense ledger account is debited when interest on partners' capital account balances is credited to partners in the distribution of limited liability partnership net income.

   Answer: False

4. A limited liability partnership generally is considered to be an association of persons rather than a separate accounting entity.

   Answer: False

5. A limited liability partnership contract provision for the allowance of interest on partners' capital account balances in the allocation of net income must be applied when the partnership has a net loss.

   Answer: True

6. From a legal standpoint, the admission or withdrawal of a partner does not terminate the existence of a limited liability partnership.

   Answer: False

7. The acquisition of an ownership interest by a new partner directly from an existing partner does not change either total assets or net assets of a limited liability partnership.

   Answer: True

8. A bonus to a partner based on income after the bonus is recognized as an expense by the limited liability partnership.

   Answer: True

9. In a limited partnership, the personal liability of one or more of the partners for the unpaid debts of the partnership is limited to the amounts those partners had invested in the partnership.

   Answer: True

10. The value assigned to noncash assets invested by partners in a limited liability partnership is the cost of the assets or the current fair value of the assets at the time of investment, whichever is lower.

    Answer: False

11. A guarantee of a minimum income of $15,000 or a salary allowance of $15,000 to a partner will give the partner the same share of partnership net income, whether the limited liability partnership has a net income or a net loss.

    Answer: False

12. Goodwill may be recognized as part of the investment of a new partner only when the new partner invests the identifiable net assets of a business enterprise that are expected to generate superior earnings for the limited liability partnership.

    Answer: True

13. Limited partnerships may be required to file registration statements with the Securities and Exchange Commission.

    Answer: True

14. Partners' drawings are displayed in a limited liability partnership's statement of cash flows as cash flows from operating activities.

    Answer: False

Multiple Choice Questions

15. A partner's withdrawal of assets from a limited liability partnership that is considered a permanent reduction in that partner's equity is debited to the partner's:
    A) Drawing account
    B) Retained Earnings account
    C) Capital account
    D) Loan Receivable account

    Answer: C

Chapter 2 Partnerships: Organization and Operation

16. The drawing ledger accounts of limited liability partners are used:
    A) To record the partners' salaries
    B) To reduce the partners' capital account balances at the end of an accounting period
    C) In the same manner as the partners' loan accounts
    D) To record the partners' share of net income or loss for an accounting period

    Answer: B

17. The partnership contract for Cole & Dane LLP provides that Cole is to receive a bonus of 20% of net income (after the bonus) and that the remaining net income is to be divided equally. If the partnership income before the bonus for Year 2006 is $57,600, Cole's share of the pre-bonus income is:
    A) $28,800
    B) $33,600
    C) $34,560
    D) $43,200
    E) Some other amount

    Answer: B
    Rationale: [($57,600 x 1/6) + ($48,000 x 1/2) = $33,600]

18. May goodwill appropriately be recognized in the journal entry to record the admission of a new partner to an existing limited liability partnership for an investment of:

	Cash?	**Net assets of a single proprietorship?**
A)	Yes	Yes
B)	Yes	No
C)	No	Yes
D)	No	No

Answer: C

19. Morse and Niguel, partners of Morse & Niguel Limited Liability Partnership, shared net income and losses equally. On March 1, 2006, Odmark was admitted to the partnership; the new ratio for sharing net income and losses was Morse, 25%; Niguel, 25%; and Odmark, 50%. Odmark invested the net assets of a single proprietorship. The value of Odmark's proprietorship as a going concern was $120,000, and the current fair value of the proprietorship's identifiable net assets was $90,000. The difference of $30,000 between the going-concern value and the identifiable net assets value is recognized as:
A) Goodwill credited to Odmark's capital account
B) Goodwill credited $15,000 each to the capital accounts of Morse and Niguel
C) A bonus of $15,000 each to Morse and Niguel
D) A bonus of $30,000 to Odmark with offsetting debits of $15,000 each to the capital accounts of Morse and Niguel

Answer: A

20. The partnership contract for Pyle & Quan LLP provided that Pyle was to receive a salary of $12,000 a year, Quan was to receive a salary of $15,000 a year, and the resultant net income or loss after partners' salaries expense was to be divided 60% to Pyle and 40% to Quan. A partnership income of $20,000 before partners' salaries expense for the fiscal year ended May 31, 2006, is allocated:
A) $12,000 to Pyle and $8,000 to Quan
B) $8,889 to Pyle and $11,111 to Quan
C) $7,800 to Pyle and $12,200 to Quan
D) In some other amounts

Answer: C

21. Bruce Chapman was admitted to the Adams & Bye Limited Liability Partnership on May 31, 2006, by an investment of $40,000 cash for a 20% interest in partnership net assets. Prior to the admission of Chapman, the capital accounts of Adams and Bye, who shared net income and losses equally, had balances of $70,000 and $30,000, respectively. The preferable accounting method for the admission of Chapman includes credits of:
A) $6,000 each to the capital accounts of Adams and Bye
B) $30,000 each to the capital accounts of Adams and Bye
C) $28,000 and $12,000, respectively, to the capital accounts of Adams and Bye
D) Some other amounts to the capital accounts of Adams and Bye

Answer: A

22. On January 31, 2006, Amy Reid withdrew from Reid, Sayle & Todd LLP, whose partners had an income-sharing ratio of 40%, 35%, and 25%, respectively, for a cash payment of $121,000, despite Reid's having a capital account balance of $100,000 on that date. The preferable method of accounting for Reid's withdrawal includes a:
A) $12,250 debit to Sayle, Capital
B) $21,000 debit to Goodwill
C) $52,500 debit to Goodwill
D) $5,250 debit to Todd, Capital

Answer: A
Rationale: [($121,000 – $100,000) x 35/60 = $12,250]

23. The partners of Ames, Brod, and Chan LLP had capital account balances of $75,000, $45,000, add $30,000, respectively, and shared net income and losses equally. For an investment of $75,000 cash, Dell was admitted to the partnership with a 25% interest in capital and net income. Based on this information, which of the following may justify the amount of investment?
A) Dell received a bonus from Ames, Brod, and Chan.
B) Partnership net assets were overvalued immediately prior to Dell's admission to the partnership.
C) The carrying amount of the partnership's net assets was less than their current fair value immediately prior to Dell's admission to the partnership.
D) Dell apparently invested goodwill in the partnership.

Answer: C

24. If a partner who retires from a limited liability partnership receives an amount of cash less than the partner's capital account balance:
A) Identifiable net assets of the partnership should be written down
B) Bonuses should be allocated to the continuing partners
C) "Negative goodwill" should be recognized by the partnership
D) None of the foregoing should take place

Answer: B

25. The partners of Wohl, Xavier, and Yepp LLP shared net income and losses in a 5:3:2 ratio, respectively. The capital account balances on April 30, 2006, were as follows:

Wohl, capital	$ 37,000
Xavier, capital	65,000
Yepp, capital	48,000
Total partners' capital	$150,000

The carrying amounts of the assets and liabilities of the partnership were the same as their current fair values. Zabb was to be admitted to the partnership with a 20% capital interest and a 20% share of net income and losses in exchange for a cash investment. No goodwill or bonus was to be recognized. The amount of cash that Partner Zabb should invest in the partnership is:
A) $30,000
B) $36,000
C) $37,500
D) $40,000
E) Some other amount

Answer: C
Rationale: ($150,000 x 1/4 = $37,500)

26. The appropriate format of the January 31, 2006, closing entry for App & Brie Limited Liability Partnership, whose two partners had withdrawn their salaries from the partnership during January, 2006, is (explanation omitted):

A) App, Drawing	XXX	
Brie, Drawing	XXX	
Salaries Expense		XXX
B) Income Summary	XXX	
App, Drawing		XXX
Brie, Drawing		XXX
C) App, Capital	XXX	
Brie, Capital	XXX	
Salaries Expense		XXX
D) App, Capital	XXX	
Brie, Capital	XXX	
App, Drawing		XXX
Brie, Drawing		XXX

Answer: D

Chapter 2 Partnerships: Organization and Operation

27. Alf and Ben, partners in Alf & Ben LLP who share net income and losses equally, had capital account balances of $40,000 and $60,000, respectively, on September 25, 2006, on which date the following journal entry was prepared for the partnership:

Cash	62,000	
Goodwill [($62,000 x 3) – ($100,000 + $62,000)]	24,000	
Alf, Capital ($24,000 x 0.50)		12,000
Ben, Capital ($24,000 x 0.50)		12,000
Cam, Capital		62,000

To record investment by Cam for a one-third interest in capital, with goodwill of $24,000 divided equally between Alf and Ben.

The foregoing journal entry:
A) Is acceptable
B) Should be replaced by an entry allocating an $8,000 bonus equally to Alf and to Ben
C) Should be replaced by an entry allocating a $24,000 bonus equally to Alf and to Ben
D) Should not reflect either a bonus or goodwill

Answer: B

28. On June 30, 2006, the balance sheet for Coll, Maduro & Prieto LLP (together with the income-sharing ratio) was as follows:

Assets	$180,000
Loan payable to Coll	$ 9,000
Coll, capital (20%)	42,000
Maduro, capital (20%)	39,000
Prieto, capital (60%)	90,000
Total	$180,000

Coll decided to retire from the partnership. By mutual agreement, the partnership assets were to be adjusted to their current fair value of $216,000 on June 30, 2006. It was agreed that the partnership would pay Coll $61,200 cash for Coll's partnership interest, including Coll's loan that was to be repaid in full. No goodwill was to be recognized. After Coll's retirement, the balance of Maduro's capital account is:
A) $36,450
B) $39,000
C) $45,450
D) $46,200
E) Some other amount

Answer: C
Rationale: ($39,000 + $7,200 – $750 = $45,450)

29. Are per unit amounts disclosed in a limited partnership's:

	Income Statement?	**Statement of Partners' Capital?**	**Balance Sheet?**
A)	Yes	Yes	Yes
B)	Yes	No	Yes
C)	Yes	No	No
D)	No	No	No

Answer: B

30. When Elsa Martin withdrew from Lewis, Martin, Noll & Ordway LLP on January 31, 2006, she was paid $80,000, although her capital account balance was only $60,000. The four partners shared net income and losses equally. The journal entry of the partnership to record Martin's withdrawal on January 31, 2006, preferably should include a debit of:
A) $6,667 to Lewis, Capital
B) $20,000 to Goodwill
C) $80,000 to Goodwill
D) $80,000 to Martin, Drawing

Answer: A
Rationale: [($80,000 − $60,000) ÷ 3 + $6,667]

31. The owners' equity ledger accounts for a limited liability partnership are:
A) Capital accounts
B) Drawing accounts
C) Loans payable to partners
D) **a** and **b** only
E) **a** and **c** only

Answer: D

Chapter 2 Partnerships: Organization and Operation

Problems

32. On September 1, 2005, Fox & George LLP admitted Lucille Hayes to a 20% interest in net assets for an investment of $50,000 cash. Prior to the admission of Hayes, Fox & George LLP had net assets of $100,000 and an income-sharing ratio of Fox—25%, George—75%. After the admission of Hayes, the partnership contract included the following provisions:

    Salary of $40,000 a year to Hayes, to be recognized as partnership expense
    Resultant net income in ratio Fox—20%, George—60%, Hayes—20%

    During the fiscal year ended August 31, 2006, Fox, George & Hayes LLP had an income of $90,000 prior to recognition of salary to Hayes.

    Prepare journal entries for Fox, George & Hayes LLP to record the admission of Hayes on September 1, 2005, and the division of income among the partners on August 31, 2006.

    Answer:

2005			
Sept. 1	Cash	50,000	
	Fox, Capital ($20,000 x 0.25)		5,000
	George, Capital ($20,000 x 0.75)		15,000
	Hayes, Capital ($150,000 x 0.20)		30,000
	To record admission of Hayes.		
2006			
Aug. 31	Partners' Salaries Expense	40,000	
	Hayes, Capital		40,000
	To allocate salary to Hayes.		
31	Income Summary ($90,000 – $40,000)	50,000	
	Fox, Capital ($50,000 x 0.20)		10,000
	George, Capital ($50,000 x 0.60)		30,000
	Hayes, Capital ($50,000 x 0.20)		10,000
	To close net income to partners' capital accounts.		

33. Roe, Soh, & Tow Limited Liability Partnership was organized and began operations on February 1, 2005, with the following capital account balances: Roe, $50,000; Soh, $70,000; Tow, $80,000. The income-sharing arrangement provided for the following:

	Roe	**Soh**	**Tow**
Annual salary (to be recognized as partnership expense and withdrawable in cash)	$40,000	$60,000	$50,000
Interest on beginning-of-year capital account balances	6%	6%	6%
Residual income or loss	25%	40%	35%

For the fiscal year ended January 31, 2006, Roe, Soh, & Tow Limited Liability Partnership had income of $180,000, before recognition of salaries expense, and the partners withdrew their authorized salaries in cash.

Prepare journal entries (omit explanations) for Roe, Soh, & Tow Limited Liability Partnership on January 31, 2006.

Answer:

2006			
Jan. 31	Partners' Salaries Expense	150,000	
	Roe, Capital		40,000
	Soh, Capital		60,000
	Tow, Capital		50,000
31	Income Summary ($180,000 – $150,000)	30,000	
	Roe, Capital ($3,000 + $4,500)		7,500
	Soh, Capital ($4,200 + $7,200)		11,400
	Tow, Capital ($4,800 + $6,300)		11,100

Chapter 2 Partnerships: Organization and Operation

34. For the fiscal year ended May 31, 2006, Ace, Bay & Cap Limited Liability Partnership had an operating loss of $120,000 before recognition of partners' salaries expense. The partnership contract provided for the following:

    Salaries of $20,000 to Ace, $30,000 to Bay, and $40,000 to Cap, to be recognized as expense by the partnership
    Bonus of 20% of income after the bonus to Ace
    Residual income or loss 20% to Ace, 50% to Bay, and 30% to Cap

    Prepare journal entries (omit explanations) for Ace, Bay & Cap Limited Liability Partnership on May 31, 2006.

    Answer:

2006			
May 31	Partners' Salaries Expense	90,000	
	Ace, Capital		20,000
	Bay, Capital		30,000
	Cap, Capital		40,000
31	Ace, Capital ($210,000 x 0.20)	42,000	
	Bay, Capital ($210,000 x 0.50)	105,000	
	Cap, Capital ($210,000 x 0.30)	63,000	
	Income Summary ($120,000 + $90,000)		210,000

    (Note: the bonus provision does not apply to a loss.)

35. The partners of Rann & Sloe LLP shared net income and losses in a 3:2 ratio and had capital account balances of $87,000 and $48,000, respectively. Trey was admitted to the partnership with the investment of a single proprietorship having identifiable net assets with a current fair value of $47,250 and was given a one-third interest in the net income or losses and the net assets of the new partnership.

    Prepare a journal entry to record the admission of Trey to Rann, Sloe & Trey LLP.

    Answer:

Identifiable Net Assets	47,250	
Goodwill	20,250	
Trey, Capital [($87,000 + $48,000) ÷ 2]		67,500

    To record admission of Trey to partnership.

Chapter 2 Partnerships: Organization and Operation

36. The partners of Bentsen & Cole LLP had capital account balances of $45,000 and $25,000, respectively. They shared net income and losses in a 3:1 ratio.

    Prepare journal entries to record the admission of Diaz to the limited liability partnership under the (1) bonus method, and (2) goodwill method for each of the following assumptions:

    a. Diaz invested a single proprietorship with identifiable assets having a current fair value of $40,000 and liabilities having a current fair value of $10,000 for a 25% interest in the net assets of the partnership.
    b. Diaz invested a single proprietorship with identifiable assets having a current fair value of $40,000 and liabilities having a current fair value of $10,000 for a 33 1/3% interest in the net assets of the partnership.

    Answer:

    a. (1) Bonus method:

Identifiable Assets	40,000	
Liabilities		10,000
Bentsen, Capital ($5,000 x 0.75)		3,750
Cole, Capital ($5,000 x 0.25)		1,250
Diaz, Capital [($70,000 + $30,000) x 0.25]		25,000
To record admission of Diaz to partnership.		

(2) Goodwill method:

Identifiable Assets	40,000	
Goodwill [($30,000 x 4) – ($70,000 + $30,000)]	20,000	
Liabilities		10,000
Bentsen, Capital ($20,000 x 0.75)		15,000
Cole, Capital ($20,000 x 0.25)		5,000
Diaz, Capital ($40,000 – $10,000)		30,000
To record admission of Diaz to partnership.		

b. (1) Bonus method:

Identifiable Assets	40,000	
Bentsen, Capital ($3,333 x 0.75)	2,500	
Cole, Capital ($3,333 x 0.25)	833	
Liabilities		10,000
Diaz, Capital [($70,000 + $30,000) ÷ 3]		33,333
To record admission of Diaz to partnership.		

(2) Goodwill method:

Identifiable Assets	40,000	
Goodwill [($70,000 ÷ 2/3) – $100,000]	5,000	
Liabilities		10,000
Diaz, Capital ($30,000 + $5,000)		35,000
To record admission of Diaz to partnership.		

37. In 2005, the partners of Julio & Fong LLP shared net income and losses equally, but in 2006 the income-sharing ratio was changed to 60% for Julio and 40% for Fong. On December 31, 2005, inventories were understated by $12,000. On December 31, 2006, employees' salaries payable in the amount of $5,400 and short-term prepayments of $2,700 had not been recognized in the accounting records.

    Prepare a correcting journal entry on December 31, 2006, assuming that the accounting records had been closed for 2006. Show supporting computations.

    Answer:

Short-term prepayments	2,700	
Julio, Capital	2,820	
Fong, Capital		120
Salaries Payable		5,400

    To correct accounting records on Dec. 31, 2003.
    The correction to partners' capital accounts is computed as follows:

	Julio, Capital	**Fong, Capital**
Inventories understated by $12,000, Dec. 31, 2005	$ 6,000	$ 6,000
Inventories understated by $12,000, Jan. 1, 2006	(7,200)	(4,800)
Accrued salaries of $5,400 not recorded, Dec. 31, 2006	(3,240)	(2,160)
Short-term prepayments of $2,700 not recorded, Dec. 31, 2006	1,620	1,080
Net corrections to partners' capital accounts	$(2,820)	$ 120

Chapter 2 Partnerships: Organization and Operation

38. The capital account balances for Ray & Randall LLP on May 31, 2006, were as follows:

Ray, capital	$210,000
Randall, capital	110,000

Ray and Randall shared net income and losses in the ratio of 3:2, respectively. The partners agreed to admit Appleton to the partnership with a 35% interest in partnership capital and net income. Appleton invested $80,000 cash, and no goodwill was recognized.

Prepare a working paper to compute the capital account balance for each partner immediately after Appleton was admitted to Ray, Randall & Appleton LLP on May 31, 2003.

Answer:
Computations of capital account balances:

	Ray	**Randall**	**Appleton**	**Combined**
Balances before Appleton is admitted	$210,000	$110,000		$320,000
Admission of Appleton to partnership—bonus method	(36,000)	(24,000)	$140,000	80,000
Balances after Appleton is admitted	$174,000	$ 86,000	$140,000	$400,000

Case

39. The balance sheet of Elsa Laing, CPA (a single proprietorship) had total assets of $200,000, including unimpaired goodwill of $15,000 recognized when Laing had acquired the accounting practice of another sole practitioner, and total liabilities of $30,000. In Laing's negotiations with the partners of Burns & Damon LLP for the acquisition of her proprietorship by the limited liability partnership, she insists on a capital account balance of $190,000, pointing out her higher-than-typical earnings over the past five years. Partners Ralph Burns and Linda Damon maintain that the current fair value of Laing's proprietorship identifiable net assets is $155,000 (their carrying amount); they offer to admit Laing to Burns, Damon & Laing LLP for a capital account balance of $175,000.

Do you support the position of Elsa Laing or of Ralph Burns and Linda Damon? Explain.

Answer:
The position of Ralph Burns and Linda Damon is supportable; that of Elsa Laing is not. Goodwill is recognized only when one business enterprise acquires another enterprise at a cost in excess of the current fair value of the acquired enterprise's **identifiable** net assets. The goodwill carried in Laing's proprietorship's balance sheet is an **unidentifiable** asset; it would have no value to Burns, Damon & Laing LLP.