HORNGREN'S ACCOUNTING

MILLER-NOBLES MATTISON MATSUMURA
MEISSNER JOHNSTON NORWOOD

VOLUME TWO

11TH CANADIAN EDITION

HORNGREN'S
ACCOUNTING

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HORNGREN'S ACCOUNTING

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In memory of *Charles T. Horngren* 1926–2011

Whose vast contributions to the teaching and learning of accounting impacted and will continue to impact generations of accounting students and professionals.

I would like to thank my students for keeping me on my toes. Hearing their new ideas and how they think about accounting makes teaching such a wonderful job.
Carol A. Meissner

I would like to thank my husband, Bill, and my family for their encouragement and support.
Jo-Ann L. Johnston

I would like to thank my wife, Helen, and my family very much for their support and encouragement.
Peter R. Norwood

Pearson

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About the Authors

TRACIE L. MILLER-NOBLES, CPA, received her bachelor's and master's degrees in accounting from Texas A&M University and is currently pursuing her Ph.D. in adult education also at Texas A&M University. She is an associate professor at Austin Community College, Austin, Texas. Previously she served as a senior lecturer at Texas State University, San Marcos, Texas, and she has taught as an adjunct at University of Texas-Austin. Tracie has public accounting experience with Deloitte Tax LLP and Sample & Bailey, CPAs.

Tracie is a recipient of the following awards: American Accounting Association J. Michael and Mary Anne Cook prize, Texas Society of CPAs Rising Star TSCPA Austin Chapter CPA of the Year, TSCPA Outstanding Accounting Educator, NISOD Teaching Excellence and Aims Community College Excellence in Teaching. She is a member of the Teachers of Accounting at Two Year Colleges, the American Accounting Association, the American Institute of Certified Public Accountants, and the Texas State Society of Certified Public Accountants. She is currently serving on the board of directors as secretary/webmaster of Teachers of Accounting at Two Year Colleges and as a member of the American Institute of Certified Public Accountants financial literacy committee. In addition, Tracie served on the Commission on Accounting Higher Education: Pathways to a Profession.

Tracie has spoken on such topics as using technology in the classroom, motivating non-business majors to learn accounting, and incorporating active learning in the classroom at numerous conferences. In her spare time she enjoys camping and hiking and spending time with friends and family.

BRENDA L. MATTISON, CMA, has a bachelor's degree in education and a master's degree in accounting, both from Clemson University. She is currently an accounting instructor at Tri-County Technical College in Pendleton, South Carolina. Brenda previously served as accounting program coordinator at TCTC and has prior experience teaching accounting at Robeson Community College, Lumberton, North Carolina; University of South Carolina Upstate, Spartanburg, South Carolina; and Rasmussen Business College, Eagan, Minnesota. She also has accounting work experience in retail and manufacturing businesses and is a Certified Management Accountant.

Brenda is a member of the American Accounting Association, Institute of Management Accountants, South Carolina Technical Education Association, and Teachers of Accounting at Two Year Colleges. She is currently serving on the board of directors as vice-president of Conference Administration of Teachers of Accounting at Two Year Colleges.

Brenda previously served as Faculty Fellow at Tri-County Technical College. She has presented at state, regional, and national conferences on topics including active learning, course development, and student engagement.

In her spare time, Brenda enjoys reading and spending time with her family. She is also an active volunteer in the community, serving her church and other organizations.

ELLA MAE MATSUMURA, PH.D., is a professor in the Department of Accounting and Information Systems in the School of Business at the University of Wisconsin–Madison, and is affiliated with the university's Center for Quick Response Manufacturing. She received an A.B. in mathematics from the University of California, Berkeley, and M.Sc. and Ph.D. degrees from the University of British Columbia. Ella Mae has won two teaching excellence awards at the University of Wisconsin–Madison and was elected as a lifetime fellow of the university's Teaching Academy, formed to promote effective teaching. She is a member of the university team awarded an IBM Total Quality Management Partnership grant to develop curriculum for total quality management education.

Ella Mae was a co-winner of the 2010 Notable Contributions to Management Accounting Literature Award. She has served in numerous leadership positions in the American Accounting Association (AAA). She was coeditor of *Accounting Horizons* and has chaired and served on numerous AAA committees. She has been secretary-treasurer and president of the AAA's Management Accounting Section. Her past and current research articles focus on decision making, performance evaluation, compensation, supply chain relationships, and sustainability. She coauthored a monograph on customer profitability analysis in credit unions.

About the Canadian Authors

CAROL A. MEISSNER is a professor in both Business and Management Studies and the Automotive Business School of Canada at Georgian College in Barrie, Ontario. She teaches in the Accounting Diploma, Automotive Business Diploma, and business degree programs.

Carol has always been a teacher. She started as a part-time college instructor when she completed her first degree and has taught full time since 2005. In 2014, Carol was awarded the Georgian College Board of Governors' Award of Excellence Academic for outstanding contributions to the college and an ongoing commitment to excellence.

Her "real world" experience includes car dealership controllership and self-employment as a part-time controller and consultant for a wide variety of businesses.

Carol has broad experience in curriculum development. She has been a curriculum chair, program coordinator, member of several curriculum committees, and has been involved in writing and renewing degree, diploma, and graduate certificate programs.

A self-professed "learning junkie," Carol holds a Bachelor of Commerce degree, a Master of Business Administration degree, a Master of Arts degree in Education (Community College concentration), and a CPA designation. She has also earned Georgian College's Professional Development Teaching Practice Credential and is a graduate of Georgian's Aspiring Leaders program. She is a regular attendee and occasional presenter at conferences related to teaching, accounting, and the automotive industry. Outside of work she is an esports mom who spends many hours watching tournaments online.

JO-ANN JOHNSTON is an instructor in the Accounting, Finance and Insurance Department at the British Columbia Institute of Technology (BCIT). She obtained her Diploma of Technology in Financial Management from BCIT, her Bachelor in Administrative Studies degree from British Columbia Open University, and her Master of Business Administration degree from Simon Fraser University. She is also a certified general accountant, has CPA designation, and completed the Canadian securities course.

Prior to entering the field of education, Jo-Ann worked in public practice and industry for over 10 years. She is a past member of the board of governors of the Certified General Accountants Association of British Columbia and has served on various committees for the association. She was also a member of the board of directors for the BCIT Faculty and Staff Association and served as treasurer during that tenure.

In addition to teaching duties and committee work for BCIT, Jo-Ann is the financial officer for a family-owned business.

PETER R. NORWOOD is an instructor in accounting and coordinator of the Accounting program at Langara College in Vancouver. A graduate of the University of Alberta, he received his Master of Business Administration from the University of Western Ontario. He is a CPA, a fellow of the Institute of Chartered Accountants of British Columbia, a certified management accountant, and a fellow of the Society of Management Accountants of Canada.

Before entering the academic community, Peter worked in public practice and industry for over 15 years. He is a past president of the Institute of Chartered Accountants of British Columbia and chair of the Chartered Accountants School of Business (CASB). He is also the chair of the Chartered Accountants Education Foundation for the British Columbia Institute of Chartered Accountants and has been active on many provincial and national committees, including the Board of Evaluators of the Canadian Institute of Chartered Accountants. Peter is also a sessional lecturer in the Sauder School of Business at the University of British Columbia.

Changes to This Edition

General (Volumes 1 and 2)

Revised end-of-chapter starters, exercises, practice sets, challenge exercises, ethical issues, problems, challenge problems, decision problems, and financial statement cases.

Moved IFRS Mini-Cases and Comprehensive Problems for each Part) to MyLab Accounting.

Learning Objectives in all chapters have been reviewed against current CPA competencies and correlation provided at the beginning of each chapter. Many of the problems in the text (Beyond the Numbers, Ethical issues, Decision Problems, Financial Statements Cases) give opportunities to develop CPA competencies, in particular Enabling Competencies, such as Communication, Problem Solving, and Professional and Ethical Behaviour.

- **NEW! Using Excel.** This end-of-chapter exercise in select chapters introduces students to Excel to solve common accounting problems as they would in the business environment.
- **NEW! Practice Set.** Practice Set questions for Chapters 2 through 9 provide another opportunity for students to practise the entire accounting cycle. The practice set uses the same company in each chapter but is often not as extensive as the serial exercises.
- **NEW! Serial Exercises.** Serial exercises in all chapters expose students to recording entries for a service company which grows to become a merchandiser later in the text.
- **NEW! Ethics box.** This feature provides common questions and potential solutions business owners face. Students are asked to determine the course of action they would take based on concepts covered in the chapter and are then given potential solutions. Available in most chapters.
- **NEW!** List of acronyms has been expanded and added to inside back cover for easier student reference.

Chapter 12

- Additional starters and exercises.

Chapter 13

NEW! chapter-opening vignette.

- Made examples more continuous so they are easier to follow (fewer companies in examples).

Chapter 14

- Updated corporate information in opening-vignette.
- Split learning objective so that errors and changes are separate. Some schools don't cover this topic so easier to see questions with or without these topics.
- Additional starters and exercises.

Chapter 15

NEW! chapter-opening vignette

- Streamlined bonds introduction.
- Schedules now in Excel.
- Improved presentation and consistency in mortgage schedules.

Chapter 16

NEW! chapter-opening vignette

- Additional starters and exercises.
- Removed Joint Ventures – the new S2056 for Joint Arrangements is complex for an introductory course.
- Moved summaries of types of investments to beginning and end of the equity sections.

Chapter 17

NEW! chapter-opening vignette

- Focused chapter on the indirect method for the cash flow statement and moved the direct method to an appendix. This will be easier for schools only covering one, though all content is still there for those who cover both methods.
- Additional starters, exercises and problems.

Chapter 18

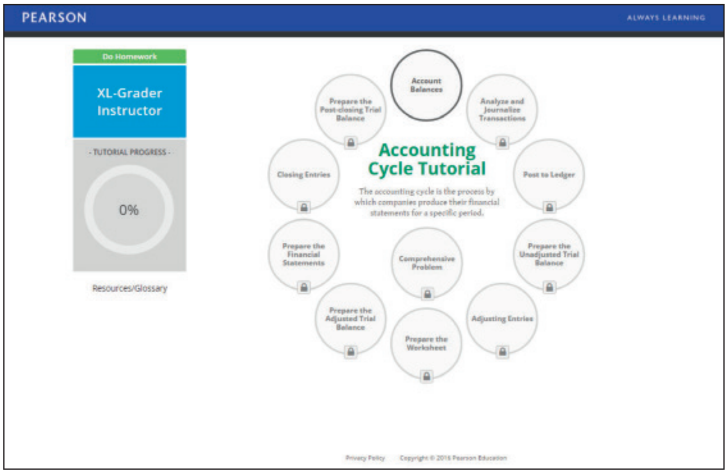
NEW! chapter-opening vignette

- Expanded explanations for days sales in inventory and debt/equity ratio.
- Additional starters and exercises.

Horngren's Accounting …
Expanding on Proven Success

Accounting Cycle Tutorial

This interactive tutorial in MyLab Accounting helps students master the Accounting Cycle for early and continued success in introduction to accounting courses. The tutorial, accessed by computer, smartphone, or tablet, provides students with brief explanations of each concept of the Accounting Cycle through engaging, interactive activities. Students are immediately assessed on their understanding, and their performance is recorded in the MyLab gradebook. Whether the Accounting Cycle Tutorial is used as a remediation self-study tool or course assignment, students have yet another resource within MyLab to help them be successful with the accounting cycle.



NEW! ACT Comprehensive Problem

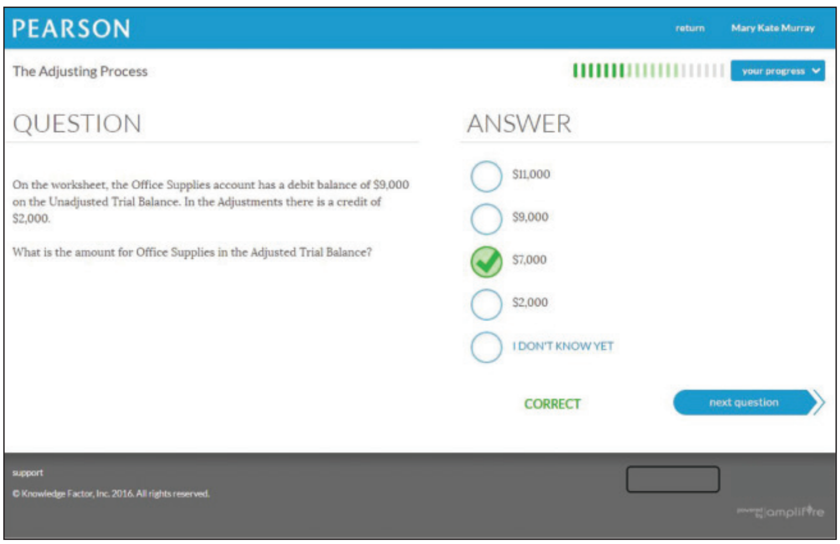
The Accounting Cycle Tutorial now includes a comprehensive problem that allows students to work with the same set of transactions throughout the accounting cycle. The comprehensive problem, which can be assigned at the beginning or the end of the full cycle, reinforces the lessons learned in the Accounting Cycle Tutorial activities by emphasizing the connections between the accounting cycle concepts.

Study Plan

The Study Plan acts as a tutor, providing personalized recommendations for each of your students based on his or her ability to master the learning objectives in your course. This allows students to focus their study time by pinpointing the precise areas they need to review and allowing them to use customized practice and learning aids–such as videos, eText, tutorials, and more–to get them back on track. Using the report available in the gradebook, you can then tailor course lectures to prioritize the content where students need the most support–offering you better insight into classroom and individual performance.

Dynamic Study Modules

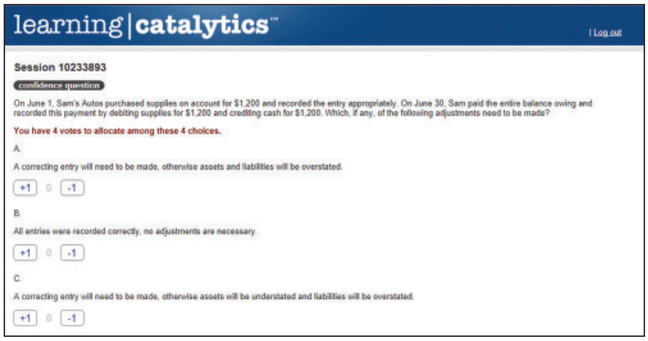
New! Chapter-specific Dynamic Study Modules help students study effectively on their own by continuously assessing their activity and performance in real time. Here's how it works: students complete a set of questions with a unique answer format that also asks them to indicate their confidence level. Questions repeat until the student can answer them all correctly and confidently. Dynamic Study Modules explain the concept using materials from the text. These are available as graded assignments and are accessible on smartphones, tablets, and computers.



Learning Catalytics

Text-specific Learning Catalytics helps you generate class discussion, customize your lecture, and promote peer-to-peer learning with real-time analytics. As a student response tool, Learning Catalytics uses students' smartphones, tablets, or laptops to engage them in more interactive tasks and thinking.

- **NEW!** Upload a full PowerPoint® deck for easy creation of slide questions.
- Help your students develop critical thinking skills.
- Monitor responses to find out where your students are struggling.
- Rely on real-time data to adjust your teaching strategy.
- Automatically group students for discussion, teamwork, and peer-to-peer learning.



Pearson Etext

Pearson eText gives students access to their textbook anytime, anywhere. In addition to note-taking, highlighting, and bookmarking, the Pearson eText offers interactive and sharing features. Instructors can share their comments or highlights, and students can add their own, creating a tight community of learners within the class.

Textbook Features

Making Connections

CONNECTING CHAPTER boxes appear at the beginning of each chapter. This feature combines the chapter outline with the learning objectives, key questions, and page references.

18 Financial Statement Analysis

CONNECTING CHAPTER 18

LEARNING OBJECTIVES

1. **Perform a horizontal analysis of financial statements**
   How do we compare several years of financial information?
   Objectives of Financial Statement Analysis, page 1032
   Methods of Analysis, page 1033
   Horizontal Analysis, page 1033
   Trend Percentages

2. **Perform a vertical analysis of financial statements**
   What is vertical analysis, and how do we perform one?
   Vertical Analysis, page 1037

3. **Prepare and use common-size financial statements**
   What are common-size financial statements, and how do we use them?
   Common-Size Statements, page 1040
   Benchmarking

4. **Compute the standard financial ratios**
   How do we compute standard financial ratios, and what do they mean?
   Using Ratios to Make Decisions, page 1044
   Measuring the Ability to Pay Current Liabilities (Liquidity)
   Measuring the Ability to Sell Inventory and Collect Receivables (Efficiency)
   Measuring the Ability to Pay Long-Term Debt (Solvency)
   Measuring Profitability
   Analyzing Shares as an Investment (Value)
   Limitations of Financial Analysis, page 1055
   Investor Decisions, page 1055
   Annual Reports
   Red Flags in Analyzing Financial Statements

5. **Describe the impact of IFRS on financial statement analysis**
   What is the impact of IFRS on financial statement analysis?
   The Impact of IFRS on Financial Statement Analysis, page 1058

The **Summary** for Chapter 18 appears on page 1061.
Key Terms with definitions for this chapter's material appears on page 1063.

LEARNING OBJECTIVES provide a roadmap showing what will be covered and what is especially important in each chapter.

PAGE REFERENCES give students the ability to quickly connect to the topic they are seeking within the chapter.

KEY QUESTIONS are questions about the important concepts in the chapter, expressed in everyday language.

CPA competencies

This text covers material outlined in **Section 1: Financial Reporting of the CPA Competency Map**. The Learning Objectives for each chapter have been aligned with the CPA Competency Map to ensure the best coverage possible.

1.1.2 Evaluates the appropriateness of the basis of financial reporting

1.4.4 Interprets financial reporting results for stakeholders (internal or external)

CPA COMPETENCY MAP Each chapter's Learning Objectives have been aligned with the latest CPA competencies, which are provided here.

CHAPTER OPENERS

Chapter openers set up the concepts to be covered in the chapter using stories students can relate to. The implications of those concepts on a company's reporting and decision-making processes are then discussed.

Susan Schmitz/Shutterstock

When Danielle Rodriguez started her business in January 2015, she wasn't thinking about accounting. As an IT professional, she was looking to combine her business skills with her love of dogs. Her "fur babies," Zoey and Maggie Mae, are an important part of her #Barknfun Team.

Her business, The Bark'N Fun Company, is a monthly subscription box service that offers premium toys, treats, and accessories for dogs and puppies. The business is online, but her office is located in the small town of Courtice, Ontario.

The majority of small businesses fail within the first three years. So how has The Bark'N Fun Company stayed in business in a competitive online market for luxury items? Danielle, The Bark'N Fun Company's owner, uses accounting information to make her business decisions. Is she an accountant? No! She is a smart businessperson who knows that she needs to understand the business's monthly revenues and expenses so that her business can survive in the short-term and thrive in the long-term. The Bark'N Fun Company needs to know if the prices of their toys and treats are high enough to cover operating expenses, or if they can afford to offer free shipping. Is it working? Yes. The Bark'N Fun Company has not only been able to stay in business but also supports charities that are important to dogs, such as canine rescue organizations and humane society shelters.

This chapter shows how The Bark'N Fun Company and other businesses record their transactions and update their financial records. The procedures outlined in this chapter are followed by businesses ranging in size from giant multinational corporations like PetSmart Inc. to micro-enterprises like The Bark'N Fun Company and Hunter Environmental Consulting, who we will continue to follow through this chapter.

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SPREADSHEET FORMATS USED IN EXHIBITS

NEW! Excel-based financial documents are used so students will familiarize themselves with the accounting information used in the business world.

EXHIBIT 10–6 | Units-of-Production Amortization for a Truck

	A	B	C	D	E	F	G	H	I
1			Amortization for the Year						
2		Asset	Amortization		Number of		Amortization	Accumulated	Asset
3	Date	Cost	Per Kilometre		Kilometres		Expense	Amortization	Book Value
4	Jan. 1, 2020	$65,000	1		2				$65,000
5	Dec. 31, 2020		$0.15	×	90,000	=	$13,500	$13,500	51,500
6	Dec. 31, 2021		0.15	×	120,000	=	18,000	31,500	33,500
7	Dec. 31, 2022		0.15	×	100,000	=	15,000	46,500	18,500
8	Dec. 31, 2023		0.15	×	60,000	=	9,000	55,500	9,500
9	Dec. 31, 2024		0.15	×	30,000	=	4,500	60,000	5,000

Residual value

EXHIBIT 2–8 | The Journal

Date of the transaction

Debit account name and dollar amount. Debits are always listed first.

Journal			Page 1
Date	**Account Titles and Explanation**	**Debit**	**Credit**
2019			
Apr. 2	Cash	250,000	
	Lisa Hunter, Capital		250,000
	Received initial investment from owner.		

Brief explanation

Credit account name and dollar amount. The credit account name is indented.

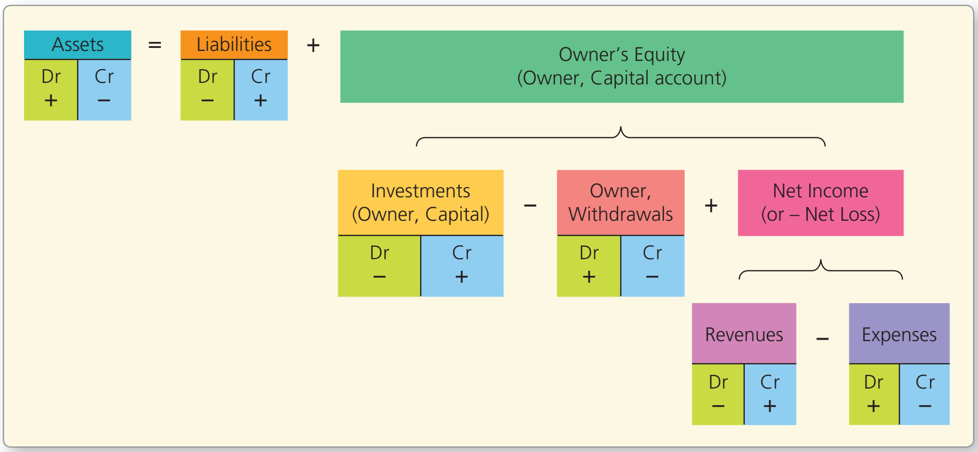
Dollar signs are omitted in the money columns because it is understood that the amounts are in dollars.

ANNOTATED EXHIBITS More annotated exhibits have been developed for this edition to improve clarity and reduce related explanations in the text.

INSTRUCTOR TIPS & TRICKS Found throughout the text, these handwritten notes mimic the experience of having an experienced teacher walk a student through concepts on the "board." Many include mnemonic devices or examples to help students remember the rules of accounting.

One way to memorize this is to use an acronym, such as AWE ROL. In this case, the (A)sset, (W)ithdrawal, and (E)xpense accounts all have debit balances, while the (R)evenue, (O)wner's Equity, and (L)iability accounts all have credit balances. Or memorize which side has the "+" (increase), and then all the "−" (decreases) are the opposite. This way you only have to memorize half of them! Try DR. AWE—the debits (dr) belong with the (A)sset, (W)ithdrawal, and (E)xpense accounts.

EXHIBIT 2–6 | Expanded Accounting Equation



TRY IT! BOXES Found after each learning objective, Try It! boxes give students opportunities to apply the concept they've just learned by completing an accounting problem. Links to these exercises appear throughout the eText, allowing students to practise in MyLab Accounting without interruption.

Try It!

8. Using the following accounts and their balances, prepare the unadjusted trial balance for Cooper Furniture Repair as of December 31, 2018. All accounts have normal balances.

Cash	$ 7,000	Advertising Expense	$ 1,200
Unearned Revenue	4,500	Utilities Expense	800
Equipment	10,000	Rent Expense	5,000
Service Revenue	8,000	Accounts Payable	2,300
M. Cooper, Capital	12,200	M. Cooper, Withdrawals	3,000

Solutions appear at the end of this chapter and on **MyLab Accounting**

IFRS/ASPE COMPARISON Provides guidance on how IFRS differs from ASPE.

EXHIBIT 1–16 | How IFRS Differ from What We See in the Chapter

ASPE	IFRS
In Canada, both International Financial Reporting Standards (IFRS) and Accounting Standards for Private Enterprises (ASPE) are prepared under the authority of the **Accounting Standards Board** and are published as part of the CPA *Canada Handbook*.	
Sole proprietorships follow ASPE, which are simpler and less costly to implement. Private corporations can choose to follow ASPE or IFRS.	Publicly accountable enterprises or those planning to become one must follow IFRS.
Financial reports contain less information under ASPE because readers have more access to the details themselves.	Financial reports under IFRS contain more detailed information than under ASPE because users do not have easy access to the information.
Companies reporting under either method must also provide notes to the financial statements, which include significant accounting policies and explanatory information.	

ETHICS Are receipts really important?

Elijah Morris, assistant manager for Red's Big Burger Restaurant, is responsible for purchasing equipment and supplies for the restaurant. Elijah recently purchased a $4,000 commercial-grade refrigerator for the restaurant, but he can't find the receipt. Elijah purchased the refrigerator with personal funds and is asking to be reimbursed by the restaurant. Hannah, the restaurant's accountant, has said that she is unsure if the business can reimburse Elijah without a receipt. Elijah suggests: "Hannah, it won't really matter if I have a receipt or not. You've seen the refrigerator in the restaurant, so you know I purchased it. What difference is a little receipt going to make?"

What should Hannah do? What would you do?

Solution

Hannah should not reimburse Elijah until she receives the receipt—the source document. Elijah could have purchased the refrigerator for less than the amount he is asking in reimbursement. Source documents provide the evidence of the amount of the transaction. If either an auditor or the owner of the restaurant investigated the $4,000 purchase, he or she would need to see the source document to verify the transaction. If Elijah truly cannot find the receipt, Hannah should ask for an alternative source document such as a credit card or bank statement that shows evidence of the purchase. In addition, Elijah should be warned about using personal funds to purchase equipment for the business.

ETHICS BOXES This feature provides common questions and potential solutions business owners face. Students are asked to determine the course of action they would take based on concepts covered in the chapter and are then given potential solutions.

NEW! **USING EXCEL** This end-of-chapter exercise in select chapters introduces students to Excel to solve common accounting problems as they would in the business environment. Students will work from a template that will aid them in solving the problem related to accounting concepts taught in the chapter.

NEW! **SERIAL EXERCISE** starts in Chapter 1 and run through Volume 1, exposing students to recording entries for a service company and then moving into recording transactions for a merchandiser later in the text.

NEW! **PRACTICE SET** The Practice Set for Chapters 2–9 provide another opportunity for students to practise the entire accounting cycle. The practice set uses the same company in each chapter, but is often not as extensive as the serial exercise.

Acknowledgments for *Horngren's Accounting*, Eleventh Canadian Edition

Acknowledgements for *Horngren's Accounting*, Eleventh Canadian Edition

Horngren's Accounting, Eleventh Canadian Edition, is the product of a rigorous research process that included multiple reviews in the various stages of development to ensure the revision meets the needs of Canadian students and instructors. The extensive feedback from the following reviewers helped shape this edition into a clearer, more readable and streamlined textbook in both the chapter content and assignment material:

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Our task is to provide educational material in the area of accounting to instructors and students to aid in the understanding of this subject area. We welcome your suggestions and comments on how to serve you better.

12 Partnerships

CONNECTING CHAPTER 12

LEARNING OBJECTIVES

1 Identify the characteristics of a partnership

What are the characteristics of a partnership?

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- Limited Life
- Mutual Agency
- Unlimited Liability
- Co-ownership of Property
- No Partnership Income Tax

Advantages and Disadvantages of Partnerships, page 663

Type of Partnerships, page 664
- General Partnerships
- Limited Partnerships

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2 Account for partners' initial investments in a partnership

How do we account for partners' investments in a partnership?

Forming a Partnership, page 666

3 Allocate profits and losses to the partners by different methods

How can we allocate profits and losses to the partners?

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- Sharing Based on Capital Investments
- Sharing Based on Capital Investments and on Service
- Sharing Based on Service and Interest
- Allocation of a Net Loss

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4 Account for the admission of a new partner

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- Admission by Purchasing a Partner's Interest
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Withdrawal of a Partner from the Business, page 678
- Withdrawal at Book Value
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6 Account for the liquidation of a partnership

How do we account for the ending of a partnership?

Liquidation of a Partnership, page 682
- Sale of Assets at a Gain
- Sale of Assets at a Loss
- Capital Deficiencies

The **Summary** for Chapter 12 appears on page 688.
Key Terms with definitions for this chapter's material appears on page 689.

CPA competencies

This text covers material outlined in **Section 1: Financial Reporting of the CPA Competency Map**. The Learning Objectives for each chapter have been aligned with the CPA Competency Map to ensure the best coverage possible.

1.3.1 Prepares financial statements

Mylitleye/Fotolia

Jenny Lo and Sam Lachlan are considering opening a miniature golf course in Wasaga Beach, Ontario. The golf course will have 18 holes with dinosaurs, windmills, water features, and more. Jenny has been carefully evaluating the tourism industry in the town and believes that the golf course will be busy enough during the summer tourist season to close during the winter months, allowing Jenny and Sam plenty of time to ski and snowboard in the off season.

Jenny and Sam are considering organizing the business as a partnership. Jenny is willing to contribute a piece of property in the prime downtown area that she just inherited. She is also interested in managing the day-to-day operations of the business. Sam, with his degree in accounting, has agreed to handle the accounting and business aspects of the golf course.

Now all Jenny and Sam need to decide is how the partnership will be organized. Some questions they are considering include, What are the specific responsibilities of each partner? How should profits and losses be shared between the partners? What if one of the partners wants out of the partnership in the future? How would the partnership add a new partner?

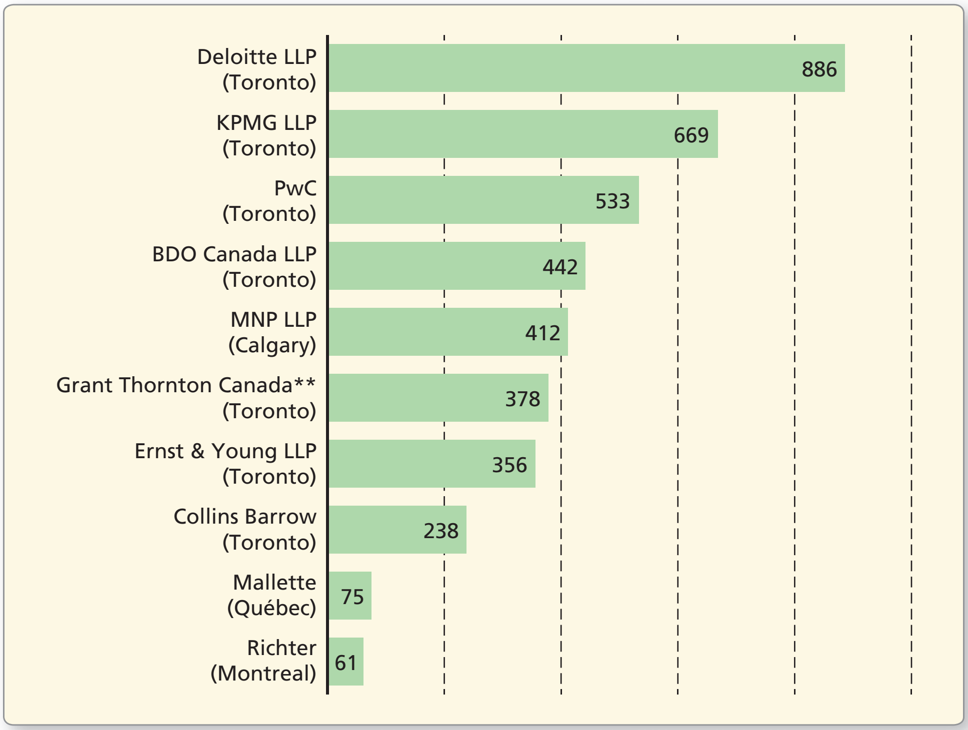
A **partnership** is an association of two or more persons who co-own a business for profit. This definition is common to the various provincial partnership acts, which tend to prescribe similar rules with respect to the organization and operation of partnerships in their jurisdictions.

Forming a partnership is easy. It requires no permission from government authorities and involves no legal procedures, with the exception that most provinces require partnerships to register information such as the names of the partners and the name under which the business will be conducted.[1] When two people decide to go into business together, a partnership is automatically formed.

A partnership combines the assets, talents, and experience of the partners. Business opportunities closed to an individual may open up to a partnership. As the chapter-opening story illustrates, this is an important characteristic of a partnership. The miniature golf course will likely be successful because it is able to combine the skills of its two owners. It is unlikely that Jenny or Sam would be able to operate the business as well if either tried to do it on his or her own.

Partnerships come in all sizes. Many partnerships have fewer than 10 partners. Some medical practices may have 10 or more partners, while some of the largest law firms in Canada have more than 500 partners. The largest accounting firm in Canada has more than 800 partners. Exhibit 12–1 lists the 10 largest public accounting firms in Canada. The majority of them are partnerships.

EXHIBIT 12–1 | The 10 Largest Accounting Firms in Canada (by Number of Partners in 2015)



Source: Data from Statista, Top 20 accounting firms in the United States in 2018, by U.S. revenue (in billion U.S. dollars), Retrieved from https://www.statista.com/statistics/478912/number-of-partners-at-leading-accounting-firms-canada/

[1] Smyth, J.E., D.A. Soberman, A.J. Easson, and S.S. McGill, *The Law and Business Administration in Canada*, 13th ed. (Toronto: Pearson Canada Inc., 2013), 598–602.

Why It's Done This Way

Beginning with this chapter, you will learn more about the different types of organization structures that were first introduced in Chapter 1. So far, we have only really looked at accounting for proprietorships.

The good news is that the principles and concepts in the accounting framework you have learned apply equally to all types of organizations.

Characteristics of a Partnership

LO 1

What are the characteristics of a partnership?

Starting a partnership is voluntary. A person cannot be forced to join a partnership, and partners cannot be forced to accept another person as a partner (unless existing partners vote and the majority accept the new partner). The following characteristics distinguish partnerships from proprietorships and from corporations.

The Written Partnership Agreement

A business partnership is somewhat like a marriage. To be successful, the partners must cooperate. However, business partners do not vow to remain together for life. To make certain that each partner fully understands how the partnership operates, partners should draw up a **partnership agreement**. Although the partnership agreement may be oral, a written agreement between the partners reduces the chance of a misunderstanding. This agreement is a contract between the partners, so transactions under the agreement are governed by contract law. The provincial legislatures in Canada have passed their respective versions of a partnership act, the terms of which apply in the absence of a partnership agreement or in the absence of particular matters in the partnership agreement.[2]

A partnership is not required to have a formal written agreement. But a written agreement prevents confusion as to the sharing of profits and losses, partners' responsibilities, admission of new partners, how the partnership will be liquidated, and so on. However, there can still be disagreements even when there is a written agreement.

The partnership agreement should specify the following points:

- Name, location, and nature of the business
- Name, capital investment, and duties of each partner
- Procedures for admitting a new partner
- Method of sharing profits and losses among the partners
- Withdrawals of assets allowed to the partners
- Procedures for settling disputes among the partners
- Procedures for settling with a partner who withdraws from the firm
- Procedures for removing a partner who will not withdraw or retire from the partnership voluntarily
- Procedures for liquidating the partnership—selling the assets, paying the liabilities, and giving any remaining cash to the partners

Limited Life

A partnership has a limited life. If one partner withdraws from the business or dies, the partnership dissolves and its books are closed. If the remaining partners want to continue as partners in the same business, they form a new partnership with a new set of financial records and a new partnership agreement. **Dissolution** is the ending of a partnership and does not require liquidation; that is, the assets need

[2] Ibid., 598–618.

not be sold to outside parties for a new partnership to be created. Often the new partnership continues the former partnership's business, and the new partnership may choose to continue to use the dissolved partnership's name. Some types of large partnerships, such as Deloitte LLP, retain the firm name even after partners resign from the firm.

Mutual Agency

Mutual agency means that every partner is a mutual agent of the firm. Any partner can bind the business to a contract within the scope of the partnership's regular business operations. If a partner enters into a contract with a person or another business to provide a service, then the firm—not just the partner who signed the contract—is bound to provide that service. If the partner signs a contract to buy her own car, however, the partnership is not liable because the car is a personal matter; it is not within the scope of the regular business operations of the partnership.

The following example shows the impact mutual agency can have on a partnership. Richard Harding and Simon Davis formed a partnership to deal in lumber and other building materials. The partners agreed that their company should not handle brick or any stone materials and that neither partner had the right to purchase these commodities. While Harding was away during the summer, Davis purchased a quantity of these materials for the company because he could buy them at a cheap price. Two months later, when Harding returned, business was very slow, and brick and stone were selling at a price lower than Davis had paid for them. Harding, therefore, refused to accept any more deliveries under the contract. Harding argued that Davis had no authority to buy these goods since the partnership was not organized to deal in brick and stone. The supplier of the brick and stone said that he did not know the partnership was not in the brick and stone business. In fact, he believed that it did handle these goods since all of the other lumber companies in the area bought or sold brick and stone. Because the supplier acted in good faith, he claimed that Harding and Davis should accept the remaining deliveries of brick and stone according to the agreement that was made. Who is correct? Under normal circumstances, the brick and stone supplier is correct because the mutual agency characteristic of a partnership allows partners to bind each other in business contracts. The agreements made within the partnership would not be known by an outside party like the supplier, so the supplier would have a solid case and could sue the partnership to abide by the contract.[3]

Unlimited Liability

Chapter 1 introduced these concepts for a sole proprietorship. You may want to go back and review them now.

Each partner has **unlimited personal liability** for the debts of the business. When a partnership cannot pay its debts with business assets, the partners must pay with their personal assets. (There are exceptions, which are described in the section, Types of Partnerships.) If either partner is unable to pay his or her part of the debt, the other partner (or partners) must make payment.

Unlimited liability and mutual agency are closely related. A dishonest partner or a partner with poor judgment may commit the partnership to a contract under which the business loses money. In turn, creditors may force *all* the partners to pay the debt from their personal assets. Hence, a business partner should be chosen with great care.

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[3] This case is based on the scenario described at ChestofBooks.com, "B. Apparent Scope of Authority," http://chestofbooks.com/business/law/Case-Method/B-Apparent-Scope-Of-Authority.html#ixzz1qimHxY2o, accessed July 1, 2018.

Co-ownership of Property

Any asset—cash, inventory, machinery, computers, and so on—that a partner invests into the partnership becomes the joint property of all the partners. The partner who invested the asset is no longer its sole owner.

There is a way for a partner to allow the partnership to use a personal asset, such as a car or money, without losing his or her claim to that asset: The partner could lease the car to the partnership. If the partnership ended, the car would have to be returned to its owner. The partner could also lend money to the partnership instead of investing it. The partnership would have to repay the loan to the lending partner before any distribution of capital to the partners.

No Partnership Income Tax

The partnership *reports* its income to the government tax authority (the Canada Revenue Agency), but the partnership pays *no* income tax. The net income of the partnership is divided and flows through the business to the partners, who pay personal income tax on their share.

For example, suppose that the Willis & Jones partnership earned net income of $150,000, shared equally by the two partners. The partnership would pay no income tax *as a business entity*. However, each partner would pay income tax *as an individual* on his or her $75,000 share of partnership income.

ETHICS Should Erik buy the new equipment?

Erik Morales was very angry with his brother. He had just come from a partnership meeting concerning the purchase of new equipment for their recording studio. His brother, Juan, disagreed about purchasing the new equipment, stating that the business didn't have enough cash to purchase the equipment without incurring additional debt. After thinking about their conversation, Erik decided that he would secure a loan to purchase the equipment. Erik knew that if his brother could just see how well the new equipment worked, Juan would change his mind. Should Erik buy the new equipment? What would you do?

Solution

Mutual agency allows Erik to act as an agent of the partnership and secure debt for the purchase of new equipment. However, the fact that his partner, Juan, does not agree with incurring additional debt should discourage Erik from taking out the loan. Erik should consider that the partnership's debt becomes a personal liability not only to Erik, but also to Juan. If the partnership can't repay the debt, then Erik and Juan must use personal assets to meet the debt. Erik could not only endanger the liquidity of the partnership by taking out a loan, but also risk his relationship with his brother. Erik should not go behind his brother's back to purchase the equipment, even though he thinks it will be a good decision in the long run.

Advantages and Disadvantages of Partnerships

Exhibit 12–2 lists the advantages and disadvantages of partnerships (compared with proprietorships and corporations). Most features of a proprietorship also apply to a partnership, most importantly:

- Limited life
- Unlimited liability
- No business income tax

EXHIBIT 12–2 | Advantages and Disadvantages of Partnerships

Partnership Advantages	Partnership Disadvantages
Versus Proprietorships: • A partnership can raise more capital since capital comes from more than one person. • A partnership brings together the abilities of more than one person. • Partners working well together can achieve more than by working alone: $1 + 1 > 2$ in a good partnership. *Versus Corporations:* • A partnership is less expensive to organize than a corporation, which requires articles of incorporation from a province or the federal government. • A partnership is subject to fewer governmental regulations and restrictions than a corporation.	• A partnership agreement may be difficult to formulate. Each time a new partner is admitted or a partner leaves the partnership, the business needs a new partnership agreement. • Relationships among partners may be fragile. It is hard to find the right partner. • Mutual agency and unlimited liability create personal obligations for each partner. • Lack of continuity of the business is faced by a partnership but not a corporation.

Types of Partnerships

There are two basic types of partnerships: general and limited.

General Partnerships

A **general partnership** is the basic form of partnership organization. Each partner is a co-owner of the business with all the privileges and risks of ownership. The general partners share the profits, losses, and the risks of the business.

Limited Partnerships

Since all partners are personally liable for any debt of the business, it is extremely important to choose a partner carefully. This is one reason some investors/partners prefer the *limited partnership* form of business organization.

Partners can avoid unlimited personal liability for partnership obligations by forming a *limited partnership*. A **limited partnership** has at least two classes of partners:

- There must be at least one *general partner,* who takes primary responsibility for the management of the business. The general partner also takes most of the risk of failure if the partnership goes bankrupt (liabilities exceed assets). In some limited partnerships, such as real estate limited partnerships, the general partner often invests little cash in the business. Instead, the general partner's contribution is her or his skill in managing the organization. Usually, the general partner is the last owner to receive a share of partnership profits and losses. But the general partner may earn all excess profits after the limited partners get their share of the income.
- The *limited partners* are so named because their personal obligation for the partnership's liabilities is limited to the amount they have invested in the business. Limited partners have limited liability similar to the limited liability that shareholders in a corporation have. Usually, the limited partners have invested the bulk of the partnership's assets and capital. They therefore usually have the first claim to partnership profits and losses, but only up to a specified limit. In exchange for their limited liability, their potential for profits usually has a limit as well.

Limited Liability Partnerships Many professionals, such as doctors, lawyers, and most public accounting firms in Canada—including most of those in Exhibit 12–1—are now organized as **limited liability partnerships (LLPs)**. An LLP can only be used by eligible professions (such as accounting) and is designed to protect innocent partners from negligence damages that result from another partner's actions. This means that each partner's personal liability for other partners' negligence is limited to a certain dollar amount, although liability for a partner's own negligence is still unlimited. The LLP must carry an adequate amount of malpractice insurance or liability insurance to protect the public.

Partnership Financial Statements

Partnership financial statements are much like those of a proprietorship. Exhibit 12–3 compares partnership statements (in Panel A) against the same reports for a sole proprietorship (in Panel B).

The key differences between a proprietorship's and a partnership's financial statements are as follows:

- A partnership income statement includes a section showing the division of net income to the partners.
- A partnership balance sheet reports a separate Capital account for each partner in the section now called Partners' Equity. Large partnerships may show one balance, the total for all partners, and provide the details in a separate report, also shown in Exhibit 12–3, called a statement of partners' equity.

EXHIBIT 12–3 | Financial Statements of a Partnership and a Proprietorship (all amounts in thousands of dollars)

Panel A—PARTNERSHIP

KIM & GALARZA Income Statement For the Year Ended December 31, 2020		
Revenues		$460
Expenses		270
Net income		$190
Allocation of net income:		
To Su-min Kim	**$114**	
To Luis Galarza	**76**	$190

KIM & GALARZA Statement of Partners' Equity For the Year Ended December 31, 2020			
	Kim	**Galarza**	**Total**
Capital, January 1, 2020	$ 50	$ 40	$ 90
Additional investments	10	—	10
Net income	114	76	190
Subtotal	174	116	290
Less: Withdrawals	72	48	120
Capital, December 31, 2020	$102	$ 68	$170

KIM & GALARZA Balance Sheet December 31, 2020		
Assets		
Cash and other assets	$170	
Total assets		$170
Partners' Equity		
Su-min Kim, capital	**$102**	
Luis Galarza, capital	**68**	
Total partners' equity		$170
Total liabilities and equity		$170

Panel B—PROPRIETORSHIP

GALARZA CONSULTING Income Statement For the Year Ended December 31, 2020	
Revenues	$460
Expenses	270
Net income	$190

GALARZA CONSULTING Statement of Owner's Equity For the Year Ended December 31, 2020	
Capital, January 1, 2020	$ 90
Additional investments	10
Net income	190
Subtotal	290
Less: Withdrawals	120
Capital, December 31, 2020	$170

GALARZA CONSULTING Balance Sheet December 31, 2020		
Assets		
Cash and other assets	$170	
Total assets		$170
Owner's Equity		
Luis Galarza, capital	$170	
Total liabilities and equity		$170

Try It!

1. Return to the story at the start of the chapter about Jenny and Sam's new miniature golf business. Detail the contents of a partnership agreement and explain the importance of a written agreement to Jenny and Sam.
2. Suppose you were giving the friends in the previous question advice on their decision to form a partnership. Detail the advantages and disadvantages of their decision.

Solutions appear at the end of this chapter and on **MyLab Accounting**

Forming a Partnership

LO 2

How do we account for partners' investments in a partnership?

Let's examine the startup of a partnership. Partners in a new partnership may invest assets and their related liabilities in the business. These contributions are journalized in the same way as for proprietorships, by debiting the assets and crediting the liabilities at their agreed-upon values. Each person's net contribution—assets minus liabilities—is credited to the equity account for that person. Often the partners hire an independent firm to *appraise* their assets and liabilities at current market value at the time a partnership is formed. This outside evaluation assures an objective valuation for what each partner brings into the business.

Suppose Katie Wilson and Dan Chao form a partnership on June 1, 2020, to develop and sell computer software. The partners agree on the following values based on an independent appraisal:

Wilson's contributions

- Cash, $10,000; inventory, $40,000; and accounts payable, $80,000
- Computer equipment: cost, $800,000; accumulated amortization, $200,000; current market value, $450,000

Chao's contributions

- Cash, $5,000
- Computer software: cost, $50,000; current market value, $100,000

The partnership entries are as follows:

The partnership records receipts of the partners' initial investments at the current market values of the assets and liabilities because, in effect, the partnership is buying the assets and assuming the liabilities at their current market values.

	Wilson's investment		
Jun. 1	Cash	10,000	
	Inventory	40,000*	
	Computer Equipment	450,000*	
	Accounts Payable		80,000*
	Katie Wilson, Capital		420,000
	To record Wilson's investment in the partnership ($500,000 − $80,000).		
	Chao's investment		
Jun. 1	Cash	5,000	
	Computer Software	100,000*	
	Dan Chao, Capital		105,000
	To record Chao's investment in the partnership.		

*Current market values are used.

The initial partnership balance sheet appears in Exhibit 12–4.

EXHIBIT 12–4 | Partnership Balance Sheet

WILSON AND CHAO Balance Sheet June 1, 2020			
Assets		**Liabilities**	
Cash	$ 15,000	Accounts payable	$ 80,000
Inventory	40,000	**Partners' Equity**	
Computer equipment	450,000	Katie Wilson, capital	420,000
Computer software	100,000	Dan Chao, capital	105,000
		Total partners' equity	525,000
Total assets	$605,000	Total liabilities and equity	$605,000

Try It!

3. Marty Kaur invests land in a partnership with Lee Manors. Kaur purchased the land in 2014 for $20,000. Three independent real estate appraisers now value the land at $50,000. Kaur wants $50,000 capital in the new partnership, but Manors objects. Manors believes that Kaur's capital investment should be measured by the book value of his land. Manors and Kaur seek your advice.

a. Which value of the land is appropriate for measuring Kaur's capital: book value or current market value?

b. Give the partnership's journal entry to record Kaur's investment in the business on September 1, 2020.

Solutions appear at the end of this chapter and on **MyLab Accounting**

LO 3

How can we allocate profits and losses to the partners?

Sharing Partnership Profits and Losses

Allocating profits and losses among partners can be challenging and can be a major source of disputes. Any division of profits and losses is allowed as long as the partners agree and it is in the partnership agreement. Typical arrangements include the following:

- Sharing profits and losses based on a stated fraction for each partner, such as 50/50, or 2/3 and 1/3, or 4:3:3 (which means 40 percent to Partner A, 30 percent to Partner B, and 30 percent to Partner C)
- Sharing based on each partner's capital investment
- Sharing based on each partner's service
- Sharing based on a combination of stated fractions, investments, service, and other items

If the partners have not drawn up an agreement, or if the agreement does not state how the partners will divide profits and losses, then, by law, the partners must share profits and losses equally. If the agreement specifies a method for sharing profits but not losses, then losses are shared in the same proportion as profits. For example, a partner receiving 75 percent of the profits would likewise absorb 75 percent of any losses.

In some cases an equal division is not fair. One partner may perform more work for the business than the other partner, or one partner may make a larger capital contribution. In the preceding example, Dan Chao might agree to work longer hours for the partnership than Katie Wilson in order to earn a greater share of profits. Wilson could argue that she should receive more of the profits because she contributed more net assets ($420,000) than Chao did ($105,000). Chao might contend that his computer software program is the partnership's most important asset, and that his share of the profits should be greater than Wilson's share. Arriving at fair sharing of profits and losses in a partnership may be difficult.

We now demonstrate how to account for some options available in determining partners' shares of profits and losses using several different partnerships.

Sharing Based on a Stated Fraction

The partnership agreement may state each partner's fraction of the total profits and losses. Suppose the partnership agreement of Shannon Kerry and Raoul Calder allocates two-thirds of the business profits and losses to Kerry and one-third to Calder. This sharing rule can also be expressed as 2:1.

Net Income If net income for the year is \$60,000, and all revenue and expense accounts have been closed, the Income Summary account has a credit balance of \$60,000 prior to its closing.

The ratio of 2:1 is equal to fractions of 2/3 and 1/3, where the denominator of the fraction is the sum of the numbers in the ratio. The ratio of 2:1 is also a 66.7%: 33.3% percent sharing ratio.

Income Summary

	Bal. 60,000

The entry to close this account and allocate the net income to the partners' Capital accounts is as follows:

Dec. 31	Income Summary	60,000	
	Shannon Kerry, Capital		40,000
	Raoul Calder, Capital		20,000
	To allocate net income to partners. (Kerry: \$60,000 × $\frac{2}{3}$; Calder: \$60,000 × $\frac{1}{3}$)		

The income summary account was introduced in Chapter 4. It holds profits/losses until distributed to owners.

Suppose Kerry's beginning Capital balance was \$50,000 and Calder's was \$10,000. After posting, the accounts appear as follows:

Income Summary

Clo. 60,000	Bal. 60,000

Shannon Kerry, Capital

	Bal. 50,000
	Clo. 40,000
	Bal. 90,000

Raoul Calder, Capital

	Bal. 10,000
	Clo. 20,000
	Bal. 30,000

Net Loss If the partnership had a net loss of \$15,000, the Income Summary account would have a debit balance of \$15,000. In that case, the closing entry to allocate the loss to the partners' Capital accounts would be:

Dec. 31	Shannon Kerry, Capital	10,000	
	Raoul Calder, Capital	5,000	
	Income Summary		15,000
	To allocate net loss to partners.		
	(Kerry: \$15,000 × $\frac{2}{3}$; Calder: \$15,000 × $\frac{1}{3}$)		

A profit or loss will increase or decrease each partner's Capital account, but cash will not change hands. The ***Withdrawals*** account records the cash each partner takes from the partnership.

Sharing Based on Capital Investments

Profits and losses are often allocated in proportion to the partners' capital investments in the business. Suppose John Abbot, Erica Baxter, and Tony Craven are