

SCHAUM'S OUTLINE SERIES

THEORY AND PROBLEMS OF

ACCOUNTING II

2/ed

JAMES A. CASHIN

JOEL J. LERNER

INCLUDING 490 SOLVED PROBLEMS

SCHAUM'S OUTLINE SERIES IN ACCOUNTING

McGRAW-HILL BOOK COMPANY

SCHAUM'S OUTLINE OF
THEORY AND PROBLEMS
of
ACCOUNTING II
Second Edition

by

JAMES A. CASHIN, M.B.A., CPA

*Emeritus Professor of Accounting
Hofstra University*

and

JOEL J. LERNER, M.S., P.D.

*Chairman, Faculty of Business
Sullivan County Community College*

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JAMES A. CASHIN is Emeritus Professor of Accounting at Hofstra University, where he was formerly Chairman of the Accounting Department. His publishing credits include some fifteen titles: he is a coauthor of several accounting textbooks, of the Schaum's Outlines of *Accounting I*, *Cost Accounting*, *Intermediate Accounting I*, and *Tax Accounting*, and he is Editor-in-Chief of the *Handbook for Auditors*. Professor Cashin is a Certified Public Accountant and a Certified Internal Auditor. He holds a B.S. degree in Accounting from the University of Georgia and an M.B.A. from New York University. He has wide experience in business with large industrial companies and has taught in the Graduate School of City University of New York and New York University.

JOEL LERNER is Professor and Chairman of the Business Division at Sullivan County Community College, Loch Sheldrake, New York. He received his B.S. from New York University and his M.S. and P.D. from Columbia University. Professor Lerner has published a booklet for *The New York Times* on teaching college business courses and has acted as editor for both *Readings in Business Organization and Management* and *Introduction to Business: A Contemporary Reader*. He has coauthored the Schaum's Outlines of *Accounting I* and *Introduction to Business* and authored *Bookkeeping and Accounting*.

Schaum's Outline of Theory and Problems of
ACCOUNTING II

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Preface

The second edition of Accounting II covers the second part of the introductory accounting course. As in *Accounting I* the *solved-problems* approach is used and emphasis is on *practical application* of basic accounting concepts. The student is provided with:

1. concise definitions and explanations, in easily understood terms
2. fully worked-out solutions to a large range of problems (against which the student can check his own solutions)
3. review questions
4. sample examinations typical of those used by two-year and four-year colleges

The two books help him to develop the all-important know-how for solving problems — on the CPA examination and in his everyday work.

The subject matter has been carefully coordinated with the leading textbooks so that any topic can easily be found from the Table of Contents or the Index.

Accounting II differs from Accounting I in that specialized areas (Manufacturing Costs, Budgets, Standard Costs, Financial Ratios, etc.) are discussed rather than general practices of a business. This book will greatly assist those students who may have been able to complete Accounting I but are having difficulty with the specialized topics. Careful study of the solved problems will help such students, including those in special programs, to keep abreast of classwork, thereby reducing the number of drop-outs from Accounting II.

The wide range of areas covered will also benefit Liberal Arts majors and those Business Administration students not majoring in Accounting. In addition, this volume can serve as an accompanying text for various Management Accounting texts which need a tie-in to basic accounting.

The authors wish to thank the members of a faculty and student panel who offered suggestions and helped in designing the problems. They are: Cheri Adler, Joseph Bass, Barbara Catanese, Kenneth Cotty, Harold Eccleston, Louis Harmin, Pat Herrmann, Sandy Kornheiser, Philip Malafsky, Elaine Morton, Vincent Newman, Robert Rolston, and Martin Siminerio.

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JAMES A. CASHIN
JOEL J. LERNER

Hofstra University
Sullivan County Community College

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Chapter 1

Partnerships

1.1 CHARACTERISTICS OF THE PARTNERSHIP

According to the Uniform Partnership Act, a *partnership* is “an association of two or more persons to carry on as co-owners a business for profit.” Generally speaking, partnership accounting is like that for the sole proprietorship, except in regard to owners’ equity. The partnership uses a capital account and a drawing account for each partner.

The partnership has the following characteristics:

Articles of partnership. Good business practice calls for a written agreement among the partners which contains provisions on the formation of the partnership, capital contribution of each partner, profit and loss distribution, admission and withdrawal of partners, withdrawal of funds, and dissolution of the business.

Unlimited liability. All partners have unlimited liability and are individually responsible to creditors for debts incurred by the partnership. The debts of the business can be satisfied not only by the assets of the partnership but also by the personal assets of the partners.

Co-ownership of property. All property invested in the business by the partners, as well as that purchased with the partnership’s funds, becomes the property of *all* partners jointly. Therefore, each partner has an interest in the partnership in proportion to his capital balance, rather than a claim against specific assets.

Participation in profits and losses. Profits and losses are distributed among the partners according to the partnership agreement. If no agreement exists, profits and losses must be shared equally.

Limited life. A partnership may be dissolved by bankruptcy, death of a partner, mutual agreement, or court order.

1.2 FORMATION OF THE PARTNERSHIP

When a partnership is formed, each partner’s capital account is credited for his initial investment and the appropriate asset account is debited. If noncash assets are invested, these should be recorded at an *agreed* amount.

If liabilities are to be assumed by the partnership, they are credited to the respective liability accounts.

EXAMPLE 1.

William Morrison has agreed to go into partnership with Robert Caine.

Morrison's Accounts	Morrison's Ledger Balances	Agreed Valuations
Cash	\$10,000	\$10,000
Accounts Receivable	5,400	5,400
Merchandise Inventory	21,000	19,000
Equipment	16,000	14,000
Accumulated Depreciation, Equipment	4,000	
Allowance for Doubtful Accounts	400	400
Notes Payable	8,000	8,000

The entry to record the initial investment of Morrison in the firm of Morrison and Caine would be:

<i>Cash</i>	<i>10,000</i>	
<i>Accounts Receivable</i>	<i>5,400</i>	
<i>Merchandise Inventory</i>	<i>19,000</i>	
<i>Equipment</i>	<i>14,000</i>	
<i>Allowance for Doubtful Accounts</i>		<i>400</i>
<i>Notes Payable</i>		<i>8,000</i>
<i>Morrison, Capital</i>		<i>40,000</i>

1.3 DIVISION OF NET INCOME AND LOSS

Partnership profits and losses may be divided in any manner that the partners agree upon. In general, a partner may be expected to share in proportion to the amount of capital and/or services he contributes. In the absence of a clear agreement the law provides that all partners share equally, regardless of the differences in time devoted or capital contributed.

Below are outlined the principal methods for profit and loss distribution. For simplicity the examples are limited to two partners.

FIXED OR CAPITAL BASIS

Profits and losses are generally divided equally, in a fixed ratio, or in a ratio based upon the amounts of capital contributed by the partners.

EXAMPLE 2.

Perez and Roth have capital balances of \$30,000 and \$20,000 respectively. The net income for the first year of operations was \$15,000. If the partners have decided to share on an equal basis, the journal entry for the allocation of the net income will be:

<i>Expense and Income Summary</i>	<i>15,000</i>	
<i>Perez, Capital</i>		<i>7,500</i>
<i>Roth, Capital</i>		<i>7,500</i>

If, however, capital investment is to be the determining factor, the entry will run as follows:

<i>Expense and Income Summary</i>	<i>15,000</i>	
<i>Perez, Capital</i>		<i>9,000*</i>
<i>Roth, Capital</i>		<i>6,000**</i>

$$* \frac{30,000}{30,000 + 20,000} (15,000)$$

$$** \frac{20,000}{30,000 + 20,000} (15,000)$$

INTEREST BASIS

Under this method, each partner is paid interest on his capital investment, and the remaining net income is divided in a fixed ratio or on some other basis. Thus, a partner's share depends *partially* on his capital investment.

EXAMPLE 3.

Instead of the equal split as in Example 2, each partner is to receive 6% interest on his capital balance, the remaining net income to be shared equally. The entry would be:

<i>Expense and Income Summary</i>	15,000	
<i>Perez, Capital</i>		7,800
<i>Roth, Capital</i>		7,200

the computation being:

	Perez	Roth	Total
Interest on investment	\$1,800	\$1,200	\$ 3,000
Balance	<u>6,000</u>	<u>6,000</u>	<u>12,000</u>
Totals	<u>\$7,800</u>	<u>\$7,200</u>	<u>\$15,000</u>

SALARY BASIS

The partners may agree to give recognition to contributions in the form of services, while the remaining net income may be divided equally or in a fixed ratio.

EXAMPLE 4.

Assume that the partnership of Perez and Roth (Example 2) agree that a yearly salary allowance of \$4,000 be given to Perez and \$3,000 to Roth, the balance to be divided equally. The entry would be:

<i>Expense and Income Summary</i>	15,000	
<i>Perez, Capital</i>		8,000
<i>Roth, Capital</i>		7,000

the computation being:

	Perez	Roth	Total
Salary	\$4,000	\$3,000	\$ 7,000
Balance	<u>4,000</u>	<u>4,000</u>	<u>8,000</u>
Totals	<u>\$8,000</u>	<u>\$7,000</u>	<u>\$15,000</u>

SALARY-PLUS-INTEREST BASIS

Here, services rendered to the business and capital contribution jointly determine the income division. Each partner gets a salary, and, at the same time, interest on capital. If any balance remains, it is divided in an agreed ratio.

EXAMPLE 5.

Perez and Roth (Example 2) decide to allow a credit of 6% interest on capital balances, respective salaries of \$4,000 and \$3,000, and equal division of any remainder. The entry would be:

<i>Expense and Income Summary</i>	15,000	
<i>Perez, Capital</i>		8,300
<i>Roth, Capital</i>		6,700

which is computed as follows:

	Perez	Roth	Total
Interest	\$1,800	\$1,200	\$ 3,000
Salary	<u>4,000</u>	<u>3,000</u>	<u>7,000</u>
	\$5,800	\$4,200	\$10,000
Balance	<u>2,500</u>	<u>2,500</u>	<u>5,000</u>
Totals	<u>\$8,300</u>	<u>\$6,700</u>	<u>\$15,000</u>

In Example 5, as well as in Examples 3 and 4, the income of the business exceeded the total of the allowances to the partners. However, this may not always be the case. If the net income is less than the total of the allowances, the balance remaining is negative and is divided among the partners equally as though it were a loss.

EXAMPLE 6.

Perez and Roth (Example 2) decide to allow a credit of 6% interest on capital balances, respective salaries of \$8,000 and \$6,000, and equal division of the remainder. The entry would be:

<i>Expense and Income Summary</i>	<i>15,000</i>
<i>Perez, Capital</i>	<i>8,800</i>
<i>Roth, Capital</i>	<i>6,200</i>

which is computed as follows:

	Perez	Roth	Total
Interest	\$1,800	\$1,200	\$ 3,000
Salary	<u>8,000</u>	<u>6,000</u>	<u>14,000</u>
	\$9,800	\$7,200	\$17,000
Balance	<u>- 1,000</u>	<u>- 1,000</u>	<u>- 2,000</u>
Totals	<u>\$8,800</u>	<u>\$6,200</u>	<u>\$15,000</u>

1.4 ADMISSION OF A NEW PARTNER

The Uniform Partnership Act states that a partner may dispose of part or all of his interest in the firm without the consent of the remaining partners.

The individual who purchases the interest receives the selling partner's rights to share in income and expense. However, he is not a full partner, since he will have no vote or right to participate in partnership activities unless he is admitted to the firm.

ADMISSION BY PURCHASE OF INTEREST

When the incoming partner purchases an interest from another partner, he pays the purchase price directly to the old partner. The only change required in the partnership's books is an entry transferring capital from the old partner's account to the account established for the new partner. Assets and liabilities of the business are not affected.

EXAMPLE 7.

Perez and Roth have capital balances of \$30,000 and \$20,000 respectively. William Stone is admitted to the partnership by purchasing half of Perez's interest for \$18,000. The only entry required is the changing of the capital balances of the affected partners.

<i>Perez, Capital</i>	<i>Roth, Capital</i>	<i>Stone, Capital</i>
15,000 Bal. 30,000	Bal. 20,000	15,000

Stone's admission results in the transfer of half of Perez's capital to Stone, regardless of the amount paid by Stone for his share of the partnership.

ADMISSION BY CONTRIBUTION OF ASSETS

The new partner may contribute assets to the partnership, thus increasing both the assets and the capital of the firm.

EXAMPLE 8.

Assume that Stone is to be admitted to the partnership of Perez and Roth, whose total capital is \$50,000 (\$30,000 and \$20,000 respectively). Stone is to contribute \$25,000 for a $\frac{1}{3}$ interest in the new partnership. The entry to record his admission is:

<i>Cash</i>	<i>25,000</i>	
	<i>Stone, Capital</i>	<i>25,000</i>

In Examples 7 and 8, it was assumed that the assets of Perez and Roth were stated in terms of the current market prices when Stone was admitted. Because of this, no adjustments were necessary in any of the assets prior to his admission. In some cases, when a new partner is admitted, assets may first have to be revalued or goodwill recognized in order to bring the capital accounts into line with current values.

- (1) **Revaluation of assets.** The book values of certain assets of the partnership must be adjusted before they agree with current prices. The net amount of the revaluation is then transferred to the capital accounts of the old partners according to their income division agreement. If it appears that a number of assets need revaluation, whether to higher or lower figures, the adjustments may be made in a temporary account, Asset Revaluation, which will subsequently be closed to the partners' capital accounts.

EXAMPLE 9.

Perez and Roth share profits and losses equally. It was discovered that the merchandise inventory account is understated: the inventory, carried on the books at \$21,000, has a current replacement cost of \$25,000. The following entry would be recorded prior to the admission of Stone into the partnership:

<i>Merchandise Inventory</i>	<i>4,000</i>	
	<i>Perez, Capital</i>	<i>2,000</i>
	<i>Roth, Capital</i>	<i>2,000</i>

EXAMPLE 10.

Before admitting Stone to the partnership, Perez and Roth decide that merchandise inventory, carried at \$19,000, is to be revalued at \$21,000.

The entry to record the above revaluations is:

<i>Merchandise Inventory</i>	<i>2,000</i>	
	<i>Asset Revaluation</i>	<i>2,000</i>

After the adjustment has been made, Asset Revaluation is closed as follows:

<i>Asset Revaluation</i>	<i>2,000</i>	
	<i>Perez, Capital</i>	<i>1,000</i>
	<i>Roth, Capital</i>	<i>1,000</i>

- (2) **Recognition of goodwill.** If a firm has the ability to earn more than the normal rate on its investment (because of a favorable location, established reputation, management skills, or better products or services), goodwill may be indicated, and an incoming partner may be charged for it. If so, the goodwill account is debited,

while the old partners' accounts are credited in the ratios set up by the articles of partnership. On the other hand, if goodwill is created by the incoming partner, the goodwill account is debited and the new partner's capital account credited.

EXAMPLE 11. Goodwill to the Old Partners.

The capital balances of Perez and Roth are \$30,000 and \$20,000 respectively. The partnership agrees to admit Stone to their firm, who is to contribute cash of \$20,000 and is to receive a 1/4 interest in the firm. Though the total capital of the firm before the admission is \$50,000, the parties agree that the firm is worth \$60,000. This excess of \$10,000 indicates the existence of goodwill; it will be allocated to the old partners equally. The entries to record goodwill and the admission of the new partner are:

<i>Goodwill</i>	<i>10,000</i>	
<i>Perez, Capital</i>		<i>5,000</i>
<i>Roth, Capital</i>		<i>5,000</i>
<i>Cash</i>	<i>20,000</i>	
<i>Stone, Capital</i>		<i>20,000</i>

EXAMPLE 12. Goodwill to the New Partner.

Perez and Roth, with capital balances of \$30,000 and \$20,000 respectively, agree to admit Stone into the firm for a \$15,000 investment, giving him a 1/3 share in profits and losses and granting him goodwill recognition of \$10,000. The entry to record the above information would be:

<i>Cash</i>	<i>15,000</i>	
<i>Goodwill</i>	<i>10,000</i>	
<i>Stone, Capital</i>		<i>25,000</i>

1.5 LIQUIDATION OF A PARTNERSHIP

If the partners of a firm decide to discontinue the operations of the business, several accounting steps are necessary:

1. The accounts are adjusted and closed.
2. All assets are converted to cash.
3. All creditors are paid in full.
4. Any remaining cash is distributed among the partners according to the balances in their capital accounts (and not according to their P&L ratios).

EXAMPLE 13. Liquidation at a Gain.

After Perez, Roth, and Stone have ceased business operations and adjusted and closed the accounts, the general ledger has the following post-closing trial balance:

<i>Cash</i>	<i>\$20,000</i>	
<i>Noncash Assets</i>	<i>65,000</i>	
<i>Liabilities</i>		<i>\$10,000</i>
<i>Perez, Capital</i>		<i>15,000</i>
<i>Roth, Capital</i>		<i>25,000</i>
<i>Stone, Capital</i>		<i>35,000</i>
	<u><i>\$85,000</i></u>	<u><i>\$85,000</i></u>

Assume for simplicity that all liabilities are paid at one time and that the noncash assets are sold in one transaction. Then, if the sale price is \$80,000 and the partners share equally in profits and losses, we have the following liquidation schedule:

	ASSETS =		LIABILITIES + CAPITAL			
	Cash	+ Other	Accounts Payable	Perez	+ Roth	+ Stone
Balances of capital accounts	\$ 20,000	\$65,000	\$10,000	\$15,000	\$25,000	\$35,000
(a) Sales of assets	+ 80,000	<u>- 65,000</u>		+ 5,000	+ 5,000	+ 5,000
Balance after sale	100,000		10,000	20,000	30,000	40,000
(b) Payment of liabilities	- 10,000		<u>- 10,000</u>			
Balance after payment	90,000			20,000	30,000	40,000
(c) Distribution to partners	- 90,000			- 20,000	- 30,000	- 40,000

The entries to record the liquidation are then:

(a) Sale of Assets	Cash	80,000
	Other Assets	65,000
	Perez, Capital	5,000
	Roth, Capital	5,000
	Stone, Capital	5,000
(b) Payment of Liabilities	Liabilities	10,000
	Cash	10,000
(c) Final Distribution to Partners	Perez, Capital	20,000
	Roth, Capital	30,000
	Stone, Capital	40,000
	Cash	90,000

Note: The final distribution of cash (\$90,000) is made to the partners based upon their *capital* balances.

EXAMPLE 14. Liquidation at a Loss.

The data are as in Example 13, except that the noncash assets are now sold for \$11,000.

	ASSETS =		LIABILITIES +		CAPITAL	
	Cash	+ Other	Accounts Payable	Perez	+ Roth	+ Stone
Balances of capital accounts	\$20,000	\$65,000	\$10,000	\$15,000	\$25,000	\$35,000
(a) Sale of assets	+ 11,000	<u>- 65,000</u>		- 18,000	- 18,000	- 18,000
Balance after sale	\$1,000		10,000	(3,000)	7,000	17,000
(b) Payment of liabilities	- 10,000		<u>- 10,000</u>			
Balance after payment	\$1,000			(3,000)	7,000	17,000
(c) Distribution to partners	- 21,000				- 5,500	- 15,500
				(3,000)	1,500	1,500

Notice that in the foregoing liquidation schedule the \$54,000 loss on sale of the noncash assets was divided equally among the three partners. However, Perez's capital balance was not sufficient to absorb his share of the loss. This resulted in a debit balance (\$3,000) in his capital account and becomes a claim of the partnership against him for that amount. The \$3,000 deficit must be borne by the two remaining partners. and thus, in the distribution to partners, Roth and Stone each take an additional loss of \$1,500.

The entries to record the liquidation are as follows:

(a) Sale of Assets	Cash	11,000
	Perez, Capital	18,000
	Roth, Capital	18,000
	Stone, Capital	18,000
	Other Assets	65,000

(b) Payment of Liabilities	<i>Liabilities</i>	10,000	
	<i>Cash</i>		10,000
(c) Distribution to Partners	<i>Roth, Capital</i>	5,500	
	<i>Stone, Capital</i>	15,500	
	<i>Cash</i>		21,000

Since there is a capital deficiency outstanding, one of three different possibilities will arise in the future: (1) Perez pays the deficiency in full; (2) Perez makes a partial payment; (3) Perez makes no payment. The entries corresponding to these possibilities are:

(1) Payment in Full

<i>Cash</i>	3,000	
<i>Perez, Capital</i>		3,000
<i>Roth, Capital</i>	1,500	
<i>Stone, Capital</i>	1,500	
<i>Cash</i>		3,000

(2) Partial Payment of \$2,000

<i>Cash</i>	2,000	
<i>Perez, Capital</i>		2,000
<i>Settlement of Perez's deficiency</i>		
<i>Roth, Capital</i>	500	
<i>Stone, Capital</i>	500	
<i>Perez, Capital</i>		1,000
<i>To close out the balance of Perez's account</i>		
<i>Roth, Capital</i>	1,000	
<i>Stone, Capital</i>	1,000	
<i>Cash</i>		2,000
<i>To distribute cash according to capital balances</i>		

(3) No Payment

<i>Roth, Capital</i>	1,500	
<i>Stone, Capital</i>	1,500	
<i>Perez, Capital</i>		3,000

Summary

- (1) Partnership and sole proprietorship accounting are alike except in _____.
- (2) Noncash assets are recorded at _____ amounts when the partnership is formed.
- (3) The book value of the partnership of Acme and Beam is \$60,000, with each partner's account showing \$30,000. If Caldwell were to purchase Beam's interest for \$40,000, the amount credited to Caldwell's equity account would be _____.
- (4) In order to reflect higher current prices, certain assets of the partnership will be debited, with the corresponding credit to _____.
- (5) A firm's superior earning power is recognized as _____.

- (6) If profits and losses are not to be shared equally, the basis of distribution must be stated in the _____.
- (7) Salaries and the interest on partners' capital balances are not included on the income statement but are shown on the _____.
- (8) When a partnership decides to go out of business, the process of selling the assets, paying the creditors, and distributing the remaining cash to the partners is known as _____.
- (9) The final distribution of cash to the partners is based on their _____.

Answers: (1) owners' equity; (2) agreed; (3) \$30,000; (4) Asset Revaluation; (5) goodwill; (6) partnership agreement; (7) capital statement; (8) liquidation; (9) capital balances

Solved Problems

- 1.1. J. Korr and B. Lear have decided to form a partnership. Korr invests the following assets at their agreed valuations, and also transfers his liabilities to the new firm.

Korr's Accounts	Korr's Ledger Balances	Agreed Valuations
Cash	\$18,000	\$18,000
Accounts Receivable	7,200	7,000
Allowance for Doubtful Accounts	600	500
Merchandise Inventory	12,200	10,000
Equipment	6,000	4,200
Accumulated Depreciation	1,000	
Accounts Payable	3,500	3,500
Notes Payable	3,600	3,600

Lear agrees to invest \$26,000 in cash. Record (a) Korr's investment, (b) Lear's investment.

(a)			
(b)			

SOLUTION

(a)	Cash	18,000	
	Accounts Receivable	7,000	
	Merchandise Inventory	10,000	
	Equipment	4,200	
	Allowance for Doubtful Accounts		500
	Accounts Payable		3,500
	Notes Payable		3,600
	J. Korr, Capital		31,600
(b)	Cash	26,000	
	B. Lear, Capital		26,000

- 1.2. The capital accounts of J. Phillips and W. Schneider have balances of \$25,000 each. E. Kurlander joins the partnership. What entry is necessary (a) if Kurlander purchases half of Phillips's investment for \$15,000? (b) if Kurlander invests \$15,000 in the firm?

(a)			
(b)			

SOLUTION

(a)	<i>J. Phillips, Capital</i>	12,500	
	<i>E. Kurlander, Capital</i>		12,500
(b)	<i>Cash</i>	15,000	
	<i>E. Kurlander, Capital</i>		15,000

- 1.3. W. Schoop and J. Epstein have capital balances of \$20,000 and \$30,000, respectively, H. Walker and W. Dunn are to be admitted to the partnership – Walker by purchasing half of Epstein's interest for \$18,000 and Dunn by investing \$10,000, for which he is to receive full equity value (\$10,000).

- (a) What entry is needed to record the above information?
 (b) On a capital basis, what is Dunn's share of profits and losses?

(a)			
(b)			

SOLUTION

(a)	<i>Cash</i>	10,000	
	<i>J. Epstein, Capital</i>	15,000	
	<i>H. Walker, Capital</i>		15,000
	<i>W. Dunn, Capital</i>		10,000
(b)	<i>W. Schoop, Capital</i>	\$20,000	
	<i>H. Walker, Capital</i>	15,000	
	<i>J. Epstein, Capital</i>	15,000	
	<i>W. Dunn, Capital</i>	10,000	
	Total Capital	\$60,000	

$$\frac{\text{Dunn's Investment}}{\text{Total Capital}} = \frac{\$10,000}{\$60,000} = \frac{1}{6}, \text{ or } 16\frac{2}{3}\%$$