

Partnership as an organizational form.

Incentives to monitor partner: Joint and Several Liability

Accounting Firms, LLP \Leftrightarrow impact on incentives

When is partnership optimal? Read BW article handout.

Key things we will focus on are reorganizations that take the form of Entry & Exit. Why? These force us to examine issues of what various “interests” are worth and how the economics of the transactions needs to be reflected in the accounting.

Key is to work backwards. Suppose I pay \$1 to buy a 10% share of a business with a FMV of \$x, then AFTER I pay \$1 to the firm, its assets are \$x+\$1. I now own 10% of \$x+1. If I paid FMV for my share, then it must be that

$$10\% (x+1) = 1$$

This means FMV of business was \$9 **before** my contribution. This is the key to most of the accounting.

Suppose I pay \$25,000 for a 25% share of a business. Then the imputed fair value of the business must be \$100,000.

Now suppose the FMV (and BV) of the old assets is \$75,000. I pay in another \$25,000. The FMV of **all the assets of the firm after I pay in** is \$100,000. I have paid exactly what I will be entitled to after admission.

My share * [FMV of old assets + My pay-in] = My pay-in

Change the facts:

Suppose I pay \$27,000. Suppose also the BV of the old assets is still \$75,000. I paid \$27,000 for a 25% share of a firm with a BV of \$75,000+\$27,000. Why would I do that?

Asset Appreciation/Goodwill

How much is the appreciation/goodwill?

Imputed value – [BV+New partner contribution]

$\$27,000 \div 25\% - [75,000 + 27,000] = \6000

Who is entitled to the asset appreciation (all of it)?

The old partners.

What happens when I enter?

I become entitled to 25% of the appreciation as it is realized.

So, to compensate them for this right, I owe them \$1,500.

Change facts again:

Suppose, instead I pay \$23,000 to buy a 25% share. Suppose also that FMV/BV of old assets is still \$75,000. Now I have paid \$23,000 for a firm with a BV of \$98,000. Why would I do that?

Asset writedown/new partner goodwill.

How much?

1. Asset writedown. We use the same formula:

Imputed value – [BV+New partner contribution]

$$\$23,000 \div 25\% - [75,000 + 23,000] = (\$6000)$$

→ Asset writedown charged to old partners.

2. New Partner Goodwill. We now have

FMV of new partnership assets =

[FMV of old assets + Cash pay-in + New partner Goodwill]

$$98,000 + x = 75,000 + 23,000 + x.$$

We must also have

New partner share of assets = New partner contribution

$$.25[98,000 + x] = 23,000 + x$$

Solving yields $x = 2,000$.

So the partnership recognizes \$2000 of goodwill brought in by new partner.

How to account for all this?

Accounting for Partnerships

1. Topics that require attention:
 - a. Adjusting values of assets when control transactions occur.
 - b. Keeping track of partnership assets and shares.

Rule: Prices/exchanges involving control transactions ought to reflect economic values. Book values before and after transactions need not reflect economic values.

This discrepancy is at the heart of all the important issues that we will run into later in corporate forms as well, so we deal with it in the simpler setting of partnerships.

Basically, asset values can differ from book values in three important ways:

Assets may have:

- (1) increased in value
- (2) decreased in value or
- (3) created but never recorded (goodwill).

In the simplest case of entry, the incoming partner will want asset base to be reduced by (1) while continuing partners will want to be paid for (2) and (3).

However the firm may not want to write up assets (various reasons including lenders' wishes, tax complications etc.).

Two principal ways to handle entry:

- Bonus Method (writedowns required but no writeups allowed)
- Goodwill method (writeups allowed as well)

ONE KEY DIFFERENCE.

Bonus method:

New partner capital =

New partner share * [**Book Value** of old partnership assets + New partner contribution]

Goodwill method:

New partner capital =

New partner share * [**Fair Market** of old partnership assets + New partner contribution]

Suppose at the time of admission of new partner, one asset has gone down in value and one has gone up.

Under the **bonus method** we proceed as follows:

Step 1 Write down the first asset and assign the loss to the existing partners in their old profit sharing ratios. (Note here the use of the profit & loss % rather than the capital %). **Ignore all gains** for this step (this is key to the bonus method).

- E 14- 1: no assets have lost value. Step is moot.

Step 2 Compute the book value of the assets of the partnership after the contribution of the new partner. Compute the new partner's share of that book value using his capital share %.

- E 14- 1: BV of partnership assets = \$900,000 + \$250,000.
Tyler's share: 20% of \$1,150,000 = \$230,000.

Step 3 Compute the bonus to continuing partners as BV of new partner's contribution (usually the FMV of the contributed items) – new partner's share computed in Step 2.

- E 14- 1: Bonus is \$20,000 (\$250,000- \$230,000).

Note: If this number is negative, either new partner gets a bonus or assets have lost value and must be written down. In either case, need to reduce existing partners' capital.

Step 4 Allocate bonus to continuing partners in their profit sharing ratios.

- E 14- 1: Riley: \$12,000 (60%), Smith: \$8,000 (40%).

Dr. Assets brought in	FMV	
Cr. Continuing partners		Bonus
New partner		Share

(this assumes bonus for continuing partners, make suitable changes for new partner bonus – what will those be?).

Under the **goodwill method** proceed as follows:

Step 1 Compute total capital of new partnership:
[New partner contribution ÷ New partner capital share %]

- E14- 1: $\$250,000 \div 20\% = \$1,250,000$

Step 2 Compute bonus to old or new partners:
Total capital from Step 1 - FMV of new partner contribution - BV of original assets = Net bonus

- E14- 1: $\$1,250,000 - \$250,000 - \$900,000 = \$100,000$

Note: net bonus may involve both unrecognized appreciation or depreciation of assets AND unrecognized goodwill of original or new partner.

Step 3: Credit the net bonus to partners to whom it is due in their old profit-sharing proportions.

- E14- 1: Riley: \$60,000 (60%), Smith \$40,000 (40%)

BUYING INTO A PARTNERSHIP

Buying directly from a partner

- In the partnership books, move old partner balance to new partner. Do nothing else.
- New partner pays old partner privately.

Buying a share from the partnership

- Partner pays in consideration to firm
- Firm assets increase
- Compute what must be paid in to acquire the necessary share of the grossed-up partnership assets.
- Credit part of consideration paid by new partner to original partners as bonus if bonus method used.
- Revalue assets and credit goodwill to original partners if goodwill method used. Credit the consideration paid in to new partner account.

WITHDRAWAL

Selling a share back to the partnership

- **Bonus method:** allow a bonus to exiting partner or continuing partners depending on facts. Split bonus between continuing partners based on their old proportions.
 - E 14- 5: Split between G%S 45/65 and 20/65.
- **Goodwill method:** Recognize goodwill paid to retiring partner or to entire entity. Goodwill computation as before.