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Study Unit 3

Changes in the ownership structure of partnerships

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Study Unit 3: Changes in the ownership structure of partnerships

INTRODUCTION

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Introduction

- Partnership is not a separate legal entity
- Therefore if the partners change the partnership changes!
  - Refer to common law
  - New partnership agreement
  - Old partnership dissolves
  - New partnership formed
- This can happen when:
  - New partner admitted
  - Partner dies
  - Partner retires
  - Profit sharing ratio changes

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Study Unit 3: Changes in the ownership structure of partnerships

THE STEPS TO PROCESS – AN OVERVIEW

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Steps

Dissolve old partnership

1. Record valuation adjustments (assets including existing goodwill & liabilities) in a valuation account
2. Close off the valuation account to the capital accounts of the old partners (including the retiring partner – if died then the estate thereof)
3. Close off current account balances to capital accounts of old partners
4. Close off drawings account directly to capital accounts of old partners
5. Close off and apportion reserves to capital accounts of old partners
6. Create Goodwill that is initially acquired (if applicable)
7. Record settlement of retiring / dead partner (if applicable)
8. Record the dissolution of the old partnership (the Transferral Account)

Record the new partnership

9. Record the formation of the new partnership
10. Reinstate reserves if new partners decide to do so
11. Adjust capital account balances of new partners to the profit sharing ratio

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STEP 1: RECORD VALUATION ADJUSTMENTS

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What and why – valuation account

- Old partners want their equity to be shown at fair value!
  - Equity = Assets – Liabilities
- Therefore:
  - Assets (including goodwill) must be at fair value
  - Liabilities must be at fair value
- Need to do some valuation adjustments
  - Adjustment in an existing asset or liability account of an existing partnership in preparation of its dissolution

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Step 1: Valuation Adjustments

Asset Valuation Adjustments

ASSETS ↑ on the DEBIT side

Debit Asset	X	
Credit Valuation Account		X

Note: Assets include existing goodwill

ASSETS ↓ on the CREDIT side

Debit Valuation Account	X	
Credit Asset		X

Liability Valuation Adjustment

LIABILITIES ↑ on the CREDIT side

Debit Valuation Account	X	
Credit Liability		X

LIABILITIES ↓ on the DEBIT side

Debit Liability	X	
Credit Valuation Account		X

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Step 1: Valuation Account

Debit	Valuation Account		*Credit*
Liability 1 (if increase)	X	Asset 1 (if increase)	X
Provision (if increase)	X	PPE (if increase)	X
Financial Liability (if increase)	X	Goodwill (if increase)	X
Asset 2 (if decrease)	X	Liability 2 (if decrease)	X
Debtors: Allowance for Credit losses) (if decrease)	X		
Balance ?	*X*		
	XX		XX

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STEP 2: CLOSE OFF VALUATION ACCOUNT TO THE CAPITAL ACCOUNTS

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Step 2: Valuation Account to Capital Account

Debit	**Valuation Account**		*Credit*
Liability 1 (if increase)	X	Asset 1 (if increase)	X
Provision (if increase)	X	PPE (if increase)	X
Financial Liability (if increase)	X	Goodwill (if increase)	X
Asset 2 (if decrease)	X	Liability 2 (if decrease)	X
Debtors: Allowance for Credit losses) (if decrease)	X		
~~Balance~~ *Capital Account*	*X*		
Capital Account: ABC	X		
Capital Account: XYZ	X		
	XX		XX

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Step 2: Valuation Account to Capital Account Journal

Valuation Account	X	
Capital Account: ABC		X
Capital Account: XYZ		X

Note:

- The valuation account is closed off to each of the existing (old) partners Capital Accounts
  - Including retired or deceased partner
- Apportioned in line with old profit sharing ratio

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Capital Account

Debit	**Capital Account – Partner ABC**		*Credit*
		Opening Balance b/d	X
		Valuation Account	**X**

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HOMEWORK – UNISA SG Exercise 3.1

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Homework

- Please attempt exercise 3.1
- UNISA study guide page 35
- Make your own attempt before proceeding with the video solution

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STEP3: CLOSE OFF CURRENT ACCOUNTS TO CAPITAL ACCOUNTS

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Remember the Current Account?

CREDIT BALANCE

Current Account – Partner ABC

Debit		*Credit*	
		Opening Balance b/d	X
Interest on Drawings (Appropriation)	X	Interest on Capital (Appropriation)	X
		Interest on Curr Acc (Appropriation)	X
		Partner ABC Salaries (Appropriation)	X
		Partner ABC Bonus (Appropriation)	X
Drawings Account: Partner A	X	Appropriation Account (*share of available profit)*	X
Balance c/d	*X*		
	XX		XX
Capital Account: ABC	**X**	**Balance b/d**	**X**
	-		-

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Step 3: Current Accounts to Capital Account Journal

Current Account: ABC (if DR bal)	X	
Current Account: XYZ (if DR bal)		X
Capital Account: ABC		X
Capital Account: XYZ	X	

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Capital Account

Debit	**Capital Account – Partner ABC**		*Credit*
		Opening Balance b/d	X
		Valuation Account	X
		Current Account: ABC	**X**

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STEP 4: CLOSE OFF DRAWINGS ACCOUNTS TO CAPITAL ACCOUNTS

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Remember the Drawings Account

Debit	**Drawings Account – Partner ABC**		*Credit*
Bank	X		
Inventory	X		
Assets		X	
Entertainment expense	X		
Stationery expense	X		
	XX	**Capital Account: ABC**	**X**

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Step 4: Drawings Accounts to Capital Account Journal

Capital Account: ABC	X	
Capital Account: XYZ	X	
Drawings Account: ABC		X
Drawings Account: XYZ		X

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Capital Account

Debit	Capital Account – Partner ABC		*Credit*
Drawings Account: ABC	**X**	Opening Balance b/d	X
		Valuation Account	X
		Current Account: ABC	X

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STEP 5: CLOSE OFF RESERVES TO CAPITAL ACCOUNTS

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Reserves?

- In study unit 2 we noted that partners can transfer some of the available profits into reserves such as the Asset Replacement Reserve (there may be others).
- We need to allocate these reserves back to the partners for dissolution
  - Note that partners may choose to reinstate the reserves in the new partnership.

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Step 5: Reserves to Capital Account Journal

Asset replacement reserve	X	
Other Reserve 1	X	
Capital Account: ABC		X
Capital Account: XYZ		X

Note:

- The reserves are closed off to each of the existing (old) partners Capital Accounts including retired or deceased partner
- Apportioned in line with old profit sharing ratio

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Capital Account

Debit	**Capital Account – Partner ABC**		*Credit*
Drawings Account: ABC	X	Opening Balance b/d	X
		Valuation Account	X
		Current Account: ABC	X
		Asset replacement reserve	**X**
		Other Reserve 1	**X**

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STEP 6: GOODWILL ACQUIRED

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Goodwill?

- Formal definition:
  - Future Economic Benefits arising from assets that are not capable of being individually identified and recognised (IFRS 3).
- Two types:
  1. Acquired goodwill
     - Amount paid in excess of net asset value
     - Recognised in the SFP
  2. Internally generated goodwill
     - Not recognised

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Goodwill in Partnerships

- Calculated when a new partner is admitted, and
  - No Goodwill was previously recorded in the old (existing) partnership
- Initially recorded at cost:
  - Cost of the business – acquirers interest in the net asset value (at fair values)
- Subsequently:
  - Cost less accumulated impairment losses

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Step 6: Goodwill Acquired Journal

Goodwill (acquired)	X	
Capital Account: ABC		X
Capital Account: XYZ		X

Note:

- The Goodwill is allocated to existing (old) partners Capital Accounts including retired or deceased partner
- Apportioned in line with old profit sharing ratio

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Capital Account

Debit	**Capital Account – Partner ABC**		*Credit*
Drawings Account: ABC	X	Opening Balance b/d	X
		Valuation Account	X
		Current Account: ABC	X
		Asset replacement reserve	X
		Other Reserve 1	X
		Goodwill (acquired)	**X**

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Calculation of Goodwill Acquired

	R
Total capital (equity) value of new partnership	X
• *New partner capital contribution X (1/new partners %)*	
Equity value of new partnership prior to Goodwill (Net Asset Value)	(X)
Goodwill Acquired	X

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Goodwill Acquired example

- Mr Blue is a new partner to the Rainbow Trading Partnership, along with the existing partners being Mr Green and Mrs Red (previously 50:50)
- Mr Blue makes a capital contribution of R2 000 cash in order to access a profit share of 10%.
- The net asset value of the partnership before this capital contribution is R5 000

Required:

Calculate the Goodwill acquire for the Rainbow Partnership.

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Solution – Goodwill Acquired

	R
Total capital (equity) value of new partnership	**R20 000**
• *New partner capital contribution X (1/new partners %)* • *R2 000 X (1/10%)*	
Equity value of new partnership prior to Goodwill (Net Asset Value) (R5 000 + R2 000)	**(R7 000)**
Goodwill Acquired	**R13 000**

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STEP 7: SETTLEMENT OF RETIRING / DECEASED PARTNER (*if applicable)*

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Retiring / deceased partner

- The retiring or deceased partners Capital Account is closed off.
- The balance that is due to the partner is then settled with:
  - A cash payment (Bank)
  - An amount payable (loan account) with the retiring partner / deceased estate
  - There could be an asset distributed other than cash (eg an item of PPE or inventory)

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Retiring partner GL : Capital Account

Debit	Capital Account – Retiring partner		*Credit*
Drawings Account: ABC	X	Opening Balance b/d	X
Balance	*X*	Valuation Account	X
Bank	**X**	Current Account: ABC	X
Loan Account: Retiring Partner	**X**	Asset replacement reserve	X
Other assets (PPE / Inventory)	**X**	Other Reserve 1	X
		Goodwill (acquired)	X
	XX		XX

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Step 7: Settlement Journal

Capital Account: Retiring Partner	X	
Bank		**X**
Loan Account: Retiring Partner		**X**
Other assets (PPE / Inventory)		**X**

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STEP 8: DISSOLUTION OF THE PARTNERSHIP – TRANSFERRAL ACCOUNT

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Transferral Account

- We have closed off all the asset, liability and capital accounts and now have final balances.
- Pass two journals:
  1. Transfer all DEBIT balance accounts (assets) to the Transferral Account and reduce debits to RNil.
  2. Transfer all CREDIT balance accounts (Equity: Capital Accounts, Liabilities, Allowance for Credit Losses) to the Transferral Account and reduce credits to RNil.

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Step 8.1: Transfer Debit Balances to Transferral Account

Transferral Account	X	
Land & Buildings		X
Goodwill		X
Inventory		X
Debtors Control (Gross Debtors)		X
Other assets		X
Bank		X

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Step 8.2: Transfer CREDIT Balances to Transferral Account

Capital Account: ABC	X	
Capital Account: XYZ	X	
Financial Liability	X	
Allowance for Credit Losses	X	
Provision	X	
Other liabilities	X	
Transferral Account		X

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GL: Transferral Account

Debit		**Transferral Account**	*Credit*
Land & Buildings	X	Capital Account: ABC	X
Goodwill	X	Capital Account: XYZ	X
Inventory	X	Financial Liability	X
Debtors Control (Gross Debtors)	X	Allowance for Credit Losses	X
Other assets	X	Provision	X
Bank	X	Other liabilities	X
	XX		XX

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Capital Account

Debit	**Capital Account: ABC**		*Credit*
Drawings Account: ABC	X	Opening Balance b/d	X
		Valuation Account	X
Balance:		Current Account: ABC	X
Transferral Account	**X**	Asset replacement reserve	X
		Other Reserve 1	X
		Goodwill (acquired)	X
	XX		XX

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Old Partnership Dissolved

- You have now finished dissolving the old partnership!
- Add up the debits and credits on the Transferral Account and you will net to R Nil!
- What's next?
  - Record the formation of the new partnership…….
    - STEP 9

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STEP 9: RECORD THE FORMATION OF THE NEW PARTNERSHIP

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Form the new Partnership

9.1 Account for capital contributions of the original partners in the NEW PARTNERSHIP:

- Record the Capital Accounts for each of the old partners joining the new partnership
- Account for the assets and liabilities that are contributed to the new partnership by the original partners,
- NB – do this in a separate journal for each of the remaining original partners and
- Bring in assets and liabilities in the partner's capital contribution ratio

9.2 Account for the capital contribution of the new partner

- Create a new Capital Account for the newly admitted partner and record any capital contributions therein.

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Step 9.1: Capital contribution of original partners (in % ratio)

Land & Buildings (x %)	X	
Goodwill (x %)	X	
Inventory (x %)	X	
Debtors Control (Gross Debtors) (x %)	X	
Other assets (x %)	X	
Bank (x %)	X	
Financial Liability (x %)		X
Allowance for Credit Losses (x %)		X
Provision (x %)		X
Other liabilities (x %)		X
Capital Account: ABC *(new partnership)*		**X**

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GL: Capital Account original partner – new partnership

Debit		**Capital Account: ABC**	*Credit*
Financial Liability (%)	X	Land & Buildings (%)	X
Allowance for Credit Losses (%)	X	Goodwill (%)	X
Provision (%)	X	Inventory (%)	X
Other liabilities (%)	X	Debtors Control (Gross Debtors) (%)	X
Balance: c/d	X	Other assets (%)	X
		Bank (%)	X
	XX		XX
		Balance: b/d	X
		(before adjusting profit sharing ratios)	

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Step 9.2: Capital contribution of the new partner

Create a new Capital Account for the newly admitted partner and record any capital contributions therein.

Bank	X	
Other assets	X	
Capital Account: Newbie		**X**

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GL: Capital Account new partner – new partnership

Debit		**Capital Account: Newbie**	*Credit*
		Bank	X
Balance: c/d	X	Other assets	X
	XX		XX
		Balance: b/d	X

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STEP 10: REINSTATE RESERVES *(if partners decide to reinstate)*

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Step 10: Reinstate Reserves

- If the new partnership partners decide to, they can reinstate the reserves (such as the Asset Replacement Reserve):

Capital Account: ABC	X	
Capital Account: XYZ	X	
Capital Account: Newbie	X	
Asset Replacement Reserve / Other Reserves		X

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GL: Capital Account

Debit		**Capital Account: ABC**	*Credit*
Financial Liability	X	Land & Buildings	X
Allowance for Credit Losses	X	Goodwill	X
Provision	X	Inventory	X
Other liabilities	X	Debtors Control (Gross Debtors)	X
Asset Replacement Reserve	**X**	Other assets	X
Other Reserves	**X**	Bank	X
Balance: c/d	X		
	XX		XX
		Balance: b/d	X
		(before adjusting profit sharing ratios)	

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STEP 11 : ADJUST CAPITAL ACCOUNTS TO NEW PROFIT SHARING RATIO

(if partners wish to / you are instructed to do so)

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Capital Accounts vs Profit Sharing Ratio

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Partner contributions / withdrawals to balance profit share ratios

Partner Contributes

To bring Capital Account in line with profit sharing ratio

Bank / other assets	X	
Loan account receivable	X	
Capital Account: ABC		X

Partner Withdraws

To bring Capital Account in line with profit sharing ratio

Capital Account: XYZ	X	
Bank / other assets		X
Loan account payable		X

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GL: Capital Account

Debit	**Capital Account: ABC**		*Credit*
Financial Liability	X	Land & Buildings	X
Allowance for Credit Losses	X	Goodwill	X
Provision	X	Inventory	X
Other liabilities	X	Debtors Control (Gross Debtors)	X
Asset Replacement Reserve	X	Other assets	X
Other Reserves	X	Bank	X
Balance: c/d	X		
	XX		XX
		Balance: b/d *(before adjusting profit sharing ratios)*	X
		Bank / other assets	X
Balance: c/d	X	Loan account receivable	X
	XX		XX
		Balance: b/d	**X**

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GL: Capital Account

Debit		Capital Account: XYZ	*Credit*
Financial Liability	X	Land & Buildings	X
Allowance for Credit Losses	X	Goodwill	X
Provision	X	Inventory	X
Other liabilities	X	Debtors Control (Gross Debtors)	X
Asset Replacement Reserve	X	Other assets	X
Other Reserves	X	Bank	X
Balance: c/d	X		
	XX		XX
Bank / other assets	X	Balance: b/d	X
Loan account payable	X	*(before adjusting profit sharing ratios)*	
Balance: c/d	X		
	XX		XX
		Balance: b/d	**X**

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Calculations

i. Admission of new partner:
   a) Reduction shared proportionately
   b) Reduction shared equally
   c) New profit sharing ratio

ii. Retirement / death of a partner

iii. Concurrent retirement and admission

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NEW PROFIT SHARING RATIO CALC:
i) ADMISSION OF NEW PARTNER

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i. Admission of new partner

a. *Reduction shared proportionately*

- Allan and Barry were in a partnership and shared profits in a ratio 2:3.
- A new partner, Carol was admitted and allocated a 20% (1/5) profit share.
- Allan and Barry reduced their profit share in proportion to their original ratios

Required:

Calculate the profit sharing ratio of the new partnership

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i. a. Solution - ratios

	OLD	Calculation	NEW	%
A	2	2/5 – (1/5 x 2/5) = 10/25 – 2/25 = 8/25	8	32%
B	3	3/5 – (1/5 x 3/5) = 15/25- 3/25 = 12/25	12	48%
C	0	0/5 + 1/5 = 5/25	5	20%
	5		25	100%

i. a. Solution - percentages

	OLD %	Calculation	NEW %	Ratio
A	2/5 = 40%	40% - (40% x 20%)	32%	8
B	3/5 = 60%	60% - (60% x 20%)	48%	12
C	0/5 = 0%	0% + 1/5 = 0% + 20%	20%	5
	5/5 = 100%		100%	25

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i. Admission of new partner
b. *Reduction shared equally*

- Allan and Barry were in a partnership and shared profits in a ratio 2:3.
- A new partner, Carol was admitted and allocated a 20% (1/5) profit share.
- Allan and Barry reduced their profit share equally

Required:

Calculate the profit sharing ratio of the new partnership

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i. b. Solution - ratios

	OLD	Calculation	NEW	%
A	2	2/5 – (1/5 x 1/2) = 4/10 – 1/10 = 3/10	3	30%
B	3	3/5 – (1/5 x 1/2) = 6/10 – 1/10 = 5/10	5	50%
C	0	0/5 + 1/5 = 0/10 + 2/10 = 2/10	2	20%
	5		5	100%

i. b. Solution - percentages

	OLD %	Calculation	NEW %	Ratio
A	2/5 = 40%	40% - (50% x 20%)	30%	3
B	3/5 = 60%	60% - (50% x 20%)	50%	5
C	0/5 = 0%	0% + 1/5 = 0% + 20%	20%	2
	5/5 = 100%		100%	5

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i. Admission of new partner
c. New Profit Sharing Ratio

- Allan and Barry were in a partnership and shared profits in a ratio 2:3.
- A new partner, Carol was admitted and allocated a 20% (1/5) profit share.
- Allan and Barry reduced their profit share in a 1:2 ratio

Required:

Calculate the profit sharing ratio of the new partnership

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i. c. Solution - ratios

	OLD	Calculation	NEW	%
A	2	2/5 – (1/5 x 1/3) = 6/15 – 1/15 = 5/15	5	33.3%
B	3	3/5 – (1/5 x 2/3) = 9/15 – 2/15 = 7/15	7	46.7%
C	0	0/5 + 1/5 = 0/15 + 3/15 = 3/15	3	20%
	5		15	100%

i. c. Solution - percentages

	OLD %	Calculation	NEW %	Ratio
A	2/5 = 40%	40% - (20% x 33.3%)	33.3%	5
B	3/5 = 60%	60% - (20% x 66.4%)	46.7%	7
C	0/5 = 0%	0% + 1/5 = 0% + 20%	20%	3
	5/5 = 100%		100%	15

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NEW PROFIT SHARING RATIO CALC:
ii) RETIRMENT / DEATH OF PARTNER

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ii. Retirement / death of a partner

- Allan, Barry and Carol were in a partnership and shared profits in a ratio 5:4:1.
- Carol died in a sky diving accidents and the remaining partners decided to carry on the business in a new partnership in the same profit sharing ratio.

Required:

Calculate the profit sharing ratio of the new partnership

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ii. Solution – ratios & %

	OLD	Calculation	NEW	%
A	5/10 = 50%	5/(10-1) = 5/9	5	55.6%
B	4/10 = 40%	4/(10-1) = 4/9	4	44.6%
C	1/10 = 10%	1/10 – 1/10 = 0	0	0%
	10/10=100%		9	100%

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NEW PROFIT SHARING RATIO CALC: iii) RETIRMENT & ADMISSION

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iii. Concurrent retirement & admission

- Allan, Barry and Carol were in a partnership and shared profits in a ratio 3:2:1.
- Carol retired and a new partner, Dean was admitted.
- It was agreed that Allan and Barry would take over 66.7% (2/3) of Carol's profit share equally, and the remaining 33.3% (1/3) would be allocated to Dean.

Required:

Calculate the profit sharing ratio of the new partnership

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iii. Solution - ratios

	OLD	Calculation	NEW	%
A	3	3/6 + [(1/6 x 2/3) x ½] = 9/18 +[2/18 x ½] = 9/18 + 1/18 = 10/18	10	55.6%
B	2	2/6 + [(1/6 x 2/3) x ½] = 6/18 +[2/18 x ½] = 6/18 + 1/18 = 7/18	7	38.8%
C	1	1/6 – 1/6 = 0	0	0%
D	0	0/6 + [1/6 x 1/3] = 0/18 + 1/18	1	5.6%
	6		18	100%

iii. Solution - percentages

	OLD %	Calculation	NEW %	Ratio
A	3/6=50%	50% + [(16.7% x 2/3) x ½]	55.6%	10
B	2/6=33.3%	33.3% + [(16.7% x 2/3) x ½]	38.8%	7
C	1/6=16.7%	16.7% - 16.7%	0%	0
D	0/6=0%	0% + (16.7% x 1/3)	5.6%	1
	6/6=100%		100%	18

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Study Unit 3: Changes in the ownership structure of partnerships

HOMEWORK – UNISA SG Exercise 3.2

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Homework

- Please attempt exercise 3.2
- UNISA study guide page 37
- Make your own attempt before proceeding with the video solution