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Module 12

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Module 12 Summary

I. Legal Forms of Business Organization

A. We will examine four legal forms of business organization in this module: ***sole proprietorships***, ***corporations***, ***partnerships***, and ***limited liability corporations***. These forms of business are the most commonly chosen in the United States.

1. Just in terms of numbers, most businesses are organized as sole proprietorships. In terms of sales volume, though, more business is conducted by corporations than any other business type. In general, then, small “Mom & Pop” businesses are usually organized as sole proprietorships, while “Big Business” chooses the corporate form of business organization.

2. *Caution!* The laws of the United States differ from the laws of other countries, and may result in completely different business forms or differences in the legal characteristics of the forms of business described below.

B. ***Sole proprietorships*** are the most commonly formed type of business in the United States. Their characteristics include:

1. ***Ease of formation***. No legal documents need to be completed in order to form a sole proprietorship. The owner can simply begin providing services or selling goods.

2. ***Unlimited liability***. The owner of a sole proprietorship is responsible for all the business debts. Often, when a small business goes under, it spells bankruptcy for the owner, unless there simply aren’t many business liabilities or the owner has a lot of wealth outside the business. Small business owners are notorious for hanging on as long as they can as their businesses deteriorate, and every dime of their savings is often invested in the business just to keep it going for one more month. By the time the doors are closed for good, the owner has nothing left and cannot pay his or her personal obligations, let alone the business debts.

3. Business ***income passes through to the owner for tax reporting*** purposes. A sole proprietorship does not pay taxes directly to the taxing authorities. The owner simply lists business income or loss along with wages and other taxable income on his or her individual tax return.

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4. The ***owner has complete control over the business***. There are no partners or other parties involved in the management of the business.

5. ***Difficulty in obtaining financing***. Since there is only a single owner, the amount of ***equity financing*** (that is, owner investment) available to the business is likely to be limited. This, in turn, will make it difficult to obtain financing from creditors.

    a. The bank will not want to "go out on a limb" and extend credit to a business that does not have much owner equity. After all, if the owner has not committed much capital to the business and does not have much left outside the business that can be invested, the bank will be afraid that it will be left "holding the bag" if the business fails. They will probably view a loan as too risky to make.

    b. One of the major causes of small business failure is the lack of sufficient financing. It often takes several years before a new business begins to generate more in cash inflows than it has in outflows (that is, generate a *positive cash flow*). During this time, infusions of cash from owners and creditors are necessary in order to keep the business going. It is the business with "deep pockets" (adequate financing) that can survive long enough to begin to function on its own, and those that are *under-capitalized* (do not have adequate financing) are usually doomed to fail.

It's Story Time! *Let's pretend that an intergalactic worm hole sweeps you back into the 1700's, and you find yourself in Colonial America. You have a great advantage over everyone else since you know in advance what will be happening in the future. (If you stayed awake during History class, that is! :)*

You know that a great period of economic growth will be occurring, and that the Wild West will soon be settled. You decide to start up a wagon wheel business, since wagon wheels will be desperately needed and the business is sure to grow. You start a ***sole proprietorship*** *in Williamsburg, West Virginia, and you begin to make high quality wagon wheels. You are the sole owner of the business, and you get to make all the decisions. You know what you're doing, you care about the product, you're a good manager. As a result, you produce a very good product. In fact, you make such good wagon wheels that everybody around Williamsburg wants to have them. Soon, you have more orders than you can fill. If you could accept all those orders you would have more profit, but you just don't have enough space, equipment and employees to do that.*

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More profit is better than less profit, so you decide to expand your business. But there's a funny thing about growing your business and growing your profits. The cash outflows that are necessary in order to enlarge the building, buy more equipment, and hire more workers have to happen before the cash inflows from the additional sales can happen. That is, you have to pay to expand your building, buy equipment, and hire workers before you can build the wagon wheels, sell them, and get cash profits back from the sale. (This economic reality is the basis for the old saying, "It takes money to make money.")

*Therefore, in order to expand your business and make more profits, a **source of financing** (also called **funding**, though both terms really just refer to the process of acquiring cash) has to be found. You, yourself, don't have the cash outside the business, so there are only two other places the financing can be obtained – (1) from creditors (you borrow it), or (2) from investors (you admit a partner, someone who receives an ownership interest in your business in exchange for a cash contribution). Your business is small, you don't have a lot of assets in your business presently, you already have bank loans in place and the bank will not approve more of them.*

You need to find a partner.

We'll stop our story here, but don't worry. It will be continued in just a bit.

C. A ***partnership*** is, in a legal sense, very similar to a sole proprietorship except that the management of the business, the business profits and losses, and the risks of ownership are shared by two or more owners (partners). When a partnership is formed, the partners should establish a partnership agreement, a legal document that spells out the rights, responsibilities and duties of the partners to each other and to the business. When there is no partnership agreement, the way profits and losses are divided and the way the ownership of business property is determined will be decided by law.

1. The two most important characteristics of partnerships are ***unlimited liability*** and ***mutual agency***. They are definite disadvantages and they explain why relatively few businesses are organized as partnerships.

2. ***Unlimited liability*** applies to sole proprietorships as well as partnerships. The owner of a sole proprietorship and the partners in a partnership are all liable for the business debts in the event that the business fails and not enough is received from the sale of the assets to pay all the liabilities. If one of the partners is unable to pay

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his or her share of the business debts, the remaining partner(s) must make up the difference.

3. ***Mutual agency*** refers to the legal right of each to enter into contracts in the name of the business. Thus, one partner can bind the partnership to contractual agreements that the business must then carry out. Under the law, each partner is viewed as a "mutual agent" who is entitled to act in the name of the business and has an equal say in the management of the business.

    a. A ***limited partnership*** may be formed to avoid the problems associated with unlimited liability and mutual agency.

        1. In a limited partnership, a ***general partner*** is given control of the business and it is the general partner who is liable for the business debts. Therefore, the ***limited partner's*** potential loss is no greater than the amount of his or her investment in the business.

        2. It may be difficult to find investors who are willing to become *limited partners*, since a limited partner has little ability to control business operations and may have difficulty withdrawing from the partnership after the investment is made.

4. ***Co-ownership of property and income by partners*** is another characteristic of partnerships. Assets contributed to the business are jointly owned by all the partners; income is shared in the profit-and-loss sharing ratio agreed to by the partners.

Story Time, Continued!

When last we left our you (our hero), you were dealing with a financing problem. **Debt financing** *was not available to you, so you were seeking* **equity financing**. *You were trying to find a partner.*

Because of the problems of unlimited liability and mutual agency, you discovered that it was difficult to find a one. Most of your friends didn't have enough money to be able to provide the financing, and the few who did were too fearful of bankruptcy to make the investment. After all, they would be responsible for the business' bank loans if the company fell upon hard times, so they could potentially lose everything they invested in the business and more besides!

Finally, though, you succeeded in persuading your neighbor, Ezra Peabody, to join

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you in the business. Ezra was not willing to be a limited partner. He insisted on an equal say in the running of the business, since it was "his money" and he wanted to be able to determine how it would be used. He became a general partner, investing all the money that was needed for the business expansion.

It wasn't long, though, before trouble appeared. Ezra insisted that lower priced and less productive equipment be purchased, something that you disagreed with completely. It was clear that Ezra preferred to produce the wagon wheels quickly and cheaply, and at the expense of quality. You believed in quality over cost. Ezra also wanted to cut the wages of the workers in order to boost short-term profits, and you were sure that such a move would ruin worker morale and further erode quality. The problem of mutual agency had reared its ugly head.

Over time, the two of you did manage to increase sales and profits (thanks to your efforts and abilities), but you had to battle Ezra constantly. You eventually decided it wasn't worth it, and once you had earned enough to be able to do so, you bought Ezra's share of the business from him, paying a hefty premium. You were happy to pay it just to be finished with him.

You were left with a larger business than you had before, but one that was much changed because of Ezra's influence and your recent growth.

Your business had saturated its market. People all over Virginia owned your wagon wheels, and given the state of transportation (dirt roads and sailing ships) and communication (messenger service on horseback), it was impossible to make sales in distant markets such as Boston and New York. You and your business settled down and continued to plod along, producing a reasonable profit year after year, but not experiencing much growth in sales.

However, that was about to change.

To be continued…

D. ***Corporations***. This is the form of business organization that is commonly chosen by "big business." Corporations produce more business volume than any other type of business in America. Their characteristics include the following:

1. ***Difficulty of formation***. Corporations are subject to the individual corporation laws of the state in which they incorporate. It is necessary to apply to the state for permission to organize a corporation, and complex regulations regarding the formation and operation of a corporation must be followed.

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2. ***Limited Liability*** for the owners, since they aren't responsible for business debts. Actually, stockholders have *no* liability for the business debts, unless stock is issued to them below the stock's *par value* (and this just doesn't happen). More on all this in the next module.

3. ***No mutual agency*** -- this means that stockholders can't enter into agreements in the name of the business.

4. ***Transferability of ownership*** occurs easily and without disrupting the business. Share of stock may simply be bought and sold between individual owners outside the business.

5. ***Ease of "capital generation"*** refers to the corporation's ability to easily raise money from investors due primarily to (1), (2), (3) and (4) above.

6. Corporations enjoy ***perpetual existence***, unlike sole proprietorships and partnerships whose legal lives end when their owner(s) leave the business.

7. ***Existence as a separate legal entity*** (the corporation is viewed, from a legal perspective, as an "individual" – an entity separate from the owners). This makes some business dealings easier to conduct and makes the advantages of limited liability and lack of mutual agency possible.

8. ***Professional management***, with its greater expertise and better decision-making ability, is a characteristic of larger corporations.

9. ***Double taxation***. Since the corporation pays income taxes on its earnings, earnings are taxed once at the corporate level and again as dividend income to stockholders. In sole proprietorships, LLC's and partnerships, income tax is not paid by the business. Instead, the income "passes through" the business to the owner(s), who then declare the income on their own personal tax returns.

10. Heavy ***regulation*** of corporations by state and federal government agencies.

11. ***Separation of ownership and control*** occurs because the owners of the corporation are not in direct control of the day-to-day management of the business. These functions are performed by professional managers. The stockholder can vote his or her shares at the annual meeting, and thereby help determine who will sit on

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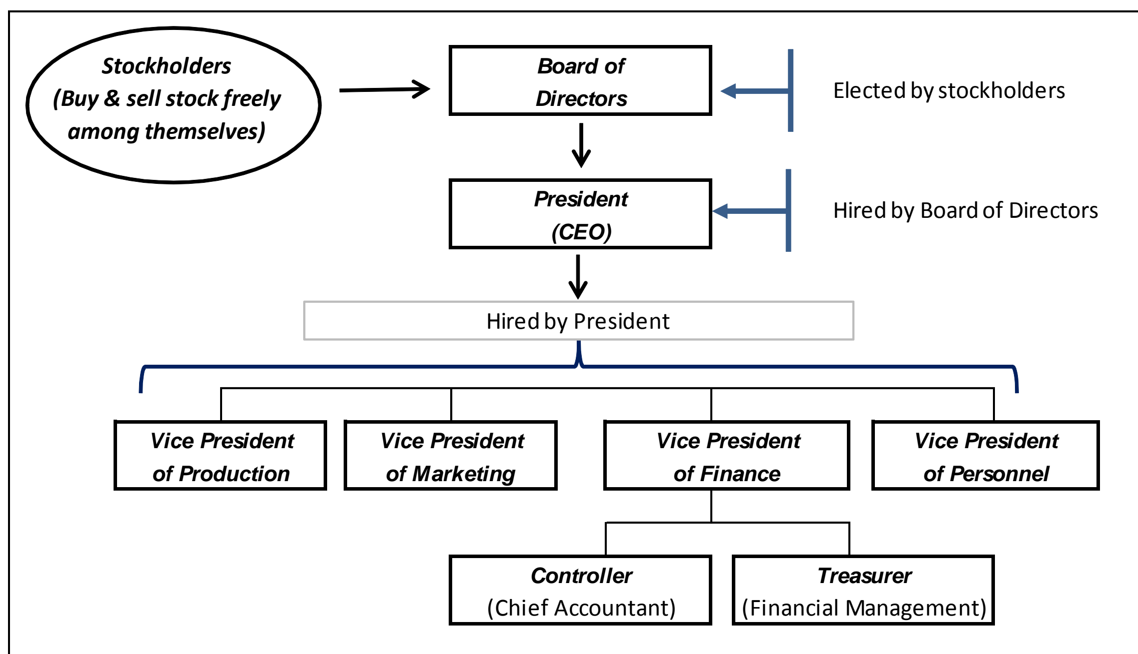
the ***Board of Directors***, but that is the limit of his or her influence over business operations.

a. The *Board of Directors* can be composed of any number of people, though the laws of the state in which the business is incorporated may dictate a minimum number. The corporation holds an ***annual meeting***, at which the stockholders can vote for the people who will sit on the corporation's Board. Usually, the number of votes a shareholder can cast is equal to the number of shares held.

b. These ***directors*** are responsible for setting broad policy objectives, making "big-picture" decisions, and for hiring a ***chief executive officer*** (the ***CEO***, or ***President***). The CEO is the top-most manager of the company, responsible for applying the Board's broad directives in the day-to-day operations of the company.

c. The CEO chooses the persons who will fill the upper-management positions, hiring people who can do a good job of carrying out the major operating functions of the business (personnel, production, marketing, accounting, and so on). These upper-level managers, in turn, hire the people who work in their departments. This is represented in the illustration below:



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More About the Separation of Ownership and Control

As mentioned above, the stockholders vote for the people who will sit on the corporation's Board of Directors at the corporation's annual meeting, and the number of votes a shareholder can cast is usually equal to the number of shares held. For example, if you hold 100 shares of IBM stock, you will be entitled cast 100 votes. If there were only 150 shares of IBM stock in existence, you would own 67% of them (100/150 = 67%) and you could cast 67% of the votes. Therefore, you would be able to elect "your people" to the Board, and effectively control the entire corporation. "Your" directors would hire the person you favored as the CEO, and "your" directors would set policies and broad directives that agreed with your vision regarding the company's future.

As you might expect, though, there are more than 150 shares of IBM stock in existence, and the more of them there are the less your 100 votes will matter when the directors are elected. Who does own enough of the IBM stock to control the corporation? As of June 29, 2012, Berkshire Hathaway, Warren Buffet's investment company, owned more shares than anyone else. They held a total of 66,645,396 shares with a value of more than 13 billion dollars. But this huge investment represented only 5.83% of the number of voting shares, so even Berkshire Hathaway could not single-handedly elect "their" directors to the Board. Large investors like this, though, form voting blocks of stock with like-minded investors in order to try to amass enough voting power to significantly influence the Board and exercise some control over the company.

d. Separation of ownership and control is a thorny issue. Critics of the corporation form of business organization say that professional managers do not take risks the way owner/managers might. They are more cautious since their jobs are on the line, and this can lead to less innovation and slower economic growth for the country as a whole. Proponents say that professional management leads to more business stability, which ensures longer lives for businesses, less economic disruption, and more security for the company's workers.

Story Time, Concluded!

The last installment of our story left you in Williamsburg with a larger business that had reached the limits of its growth potential. Like most business in Colonial America, yours was a small, individually owned and operated company. Why were there no Wal-Marts at the time? Because transportation and communication services were very limited, making it extremely difficult to expand business beyond a small geographical area.

This all changed as America grew. The coming of the railroads and the telegraph made it possible to produce in Virginia and to sell in Boston, New York, and even San Francisco. As markets expanded, so did business growth opportunities.

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You realized that you would be able to expand your business and make additional profits once again. However, you knew you would need a huge amount of financing in order to ramp up production and meet a nation-wide demand for wagon wheels. The idea of admitting one partner into your business, let alone the dozens it would take in order to raise all the necessary financing, was something you didn't want to contemplate. First, it would be difficult to find so many willing partners. Second, you remembered how mutual agency had been such a problem with Ezra, and there would be dozens of Ezra's for you to deal with this time around.

Fortunately for you, Virginia had recently enacted legislation that enabled you to ***incorporate*** *your business. As a corporation, your business could issue stock certificates to investors in exchange for their contributions. And not only would these stockholders have no liability for the debts of the business, they would also have no say in how the business was run. The two big problems that had plagued you in the past, unlimited liability and mutual agency, were now gone.*

Because of this, you had no reluctance to issue shares of stock to hundreds of your friends and neighbors. And they were all much more willing to invest now, because their losses would be limited to the amount they had invested. They were not personally liable for business debts.

Some invested large amounts, and some invested very small amounts. Some were sophisticated business people, and some were common laborers. Under the Virginia law, they had the right to vote for the people who sat on the Board of Directors but they could not personally control business operations. This was OK with them, though, since they also didn't want to have to deal with mutual agency problems, and they understood that most of the investors had no clue about how the business really should be run.

If the stockholders would not be running the business, then who would? The Board of Directors was responsible for overseeing the company, but the Board could not make the day-to-day decisions that were required to manage the company. Who would do that? The corporation's President, of course, a professional manager hired by the Board of Directors to do the job of actually running the company. And who, dear Reader, do you suppose the Board hired? They hired you, of course, and this is why:

After incorporating your business, you were careful to retain 51% of all the shares of stock that were issued. Each shareholder gets one vote for each share of stock held, so you had 51% of the votes. That meant that you were able to determine who was elected to the Board, and since the directors were all "your people," they, of course, made you the President of the company. You retained complete control of your business, and you had the financing in place that would enable you to expand.

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The corporate form of business organization, by eliminating the problems of unlimited liability and mutual agency, made it possible for you and a host of other business owners to expand. Without it, your business and most other businesses in America would have been destined to remain small, local operations.

What conclusion can we draw from our story? The corporate form of business organization, coupled with the existence of stable banking and investment systems, enabled the rapid economic growth experienced by the United States during the 19th century. It is no coincidence that during this time we see the creation of numerous corporation laws in each of the states. It is the beginning of "big business," the corporate era in America.

Not everyone sings the praises of the corporate form of business, though. For a critical appraisal and an overview of the history of corporation law within the United States, see the following:

http://reclaimdemocracy.org/corporate_accountability/history_corporations_us.html

http://hlpronline.com/2011/11/corporate-personhood-19th-century-invention-and-contemporary-challenge/

E. ***Limited Liability Corporations*** (***LLC's***) offer an alternative to the partnership and corporation forms of business by combining the corporate advantages of limited liability with the partnership advantage of pass-through taxation. As is the case with corporations, *articles of organization* must be prepared and filed with the state in order to form the LLC.

1. Like partnerships, the ownership equity in an LLC is divided among individual owners who share profits and losses according to a profit-and-loss sharing ratio.

2. Like partnerships, the LLC does not pay taxes directly to the government. Business income flows through the LLC directly to the individual owners' personal tax returns.

3. An LLC may be managed by its members (owners) or by professional managers. If the LLC is to be managed by its members, it operates much like a partnership. Each member has an equal say in the decision making process of the company. If the members choose, they may elect a manager or managers to direct the company's operations. In this case, the LLC operates much like a corporation and it avoids the *mutual agency* problem inherent in partnerships.

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4. If the members agree, the LLC may be organized with the corporation characteristic of *unlimited life*. More commonly, the LLC functions with a *limited life* just as sole proprietorships and partnerships do, and the business ends if one of the members dies or withdraws from the business.

II. Sharing Profits and Losses in Partnerships and LLC's

A. Since there is more than one owner in a partnership, there must be a *Capital* account and a *Drawing* account for each partner. Each partner's investments and withdrawals are recorded just as they are in a sole proprietorship. Closing the temporary accounts requires entries to each *Capital* account for the partner's share of the income (or loss) and for each partner's withdrawals. When accounting for an *LLC*, the owner's equity is recorded in a *Member Equity* account rather than a *Capital* account.

B. Income and loss may be divided among partners in any way they wish, as long as it is specified in the *Partnership Agreement* (in the absence of a partnership agreement the law requires equal shares). This is also true of LLC's, though the agreement among the members that determines how profits and losses are shared is called the *Operating Agreement*. The entries in the examples that follow are made for a partnership. They are the same entries that would be made for an LLC, except that a *Member Equity* account would be used for each owner instead of a *Capital* account.

1. ***Profit-and-loss sharing ratio.*** The partners may agree to share profits and losses in any *ratio* they wish. For example, suppose the ***P&L sharing ratio*** is 3-to-1 (written as 3:1) between partners A and B. To determine the fraction received by each, add the numbers in the ratio together (3+1=4) and then divide the sum into each of the numbers (3/4 and 1/4). In this case, Partner A receives 3/4 of the profit (or loss) and B receives 1/4.

2. An *allowance* may be granted for differences in the amounts invested made by each partner, or for the amount of time spent running the business (usually referred to as a salary allowance).

3. When allowances are used, the partnership's profit or loss amount must first be reduced by them (even if a negative remainder is left) before the remainder is divided in the P&L sharing ratio.

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Click the link below to play a video presentation that discusses the example below, and illustrates the division of profits and losses among the partners in a partnership.

Link to Profit and Loss Distribution Presentation

Example. Partners A and B agree to grant partner A a salary allowance of $10,000 (B receives no salary allowance) and to provide an interest allowance of 10% of their respective average capital balances. A's average capital balance is $200,000 and B's is $300,000. The remainder is shared in the P&L sharing ratio of 3:1 for A and B.

(a). If income = $70,000	Distributed To Partner A	Distributed To Partner B	Undistributed Profit
Profit to Distribute			$70,000
Salary Allowance	$10,000	0	(10,000)
Interest Allowance	20,000	$30,000	(50,000)
Remainder to Distribute			$10,000
Final Distribution (3:1)	7,500	2,500	(10,000)
Total	$37,500	$32,500	0

(b). If income = $30,000	Distributed To Partner A	Distributed To Partner B	Undistributed Profit
Profit to Distribute			$30,000
Salary Allowance	$10,000	0	(10,000)
Interest Allowance	20,000	$30,000	(50,000)
Remainder to Distribute			(30,000)
Final Distribution (3:1)	(22,500)	(7,500)	+30,000
Total	$7,500	$22,500	0

(c). If loss = ($10,000)	Distributed To Partner A	Distributed To Partner B	Undistributed Profit
Loss to Distribute			($10,000)
Salary Allowance	$10,000	0	(10,000)
Interest Allowance	20,000	$30,000	(50,000)
Remainder to Distribute			(70,000)
Final Distribution (3:1)	(52,500)	(17,500)	+70,000
Total	(22,500)	$12,500	0

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III. Advanced Topics Related to Partnerships and LLC's

A. ***Revaluation of Partnership Assets.*** When new partners are admitted to the partnership, or when existing partners leave the partnership, it is necessary to revalue the partnership's assets. This results in asset balances that are equal to estimated market value, and results in a fair accounting for ownership equity in the partnership. Any change in ownership equity that occurs as a result of the revaluation is divided between the partners in the P&L sharing ratio.

Example: Suppose A and B are partners who share profits and losses in the ratio of 3:1. If the partnership assets are revalued, and it is determined that the Equipment assets should be written up by $20,000, then an entry is made increasing the Equipment account and increasing A and B's Capital account balances by $15,000 (3/4 of $20,000) and $5,000 (1/4 of $20,000), respectively:

	Debit	Credit
Equipment	***20,000***	
A, Capital		***15,000***
B, Capital		***5,000***

B. ***Admission of New Partners***. New partners may be admitted to the partnership in several ways:

1. ***Purchase of an Interest from Present Partner***. Since this is done outside the business between the two parties, no business assets are received or lost. It is only necessary to record the change in ownership equity by reducing the present partner's *Capital* account balance and increasing the new partner's *Capital* account by the agreed-upon amount:

	Debit	Credit
Capital, Old Partner	***$X***	
Capital, New Partner		***$X***

2. ***New Partner Makes an Investment in the Business***.

a. No Bonus Paid. If no bonus is involved, the new partner's Capital account is increased by the fair market value of the assets invested. The present partner's accounts are unaffected:

	Debit	Credit
Cash (or other assets)	***$X***	
New Partner, Capital		***$X***

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C. ***Bonus Paid to Existing Partners.*** It may be that the new partner is so anxious to join the business that he or she is willing to pay the existing partners a ***bonus***. When this occurs, the new partner's *Capital* account is increased by less than the fair value of the assets invested, and the present partners' *Capital* accounts increase by the difference (the *bonus*). This is usually done in their P&L sharing ratio:

Cash (or other assets)	***$X***	
New Partner, Capital		***$X***
Old Partner, Capital		***$X***
Old Partner, Capital		***$X***

D. ***Bonus Paid to New Partner.*** It may be that the present partners are so anxious to have the new partner join the business that they are willing to pay the new partner a ***bonus***. When this occurs, the new partner's *Capital* account is increased by more than the fair value of the assets invested, and the present partners' *Capital* accounts are decreased by the difference (the *bonus*). This is, again, usually done in their P&L sharing ratio:

Cash (or other assets)	***$X***	
Old Partner, Capital	***$X***	
Old Partner, Capital	***$X***	
New Partner, Capital		***$X***

E. ***Withdrawal of Existing Partner.*** This may occur in several ways:

1. ***Present partner's purchase of an interest from an existing partner***. Since this is done outside the business, no business assets are received or lost. It is only necessary to record the change in ownership by reducing the withdrawing partner's *Capital* account balance and increasing the present (purchasing) partner's *Capital* account.

Capital, Withdrawing Partner	***$X***	
Capital, Purchasing Partner		***$X***

2. ***Withdrawing partner's interest purchased by the partnership***.

   a. ***No Bonus Paid.*** If no ***bonus*** is involved, the withdrawing partner's *Capital* account is decreased by the balance in the account and assets are decreased. The remaining partners' *Capital* accounts are unaffected:

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Capital, Withdrawing Partner	***$X***	
Cash (or other assets)		***$X***

b. ***Bonus paid by Withdrawing Partner.*** A bonus may be paid by withdrawing partner to the remaining partners. In this case, the withdrawing partner's *Capital* account balance is greater than the amount of assets taken out of the business by the withdrawing partner. The remaining partners' *Capital* accounts increase by the difference (the bonus). This is usually divided in their P&L sharing ratio:

Withdrawing Partner, Capital	***$X***	
Old Partner, Capital		***$X***
Old Partner, Capital		***$X***
Cash (or other assets)		***$X***

c. ***Bonus paid to Withdrawing Partner.*** A bonus may also be paid by the remaining partners to the withdrawing partner. In this case, the withdrawing partner's *Capital* account balance is less than the amount received; remaining partner's accounts decrease by the difference (the bonus) in their P&L sharing ratio:

Withdrawing Partner, Capital	***$X***	
Old Partner, Capital	***$X***	
Old Partner, Capital	***$X***	
Cash (or other assets)		***$X***

F. ***Final Liquidation of the Business***. When a partnership or an LLC goes out of business (called ***liquidating*** the business), it is first necessary to sell the business assets and pay any existing business debts. Any cash left in the business is then distributed to the partners. The business will now have reached the end of its life; there will be no account balances left open for the business.

1. Assuming sufficient cash exists to pay the business debts, the entry to record their retirement is:

Accounts Payable	***$X***	
Notes Payable	***$X***	
Cash		***$X***

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2. When the assets are sold, the amount of cash received may be either greater than or less than their book values. This will result in either a gain or a loss being recorded from their sale:

    Gain on Sale:

Cash	***$X***	
Assets		***$X***
Gain on Sale of Assets		***$X***

    Loss on Sale:

Cash	***$X***	
Loss on Sale of Assets	***$X***	
Assets		***$X***

3. The gain or loss must be distributed to the partners in their P&L sharing ratio:

    Gain on Sale:

Gain on Sale of Assets	***$X***	
Partner A, Capital		***$X***
Partner B, Capital		***$X***

    Loss on Sale:

Partner A, Capital	***$X***	
Partner B, Capital	***$X***	
Loss on Sale of Assets		***$X***

4. After the gain or loss is closed, there will only be one asset account with a balance, the Cash account, and the Capital account balances will be equal to it. The business cash can then be distributed to the partners according to the balances in their Capital accounts:

Partner A, Capital	***$X***	
Partner B, Capital	***$X***	
Cash		***$X***

    Following this entry, there will be no balances left in any of the business's accounts. The business will have ceased to exist.

5. A ***deficiency*** can occur if a partner's *Capital* account balance is not large enough to absorb his or her share of a loss. This produces a debit balance in that partner's *Capital* account. The partner is obligated to make up this *deficiency* by contributing cash to the partnership. If the partner is able to do this, then his or her *Capital* account balance will go to zero, and, because the deficiency has

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been made up, the remaining partners will be able to receive cash equal to their Capital account balances. If the *deficient partner* is unable to pay the cash to the business, the remaining partners are able to sue the deficient partner for their share of the deficiency.

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G. We have examined the accounting for partnerships in depth in the sections above. Corporation accounts and financial statement reporting will be examined in depth in the following module.

-END-

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