# Accounting for the Admissions and Retirements of Partners

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I

## INTRODUCTION

THE facility with which a partnership may be created gives an indication of why that form of business organization is so prevalent. The merest temporary desire is a force sufficient to bring a partnership into being. Though popular for this reason, and although sometimes highly successful, the partnership is notoriously unstable in character. A corporation is created only by the sovereign power of the state and it may be endowed with perpetual life. A partnership may be created merely by the mutual enthusiasms of two persons, but it may be dissolved by a variety of contingencies, and over some of these contingencies the partners have no control. It follows, therefore, that relatively the proprietorship in the partnership form of business organization is subject to change.

Whenever there is a change in the personnel of a partnership, there should be an accounting. Thus the manner of accounting for such changes comes within the particular province of the accountant. The primary object of the accountant is to record accurately, and in clear and orderly sequence the events which relate to a business enterprise. The purpose of this discussion will be to show how the facts concerning the admission and withdrawal of partners are embodied in the accounting records.

## THE LAW EXERTS ITS INFLUENCE ON PARTNERSHIP ACCOUNTING

A partnership is a business relationship based upon a contract. It follows from this that, when a partnership is formed, it must be formed with the consent of all of the partners. A person cannot be required to contract to become a partner against his will nor for any reason other than his own free choice. It further follows that a person cannot become a partner in any existing business organization if any member in the organization objects. Otherwise the objector would be required to be a partner of the objectionable person. The law recognizes the logic of this reasoning by denying the privileges of partnership to one who has acquired, without the assent of all partners, any rights or equities in the proprietorship of the enterprise. At common law, a sale or an attempted sale of a partner's interest to anyone not a member of the partnership dissolves the partnership. Liquidation of the business becomes mandatory, and the purchaser is entitled to whatever rights his transferor would have enjoyed upon liquidation. In such a case the other partners would have an action against the offending partner for having caused the interruption of a profitable business.

In those jurisdictions in which the uniform partnership act has been made a part of the law, the situation is modified somewhat. The partnership is not dissolved, but the assignee enjoys only his assignor's share of the profits. So long as the partnership continues, he will have no voice in the management and no right to inspect the books. He will not be allowed access to any confidential information and will not even have the right to an accounting in the usual course of business. He is entitled to an accounting in the event of dissolution, but otherwise his only right is to share the profits and the losses. Under no circumstances may he become a partner.

Similarly no partner has the right to withdraw from a partnership without the consent of all of the partners. To do so is to violate the partnership contract. He has the power to withdraw, but the arbitrary exercise of that power makes him liable to the other partners in damages sustained by them because of the termination of a profitable enterprise.

Any partner can of course withdraw from a partnership without penalty by the mutual agreement of all of the partners. The partnership agreement may and should make provision for the conditions of withdrawal or for expulsion. If a partner violates the partnership agreement, an offended partner has the right to dissolve the relationship. Death or the bankruptcy of any partner dissolves a partnership automatically. A court of equity will receive a petition and by decree will dissolve a partnership if a partner is shown to be of unsound mind or otherwise incapable in any way of performing his duties, or if his personal conduct is injurious to the business.

When a new partner joins an existing business, it cannot be said that he joins the former partnership. Although the old business may continue, the old partnership is dissolved. A new partnership has been formed to carry on the business of the former partners.

Frequently new partnerships are formed without the partners comprehending, in their ignorance, that a new contract has been made. The business goes on. It is exceedingly important at that point that a new partnership contract be drawn up, and that the contract shall recite the terms of the agreement in language which is unmistakeable. The contract made by the former partners has been terminated, either by mutual consent or otherwise. It is impossible for that contract to bind a new partner, for he was not a party to it; it cannot bind a former partner, because for him it has been terminated. It is conclusively presumed in law that the terms of the contract governing a former partnership do not carry over to the new one.

In the absence of a definite agreement, it may be necessary to resort to the law to construe an agreement. If the law is applied to construe a partnership agreement, in the absence of a definite showing that it was agreed to share profits otherwise, the law holds that profits are to be divided equally.

None of the terms of agreement of a former partnership can be introduced to prove the terms of a subsequent one. Consequently, profit-sharing ratios of a former partnership cannot be considered to influence in any respect the ratios of the partnership which was subsequently formed.

Definite agreements should be made also in respect of the capital interest of every partner. For example, an agreement that a partner shall be admitted to a one-quarter interest in the profits of the business upon his payment of $10,000 into the partnership is very apt to end in disagreement. The investor will contend that he is entitled to a capital interest in the amount of $10,000, but the other partners may contend that he has only a right to one-quarter of the profits and that he can enjoy no capital credit until and unless future profits are credited to his account or he makes capital contributions to the enterprise. The investor would insist that the entry to admit him should be—

| | | |
|---|---|---|
| Cash | $10,000 | |
| Investor's capital account | | $10,000 |
| To admit investor to a one-quarter interest in the business. | | |

The former partners on the other hand would contend that the entry should read—

| | | |
|---|---|---|
| Cash | $10,000 | |
| A, Capital | | $ 5,000 |
| B, Capital | | 5,000 |
| To record the receipt of the above amount from investor as payment for a share of one-quarter of the profits of the business. | | |

The last entry is to the effect that all of the investor's payment was distributed among the other partners as a bonus.

Frequently the withdrawal of one partner and the admission of another are simultaneous, or virtually so. One partner, who for some reason is about to withdraw from the business, will arrange to sell his rights, interests, and equities in the business to another. Inasmuch as the remaining partners have consented to admit the new member to the firm, the retiring partner may negotiate for the sale of his partnership interests to the newcomer. When a partner in a going business sells his interest to another, he assigns to the other whatever rights he has in the business. The legal effect of a contract of assignment is to transfer the rights of the assignor to the assignee. The assignee is said to stand in the shoes of the assignor. Whatever rights the assignor had the assignee takes, and whatever disabilities the assignor supported the assignee assumes. This contract would be strictly between the individuals who are parties to the assignment. The purchase price may be double the book value of the interest acquired or any other consideration. On the other hand the interest may be a gift from one to the other. Whatever the consideration, it is a matter to be determined strictly between the contracting parties. As a practical matter, however, it is highly improbable that, with the obstacles in the way of a free exchange of a partnership interest, the terms of the assignment will not be known to all of the partners. There may be a number of such assignment contracts. The newcomer may contract with each of the partners to buy fractional parts of interest.

### General Aspects of Changes in Personnel

A great number of different situations may arise to modify established partnership personnel, but of all the possible situations, any of them can be found to have something in common with some other situation, and thus can be classified. If a change in personnel occurs, manifestly there must be involved either the admission or the withdrawal of a partner. A method of accounting must be devised for any and every situation which may arise.

There is always a cause for any change in partnership personnel. Dissension and conflict between or among the partners may be the underlying reason for the withdrawal of a partner. The partnership relation is a trying one. It is a test not only of business ability, but of character. For a partnership to succeed, it is essential that the partners be mutually agreeable and that each must be willing to coöperate for the good of all. Another cause for withdrawal may be the incapacity of one of the members by reason of accident, or illness, or of advancing years. Or it may be a desire to enjoy the fruits of one's labors before advancing years diminish the prospect of their enjoyment. The death of one of the partners modifies the personnel of the partnership immediately.

A new partner may be admitted to a partnership by reason of the retirement of a former partner whose services must be substituted for the good of the enterprise. Or he may be admitted in order to supply needed additional capital to the business, or because of some faculty or aptitude among his personal qualifications.

There are two different and distinct ways in which a newcomer may join an existing business. First, he may invest additional capital in the enterprise itself or buy a proprietary interest from one of the owners of the business.

The making of an investment in the business is distinguished from the purchase of an interest by the fact that new assets are contributed to the business with a corresponding increase of the aggregate capital. In such a case the price which the newcomer pays, instead of going into the private funds of the partners, augments the assets of the business. The business is benefited by the value of the price of admission. The newcomer's capital account is not necessarily credited with that amount. The difference, however, is balanced by distributing it in one manner or another among the other partners, and all of it remains in the business. All of these facts are recorded in the books of account of the partnership after a new partner is admitted. The investor takes over proprietorship rights subject to the contract, by reason of his contribution to the common capital.

A person is said to acquire an interest in a business when he becomes the transferee of the equity of a proprietorship interest in the business. He takes certain rights in the business transferred to him by the person who formerly owned the rights. Any terms of a contract which describe these conditions will serve to transfer the rights of proprietorship.

Upon the transfer of an interest, the consideration paid is not reflected on the partnership books in any way whatever. The partnership was not a party to the contract. Thereafter the partnership books will show the former partner's capital account diminished by the amount of it which he assigned to the new partner, and on the books will appear a new capital account of a corresponding amount in the name of the new partner.

For the solution of hypothetical accounting problems, in the absence of a definite statement to the contrary, it is necessary to assume that the newcomer acquires his interest by buying ratable proportions of the interest of each partner. If he buys a one-quarter interest, each of the former partners transfers to the new partner a quarter of his former interest and in that manner a one-quarter interest in the entire partnership is allocated to the new partner.

If any number of the partners, fewer than all, are to surrender their interests or a portion of them, the facts must be stated. Such facts cannot be assumed. In real life, however, the accounting is always governed by the facts. One partner can sell all of his interest or only a portion of it. Any two or more can do likewise. All of them can transfer equal proportions of interest, or ratable proportions. They can transfer equal amounts, or arbitrary proportions, or arbitrary amounts. These matters are limited only by mutual agreement of the partners.

Whatever entries may be made upon the admission of a partner to modify or establish the capital accounts, they have no effect upon the profit-and-loss ratios of the partners. Not only have they no effect upon those ratios, but they give no indication of them and bear no relation to them. The entries serve only to fix the capital interests of the various partners; they relate to the shares of the partners in the net assets of the business. The profit-and-loss ratio is found only by reference to the partnership agreement. It is reflected in the books of account only when the ratios are applied to some profit, as when the profit-and-loss account is closed into the capital accounts at the end of an accounting period, or when a fixed asset has been sold at a profit or a loss.

Thus there are two methods by which a newcomer may join a business. If the newcomer buys over the entire interest of one or more of the former partners, the number of partners remains the same, or is decreased one or more as the case may be. Under all other circumstances it is increased by one.

A new partner can join the business either by contributing additional capital to the enterprise or by taking over portions of the capital credits of the former partners. Although such transactions as these constitute the formation of a new partnership, the books of account, which were used by the former partners, may be used also by the new partners as a matter of convenience. Naturally the old books give the full history of the values in possession of the new partnership. Upon any change in the partnership personnel, the books should be formally closed. That matter however is removed from the purposes of this discussion.

BUYING AN INTEREST FOR BOOK VALUE

Let it be assumed that D buys for $7,500 a one-quarter interest in a partnership, the capital accounts of which were as shown below:

| | A | B | C | D | Total |
|---|---|---|---|---|---|
| Old capital balances........... | $5,000 | $10,000 | $15,000 | $.... | $30,000 |
| ¼ of them transferred to D.... | 1,250 | 2,500 | 3,750 | ..... | ...... |
| New capital balances.......... | $3,750 | $ 7,500 | $11,250 | $7,500 | $30,000 |

One-quarter of the capital (at book value) of the partnership is $7,500, the exact amount which is being paid by D. Each partner transfers to D one-quarter of his former capital and receives from D the same value in cash.

Ordinarily in an actual situation the profit-and-loss ratios of the former partners would be the same in relation to each other as before. The new partner must be allocated 25 per cent of the profits and losses. The former partners would probably share in the remaining 75 per cent in the same ratios in which they shared the entire profits formerly. Nevertheless, the ratios would need to be determined by the new agreement, in the absence of which profits and losses would be shared equally.

There is only one entry required to record the admission of D. It is:

| | | |
|---|---|---|
| A, Capital........... | $1,250 | |
| B, Capital........... | 2,500 | |
| C, Capital........... | 3,750 | |
| D, Capital....... | | $7,500 |

The hypothetical problem states that D purchased the interest for cash at book value. Under actual conditions it would never be known from the books whether he paid the book value or not, or whether or not he paid anything.

It is sometimes agreed that after the admission of a new partner, all of the partners' capital accounts shall be adjusted to equality, or to some other relation to each other. The entries required to reflect adjustment to equality will be shown in connection with another situation later. Its demonstration is delayed because the later illustration involves some additional conditions and the matter is best discussed in a single problem.

Under a contract by the terms of which partners are required to adjust their capital accounts to equality, the profit-and-loss ratios may also be adjusted to equality under actual conditions. Hypothetical problems do not mention the subsequent profit-and-loss ratios, knowledge of such facts not usually being necessary in order to arrive at a solution.

### Buying an Interest for a Payment in Excess of Book Value

*First Method*

One method of admitting a partner who has bought an interest for more than book value is to ignore the excess values. For instance, the capital accounts of a partnership were: A, $5,000, B, $10,000, C, $15,000. D buys a one-quarter interest in the business for $10,000.

The combined capital of the partnership before the admission of D is $30,000. Since there is no investment in the partnership being made, the capital will remain at $30,000 after D's admission. One-quarter of $30,000 is $7,500. The problem states that D is to have a one-quarter interest in the business. He therefore acquires a one-quarter interest in both the net assets and the profits.

| | A | B | C | D | Total |
|---|---|---|---|---|---|
| Old capital balances | $5,000 | $10,000 | $15,000 | $...... | $30,000 |

| | |
|---|---|
| Book value of one-quarter of the business | $ 7,500 |
| Price paid for one-quarter of the business | 10,000 |
| Profit to old partners on sale of one-quarter of the business (payment by D for excess values) | $ 2,500 |

Distribution of the profit if profits of the former partnership had been divided equally:

| | A | B | C | | |
|---|---|---|---|---|---|
| ⅓ of $2,500 | $ 833 | $ 833 | $ 834 | $...... | 2,500 |

However, there are no entries in the partnership books to reflect the passing of the $2,500 from D to the other partners. The only entry appearing upon the partnership books is one to transfer the share in the proprietorship surrendered by each of them to D. D has purchased a one-quarter interest which means that he has a one-quarter interest in the capital of the partnership. Unless otherwise agreed, each of the partners must transfer to him one-quarter of his interest.

| | | |
|---|---|---|
| ¼ of A, Capital of | $ 5,000 = | $1,250 |
| ¼ of B, Capital of | 10,000 = | 2,500 |
| ¼ of C, Capital of | 15,000 = | 3,750 |
| | | $7,500 |

The entry to record on the partnership books the transfers of the interests of the former partners to the new partner is the same as that shown where the purchase price coincided with book value. Transfers of capital credits and capital balances are the same. The difference is that in this illustration the former partners, as individuals, have each pocketed $833 more than in the previous illustration. The books, however, will not reveal it.

The purchase price of $10,000 paid by D may be considered to be divisible into two component parts, namely: the portion of it which represents the book value of his acquisition ($7,500); and the excess paid over and above that amount ($2,500). The two component parts may be, and probably will be in the great majority of instances, divided among the former partners in two entirely different ratios. That portion which represents the book value will be distributed among them in their capital ratios; and that portion which represents the excess will be distributed in the profit-and-loss ratio. The journal entry and the capital accounts reflect the distribution of the portion representing the book value. The entry transfers different amounts from the capital accounts of the former partners to the capital account of the new partner. It must not be overlooked, however, that for the amount surrendered by each, compensation was received in cash (according to the express terms of this hypothetical problem) in that amount.

The entries reflect the division of that portion of D's payment which represented the book value. That portion which represented the excess was divided privately and in different ratios. The only conditions under which the amount surrendered by each partner would be in the same ratio as the ratio of the excess received, would be if the capital ratios and the profit-and-loss ratios were the same. The following table shows the same ratios for capital and profits:

| | Capitals | Capital ratios | Profit-sharing percentages | Profit-sharing ratios |
|---|---|---|---|---|
| A, Capital | $ 5,000 | 1 | $16\frac{2}{3}$ | 1 |
| B, Capital | 10,000 | 2 | $33\frac{1}{3}$ | 2 |
| C, Capital | 15,000 | 3 | 50 | 3 |
| | $30,000 | 6 | 100 | 6 |

Conservatism on the part of the management is usually the controlling influence resulting in the failure to record the excess values on the books, rather than a desire to conceal the actual cost to the new partner. The new partner suffers a disadvantage by the use of this method to the extent that his cost exceeds the credit to his capital account. The apparent disadvantage would become real, in the event of dissolution, or in the event of the retirement or death of the new partner, and the potential disability is forever present.

### *Variations in Values Placed Upon a Partnership*

Every business is continuously exposed to an infinite variety of economic vicissitudes. Yet the values of the assets, liabilities, and net-worth items after once having been recorded on the books of account remain as a fixed and permanent record in the usual course of business affairs. There are some exceptions. Inventories valued at the lower of cost or market do not reflect the book value of the inventories but this is an accounting device leaning toward conservatism. The writing up of assets to appraised values may sometimes also be justified from an accounting standpoint. Otherwise, book recordings ordinarily are not altered to reflect the changes in the productive value of the business nor in the market values of any of the assets. If recorded values were changed whenever real values changed, changes would be necessary every day, perhaps every moment. External forces over which the business has no control, are continuously operating to modify its values. The value of money, the threat of war, the stage of the business cycle, the foreign trade situation; any of these or all of them and many more conditions will have their effect upon the true worth of the business. It must be evident then that book values do not invariably coincide with real values. Such a disparity can conceivably exist at the time of the admission of a new partner.

One does not buy into a business as he would buy a sweepstakes ticket. Before deciding to invest his money in any business—much less in a partnership—an ordinarily prudent person would make extensive investigations. He should send in his auditors to report on the conditions of the business. He should confer with his lawyer to the same end and with his banker, and his economist. In brief, he should determine as nearly as possible the actual value of the business. So the price which an investor pays to join a business, when considered in relation to all of the other terms of the purchase contract, is likely to represent very nearly the actual value of that business. A retiring partner, because of his past association with the business, is in a highly favorable position to arrive at the actual value of the business.

If a share of proprietorship is actually worth more than book value, the excess value may be due to two causes: either the assets booked are worth more than the books indicate; or the earning power of the business is greater than a fair return on the invested capital. In the first instance there may be secret reserves. The second cause indicates the existence of goodwill. Some of the more common examples of asset values in excess of values shown on the books may be found in inventories, the market value of which is greater than cost; appreciation in the market value of real estate owned; fixed assets depreciated on the books at a higher rate than actually depreciated; or goodwill, present but never booked.

Whether or not the excess values are recorded on the books, the values themselves cannot be denied. When a newcomer buys an interest the excess (or bonus) paid by the newcomer represents payment for values in excess of book values and whether or not they are booked the proceeds belong in the private funds of the transferor or the transferors, as the case may be.

### Purchase of an Interest for a Payment in Excess of Book Value

*Second Method*

Let it be assumed first for the sake of illustration that under the facts given in the preceding case the excess value paid for by D represented tangible asset values not reflected in the accounts. An entry may be passed to bring the book values up to actual values, thus:

| | | |
|---|---|---|
| Tangible assets (segregated) ....... | $10,000 | |
| A, Capital ...... | | $3,333 |
| B, Capital ...... | | 3,333 |
| C, Capital ...... | | 3,334 |

Now let it be assumed that the excess represented intangible asset values not in the accounts. The entry would be:

*Third Method*

| | | |
|---|---|---|
| Goodwill (or other intangibles) ........ | $10,000 | |
| A, Capital ...... | | $3,333 |
| B, Capital ...... | | 3,333 |
| C, Capital ...... | | 3,334 |

The second and third methods reflect the assumption in the books of account that D's purchase has put a value of $10,000 on one-quarter of the business of the former partners. Therefore the entire excess over book value of that business is $10,000, computed as follows:

| | | |
|---|---|---|
| Value of business prior to D's admission ................ | | $30,000 |
| Price paid by D for ¼ of $30,000 (book value $7,500) ..... | $10,000 | |
| Value of business on basis of D's payment (4 × $10,000).... | | 40,000 |
| Excess of determined value over book value .............. | | $10,000 |

It is intended to carry this excess over book value into the accounts of the new partnership. It is a profit to the former partners and is therefore divided among them in the profit sharing ratio which was in force among the former partners at the time D agreed to buy the interest. For convenience it is assumed that they shared profits equally. Each partner's capital account has been increased about $3,333 by the distribution of goodwill and the total assets have been increased by $10,000. As before, each partner transfers to D's capital account ¼ of his capital and D is admitted.

| | A | B | C | D | Total |
|---|---|---|---|---|---|
| Original balances | $5,000 | $10,000 | $15,000 | $ ..... | $30,000 |
| Distribution of excess | 3,333 | 3,333 | 3,334 | ...... | 10,000 |
| Total | $8,333 | $13,333 | $18,334 | $ ..... | $40,000 |
| Transfers to D (¼) | 2,083 | 3,333 | 4,584 | 10,000 | |
| New balances | $6,250 | $10,000 | $13,750 | $10,000 | $40,000 |

By this method D's capital account shows a credit to him of the amount of his contribution. The entry to admit him is:

| | | |
|---|---|---|
| A, Capital | $2,083 | |
| B, Capital | 3,333 | |
| C, Capital | 4,584 | |
| D, Capital | | $10,000 |
| To admit D to a one-quarter interest. | | |

In all three of the preceding methods, it could have been agreed that all of the capital accounts should be equalized.

In the second and third methods book entries were passed as a result of the payment of the new partner. Nevertheless, no entry was made to reflect his actual payment, but the entries which were made were calculated from the amount paid by him.

It will be observed that where the excess values are ignored, the result is different from the result obtained when they are recognized. The assets of the partnership are different as well as the capital accounts of the partners. When the excess values were not set up, the net assets of the partnership amounted to $30,000, and when they were set up, the net assets amounted to $40,000. That in itself is not particularly objectionable from the point of view of the partners because, practically, there is little choice between owning a one-quarter interest in a business valued at $30,000 without the excess values and in owning a one-quarter interest in a business valued at $40,000 which includes $10,000 of assets arbitrarily written up. But what about the interested outside parties? It might be assumed that if only the goodwill has been written up a reader of the balance-sheet would be put on notice to inquire into the value of the goodwill. Perhaps he would. But what clue would he have to the write-up if the write-up had been applied to tangible assets? More about these methods of accounting will be discussed subsequently.

### Buying an Interest for a Payment Less Than Book Value

Up to this point consideration has been given to methods of accounting for the admission of a partner when the newcomer was convinced that the actual value of the business exactly equalled, or exceeded book value. It can conceivably be that book value is in excess of actual value.

The business may have passed through a cycle of diminished returns. A capitalization of its earnings after such an experience might show a value less than book value. Under such circumstances a new partner would pay only for actual value. The excess of book value over actual value would represent a loss to the former partners.

Even in the midst of prosperity, the value of a business can suddenly decline. The active manager may suddenly die or become incapacitated or otherwise terminate his affiliation with the enterprise. This would leave the business without motive power. The prospect of continued earnings would then become materially impaired with a resultant loss of value. If the manager were a partner, matters would be even worse. Book value would be unaltered but immaterial in the opinion of a prospective purchaser. Such a condition in a partnership would represent a loss to the old partners. They should have taken steps to minimize the severity of such a contingency.

Upon the death of a partner, the books should be immediately closed. The deceased partner's estate has an equity in the business measured by the post-closing balance of his capital account. If there has been no provision made by prior agreement as to the disposition of a partner's interest at death, settlement must be made with the estate of the decedent at once. If there are no available funds, the situation is grave. It may become desperate because liquidation of the business may become mandatory in order to make the settlement. Under such circumstances a new partner is desperately needed; one who will supply funds that the business may continue. If the old partners are fortunate enough to find someone with liquid funds who would be willing to buy into the business, and join it as a partner, the new partner would probably in the emergency have an opportunity to buy in at less than book value. Such a state of affairs represents a loss to the former partners. They could have anticipated the emergency of death and could have provided for it. Having neglected to provide for it they suffer a loss. The loss must be distributed to the surviving former partners in their loss-sharing ratios in the former partnership.

Under these circumstances, the new partner could perhaps join the business by buying the interest formerly held by the deceased. If his cost were less than the book value, the remaining partners would be required to make up the deficiency to pay off the estate. But it may be considered that the loss to be distributed to the surviving former partners is not limited to the excess of the book value of the new partner's share over the value of his contribution. The loss is represented by that excess multiplied by the ratio which the total capital of the new firm bears to the new partner's interest in it. The price he paid puts a value upon his share. The entire business must be revalued by that standard.

The accounting for losses such as these will be shown in the next illustration to be given.

*First Method*

D buys a one-quarter interest in the business for $5,000.

This method assumes that the price paid by D for a one-quarter interest properly places a value of $5,000 on one-quarter of the capital. That being the case, the total capital which was valued at $30,000 was overstated. The correct value is admitted to be $20,000 computed by multiplying by four the price of $5,000 paid by D for one-quarter of it.

The difference between the book value of $30,000 and the actual value of $20,000 represents a loss to the former partners in the amount of $10,000 which they must bear among themselves in their loss-sharing ratios. Each of them must take up $3,333, but they make this adjustment privately among themselves because it is intended that the total book value of the partnership shall be $30,000. The following schedule shows how the adjustment should be made among them:

| | A | B | C | Total |
|---|---|---|---|---|
| Original capital balances | $5,000 | $10,000 | $15,000 | $30,000 |
| Loss indicated by sale to D | 3,333 | 3,333 | 3,333 | 10,000 |
| Provisional capital values | $1,667 | $ 6,667 | $11,667 | $20,000 |
| Distribution of D's payment | $ .... | $ ..... | $ ..... | $ 5,000 |
| To A— 1,667/20,000 of 5,000 | 417 | ...... | ...... | ...... |
| To B— 6,667/20,000 of 5,000 | ..... | 1,667 | ...... | ...... |
| To C—11,667/20,000 of 5,000 | ..... | ...... | 2,916 | ...... |
| Amounts appropriated by partners | $ 417 | $ 1,667 | $ 2,916 | $ 5,000 |

In other words, the distribution among the former partners of the $5,000 paid by D is made according to the capital ratios because capital is being distributed to D in exchange for the payment.

At this point D is hypothetically admitted to the partnership the value of which is $20,000, by reason of his payment of $5,000. But it is intended that the books should show a total capital of $30,000. An increase in book value represents a profit. The difference between the provisional $20,000 value of the business and the book value of $30,000, or $10,000, is a profit to all of the partners. D shares in this profit as well as A, B, and C. Its distribution reëstablishes each partner in the position he would have occupied if each former partner had transferred to the new partner one-quarter of his original capital balance. The manner of transfer is computed as follows:

| | A | B | C | D | Total |
|---|---|---|---|---|---|
| Provisional capital values | $1,667 | $ 6,667 | $11,667 | $ ..... | $20,000 |
| Transfers to D | 417 | 1,667 | 2,917 | 5,000 | ...... |
| Provisional balance | $1,250 | $ 5,000 | $ 8,750 | $ 5,000 | $20,000 |
| Distribution of increase in book value | 2,500 | 2,500 | 2,500 | 2,500 | 10,000 |
| New capital balances | $3,750 | $ 7,500 | $11,250 | $ 7,500 | $30,000 |
| Original capital balances | 5,000 | 10,000 | 15,000 | ...... | 30,000 |
| Journal entry | $1,250 | $ 2,500 | $ 3,750 | $ 7,500 | $30,000 |

The journal entry is the same as the entry to transfer an interest at book value. It is

| | | |
|---|---|---|
| A, Capital | $1,250 | |
| B, Capital | 2,500 | |
| C, Capital | 3,750 | |
| D, Capital | | $7,500 |

This method provides a bonus to the new partner. And in connection with this problem it must be observed that the distribution of the excess of book value over agreed value would have the same effect as transferring one-quarter of the original capital only if the loss-sharing ratios of the former partners are identical with the profit-sharing ratios. If they were different the parity would not be re-established among them.

After this point has been reached, the accounts may be equalized.

The retention of the $30,000 book value is not necessarily a falsification of the facts. The retention conforms with the accepted accounting principle that book values are understood to represent "going concern" values of a business. It is not contemplated that they shall be changed to coincide with varying economic causes. They are the values which were used to operate the business before the new partner's entry and they furnish a convenient basis upon which the operation of the same business may still be continued. Indeed, it would be a tremendous and useless task to revalue all of the assets upon some selected basis other than book value, only to have their relative value change even while it was being established. At some time during the future life of the business the book value may exceed the real value.

Even if the loss of actual value of the business had been caused by failure of earnings, still the earning capacity may become improved; and if it improved to its former position, the assets would then be undervalued if they had been written down. The accepted accounting principle is that asset values should neither be written up nor written down to conform with varying economic changes. If an attempt were made to write down the asset values to agree with the earning power, a practically insurmountable obstacle would have been presented in deciding what assets were to be devalued and to what degree.

*Second Method*

D buys a one-quarter interest in the business for $5,000.

On the other hand, there are circumstances in which it is definitely known that certain of the assets are overvalued. In such circumstances the writing down of asset values truly reflects the facts. If goodwill, for example, appeared among the assets of the former partnership, it would seem almost certain that if a newcomer paid less than book value the goodwill, at least to the extent of the deficiency, was worthless. Insufficient charges to depreciation in prior years may indicate a degree of overvaluation in some of the fixed assets, or previous arbitrary write-ups of assets would show what assets should be written down. Accounts receivable may be known to be overvalued and inventories may have been improperly valued. Investments carried at cost may be worth much less than their cost at current values.

The accounting for these and similar facts is as follows:

| | | |
|---|---|---|
| A, Capital | $3,334 | |
| B, Capital | 3,333 | |
| C, Capital | 3,333 | |
| Assets (segregated) | | $10,000 |

To write down the value of the assets to actual value and distribute the loss of book value to the three partners in their loss-sharing ratio.

| | | |
|---|---|---|
| A, Capital | 416 | |
| B, Capital | 1,667 | |
| C, Capital | 2,917 | |
| D, Capital | | 5,000 |

To admit D to a one-quarter interest in the business, each partner transferring to D one-quarter of his capital balance.

RECAPITULATION

| | A | B | C | D | Total |
|---|---|---|---|---|---|
| Old capital balances......... | $5,000 | $10,000 | $15,000 | $.... | $30,000 |
| Capital debits.............. | 3,334 | 3,333 | 3,333 | ..... | 10,000 |
| Adjusted balances.......... | $1,666 | $ 6,667 | $11,666 | $.... | $20,000 |
| Transfers to D (¼)......... | 416 | 1,667 | 2,917 | 5,000 | ...... |
| New capital balances........ | $1,250 | $ 5,000 | $ 8,749 | $5,000 | $20,000 |

This method is based upon the hypothesis that a one-quarter interest in the business is worth only $5,000. The use of this method presupposes that the book values had been improperly computed. An audit of the books shows that the correctly computed book value of the net assets is $20,000. The business, instead of being worth $30,000 as indicated by its unaudited books, is actually worth only $20,000. The first entry therefore is made to correct the asset values so that they reflect actual value on the books. Thereafter the book value shows only $20,000. Necessarily there is a loss to the partners involved which must be taken up by them before D is admitted. After the entry is posted, however, the books show the actual value as measured by D's purchase, which means that D then buys an interest at book value. The accounting for the purchase of an interest at book value was previously shown.

It was assumed in the last entry shown that, in order to make up D's capital account, each former partner contributed one-quarter of his remaining balance after the loss had been distributed. As a matter of fact, the former partners could have contributed any amounts arbitrarily agreed to among themselves. Since D was paying book value at this point, presumably no former partner would have contributed to D's capital account except as he received that exact amount taken from the $5,000 price paid by D. Following that distribution, the partners could also have equalized their accounts by exchanges of cash among themselves, and off the record, or in any arbitrary manner agreed to.

*Third Method*

D buys a one-quarter interest in the business for $5,000.

Sometimes when a new individual joins an old business, it has the effect of a blood transfusion upon a dying man. The newcomer may be entirely new to the industry he is entering, and yet possess a type of business acumen or perhaps some specialized knowledge or faculty which will raise the business from the depths of despair. Following the admission of such an individual, the business doubtlessly possesses an intangible something which was previously lacking and which the new member supplied. That something may be referred to as goodwill, and unquestionably becomes an asset of the new business. It cannot be said that the knowledge, or the faculty, is thereafter exclusively of benefit to the individual who contributed it. Manifestly the business with which he has joined will share in the benefits which his talent will bestow, and which was his contribution as a newcomer. The new member need not be an intellectual giant nor an industrial genius. He may be a former competitor who has demonstrated certain abilities which will bring prosperity to the business.

When such a person joins a business, he joins it upon the best terms he is able to negotiate for himself and he sells his services at the highest price he can get for them. The old business naturally is willing to make concessions to him in order to induce him to join it. If he is given a portion of the net worth of the business in recognition of such anticipated benefit, it can only come from the capital accounts of the other partners. It is reasonable to consider that the asset thus paid for by the former owners is goodwill, and that it is a value present in the business. Other assets of the business were exchanged for it. It may therefore properly be reflected on the books.

| | A | B | C | D | Total |
|---|---|---|---|---|---|
| Old capital balances........ | $5,000 | $10,000 | $15,000 | $ .... | $30,000 |
| Value of one-quarter........ | 1,250 | 2,500 | 3,750 | .... | 7,500 |
| Cash payment of D......... | ..... | ..... | ..... | 5,000 | (5,000) |
| Goodwill contributed by D... | ..... | ..... | ..... | 2,500 | (2,500) |
| New capital balances........ | $3,750 | $ 7,500 | $11,250 | $7,500 | $30,000 |

The journal entry to admit D is the same as would be passed if D had bought in at book value for cash.

The goodwill purchased is considered to be the purchase of a capital asset and therefore is not distributed among the partners as a loss would be. So the new member is really paying book value for his interest in the business. He pays the book value partly in cash and partly in goodwill. Of course, inasmuch as no portion of the price paid by him appears on the books, the goodwill does not appear on the books.

### Making an Investment by a Contribution Equal to Book Value

Suppose now that D invested $10,000 in the partnership the capital accounts of which were as shown below, and that he becomes a one-quarter partner in the business.

| | A | B | C | D | Total |
|---|---|---|---|---|---|
| Old capital balances.......... | $5,000 | $10,000 | $15,000 | $...... | $30,000 |
| D's investment (1/3 of $30,000).. | ..... | ...... | ...... | 10,000 | 10,000 |
| New capital balances.......... | $5,000 | $10,000 | $15,000 | $10,000 | $40,000 |

When a person makes an investment in a partnership business, the price paid for his admission is his contribution to the assets of the former partnership. The new partner's contributed assets are combined with and included among the assets of the new partnership. It is a situation strictly different from the situation in which a person buys the interest of a former partner. In the latter situation none of the arrangements for the purchase or sale of the interest is reflected on the books of account; in the former, all of them are. When a person buys an interest, naturally his share is computed on the basis of the capital of the former partnership because the total capital of the new partnership will remain the same as was the total capital of the former partnership. Not so when an investment is made because the capital of the new partnership will be greater by the amount of the newcomer's contribution. Accordingly, whenever an investment is being made in a partnership the interest of the new partner must be computed on the basis of the total capital *after* his contribution has been made. In this illustration, the total capital of the three partners before D's entry was $30,000. D's investment of $10,000 increased the total capital to $40,000. The new partner's one-quarter must be computed as one-quarter of $40,000 because after the new partnership has been formed he is to have a one-quarter interest in it. The value of the total net worth of the former partnership was $30,000 and there were three partners. The value of the fractional one-third then was $10,000. After D had invested $10,000 in the business, there were four partners and the value of the fractional one-fourth was also $10,000, even though three of the fractional shares were distributed among three of the partners unequally. The total net worth was then increased to $40,000.

One simple journal entry is all that need be passed through the books to record D's admission. It is:

| | | |
|---|---|---|
| Cash (or other assets) | $10,000 | |
| D, Capital..... | | $10,000 |

In order to make as clear a distinction as possible between buying an interest and making an investment, it has been assumed in this illustration that the price paid by the incoming partner for the property he received was exactly book value. Under actual conditions the book value and the real value would very rarely coincide.

### Making an Investment by a Contribution in Excess of Book Value

The assets of a business are increased by the investment of an incoming partner whose capital credit may or may not be the amount of his contribution. It has already been demonstrated that the newcomer's payment for another's interest is not necessarily reflected in his capital account. Likewise when the newcomer makes an investment, the value of his investment does not necessarily reflect his capital interest in the business. A portion of his payment may represent a bonus to the old partners, or the newcomer may enjoy a bonus. Nevertheless when an investment is being made, whatever the adjustments among the partners may be, those adjustments will be reflected upon the books. In the following illustration the old partners receive a bonus. D makes an investment of $15,000 in the partnership for a one-quarter interest.

*First Method*

| | Former partnership | New partnership | |
|---|---|---|---|
| A, Capital.............................. | $ 5,000 | | |
| B, Capital.............................. | 10,000 | | |
| C, Capital.............................. | 15,000 | | |
| Total of former partnership......... | | $30,000 | |
| D's investment.................... | | 15,000 | $15,000 |
| Total net worth of new partnership... | | $45,000 | |
| One-quarter of total................ | | $11,250 | 11,250 |
| Excess over book value paid by D.... | | | $ 3,750 |
| One-third of excess to each old partner | | | $ 1,250 |

D's interest must be computed based on the value of the total assets after he has added his assets to those of the former partnership. He must therefore be allocated a capital interest in the amount of $11,250; that is, one-quarter of the total net worth of the new partnership. The total net worth will be

$45,000. The excess of his payment over the value of that one-quarter will represent a bonus to the old partners. Such a bonus is a payment for some excess value, tangible or intangible, whether or not the asset accounts are revised to reflect it.

The excess over book value paid by D is divided among the three former partners in their profit-sharing ratio. It is a profit to them because they created it in prior periods. In the absence of an agreement, they must divide it equally.

The pro-rata share of each partner in this profit must be credited to his capital account. When a new partner buys an interest, the former partners may appropriate their shares of the purchase price. The values of the appropriated amounts never are reflected among the partnership assets. But when a new partner enters a business by making an investment, the former partners must leave among the assets of the new partnership their profits on the transaction. If they took them out, the total assets of the partnership would be decreased by the amounts withdrawn, so that the new partner's capital account would show less than the agreed ratio. In the example given, if the former partners withdrew the excess over book value, the total assets of the partnership then would be $45,000 minus $3,750 or $41,250. D's share is to be one-quarter. One-quarter of $41,250 is $10,312.50, whereas D's capital account should show $11,250.

But there must be passed a credit to the capital account of each former partner in the amount of his share of the profit on the transaction. Each partner must be credited regardless of the status of his account. Whether he has a credit balance in his account or whether he has a debit balance is immaterial.

A partner need have no capital whatever in the business in order to be entitled to share in a profit; and his right in respect to the profit on this transaction is not different from his right to share in operating profits.

To record these facts on the books only one compound journal entry need be passed. It is:

| | | |
|---|---|---|
| Cash (or other assets) | $15,000 | |
| D, Capital | | $11,250 |
| A, Capital | | 1,250 |
| B, Capital | | 1,250 |
| C, Capital | | 1,250 |

Summary

| | A | B | C | D | Total |
|---|---|---|---|---|---|
| Old capital balances | $5,000 | $10,000 | $15,000 | $ ..... | $30,000 |
| D's investment | ...... | ....... | ....... | 15,000 | 15,000 |
| Distribution of investment | 1,250 | 1,250 | 1,250 | $11,250 | $45,000 |
| New capital balances | $6,250 | $11,250 | $16,250 | $11,250 | $45,000 |

Thus D's contribution is added to the assets of the business. But D does not receive credit in his capital account in the amount he contributed. A portion of his contribution has been absorbed as a profit, or bonus to the former partners and is reflected as additions to their capitals. No goodwill has been set up.

*Second Method*

D makes an investment of $15,000 in the partnership for a one-quarter interest.

When it is decided to set up goodwill, the entries may appear like this:

| | | |
|---|---|---|
| Goodwill | $15,000 | |
| A, Capital | | $5,000 |
| B, Capital | | 5,000 |
| C, Capital | | 5,000 |
| To set up goodwill upon the books and to distribute the value of it among the former partners in their profit-sharing ratio. | | |

This entry is followed by the entry recording the admission of D, which is:

| | | |
|---|---|---|
| Cash (or other assets) | $15,000 | |
| D, Capital | | $15,000 |

The amount and value of goodwill is computed as follows:

| | | |
|---|---|---|
| Original capital of three partners | $30,000 | |
| Fractional value of an undivided one-third | | $10,000 |
| Contribution of D for parity with fractional shares | | 15,000 |
| Excess of D's contribution over value of undivided 1/3 | | 5,000 |
| Excess value of three-thirds as represented by D's investment | | $15,000 |

The excess of D's contribution represents the additional value of each undivided one-third as determined by his investment. D was convinced that an undivided one-third interest in the business was actually worth $15,000. The book value is only $10,000. If each one-third has an excess of $5,000 over book value, the entire excess value was $15,000 more than book value. This excess is now brought upon the books and included among the assets as an intangible goodwill. The recording of the asset goodwill represents a profit and is distributed among the original partners in their profit-sharing ratio.

After the entry has been made setting up the goodwill and distributing its value among the former partners, the entry admitting D may be passed so as to cause his capital account to represent his actual contribution.

The amount of goodwill to be brought upon the books was arrived at in this problem in a slightly different manner than it was in the case of the purchase of an interest. When an interest is sold and the entire goodwill is set up, the excess value of each fractional share as determined by the price paid by the new partner, is set up as goodwill. The goodwill applicable to the share of the new partner as well as to the shares of the old partners is set up. In the problem illustrating the purchase of an interest, the excess over each fractional share amounted to $2,500 and that amount was multiplied by the total number of partners, old and new, or by four, in order to arrive at the amount of goodwill to be set up. In the last illustration, in which the problem stated that an investment had been made, the excess over each fractional share amounted to $5,000. That amount was multiplied by only the number of former partners, or by three, in order to arrive at the amount of goodwill to be set up.

The reason for the difference in the manner of arriving at the two results is that in the latter case the incoming partner is contributing his share entirely in tangible assets to the extent of one-quarter of the total new capital. Consequently the fraction of his contribution representing the excess over book value cannot be expressed as an intangible asset for the very good reason that he has contributed to the partnership this excess in tangible assets. On the other hand, the aggregate capitals of the three former partners, in order to be three times that of the new partner, must be increased by placing upon the books the intangible asset goodwill in the amount of $15,000 and dividing it among them.

SUMMARY

| | A | B | C | D | Total |
|---|---|---|---|---|---|
| Old capital balances.......... | $ 5,000 | $10,000 | $15,000 | $...... | $30,000 |
| Goodwill established......... | 5,000 | 5,000 | 5,000 | ....... | 15,000 |
| Balances before D's admission. | $10,000 | $15,000 | $20,000 | $...... | $45,000 |
| D's Investment............. | ....... | ....... | ....... | 15,000 | 15,000 |
| New capital balances......... | $10,000 | $15,000 | $20,000 | $15,000 | $60,000 |

The total assets are now $60,000 and D has a one-quarter interest in them. When goodwill was not set up the total assets were $45,000 and D had a one-quarter interest.

It should be observed, however, that although D's capital ratio is the same in both situations, the ratios of the other partners are different. If goodwill is set up, the former partners' ratios in relation to D are different from what they are if goodwill is not set up, and they are also different from each other.

| | A | B | C | D |
|---|---|---|---|---|
| Capitals—no goodwill set up......... | $ 6,250 | $11,250 | $16,250 | $11,250 |
| Capital ratios.................. | 13.89% | 25% | 36.11% | 25% |
| Capitals—when goodwill was set up... | $10,000 | $15,000 | $20,000 | $15,000 |
| Capital ratios................. | 16.67% | 25% | 33.33% | 25% |

The capital accounts of all partners can be equalized if agreed but they must be equalized privately among them.

The example just given has the advantage of reflecting in D's capital account the actual amount invested by him in the partnership, and explains the reason for the preference frequently given to this treatment. The treatment seems to show hardly less restraint in the matter of setting up goodwill than does the treatment when goodwill is set up upon the purchase of an interest. In neither instance has all of the goodwill set up been paid for. Yet goodwill cannot be brought upon the books otherwise.

*Third Method*

Instead of having been represented by goodwill, the excess value paid for by D might have been represented by tangible assets. Real estate owned by the business might have appreciated in value; inventories at market might be higher than cost; secret reserves might have been created by one means or another. Under these circumstances the assets might be written up to their full actual values and the excesses would be divided among the former partners as a profit, in some such manner as the following:

| | | |
|---|---|---|
| Assets (segregated) | $15,000 | |
| A, Capital | | $ 5,000 |
| B, Capital | | 5,000 |
| C, Capital | | 5,000 |
| (Explanation) To increase the book values of the above assets to represent their market values. | | |
| Then the following entry admits D. | | |
| Cash (or other assets) | $15,000 | |
| D, Capital | | 15,000 |

The amounts used are assumed to be the same as those used in the illustration next preceding in which goodwill was divided among the former partners. The computations are all identical and it is considered unnecessary to repeat them and the explanations applying to them. The method also is subject to criticism similar to that applicable to the preceding method.

### Making an Investment by a Contribution Less Than Book Value

#### *First Method*

D makes an investment of $5,000 for a one-quarter interest in the business. The following method is used when the agreement has provided that a bonus shall be allowed to the new partner.

Summary

| | A | B | C | D | Total |
|---|---|---|---|---|---|
| Old capital balances | $ 5,000 | $10,000 | $15,000 | $..... | $30,000 |
| Transfers to D | (1,250) | (1,250) | (1,250) | 3,750 | ....... |
| D's cash contribution | ....... | ....... | ....... | 5,000 | 5,000 |
| New capital balances | $ 3,750 | $ 8,750 | $13,750 | $8,750 | $35,000 |

The journal entry required is:

| | | |
|---|---|---|
| Cash | $5,000 | |
| A, Capital | 1,250 | |
| B, Capital | 1,250 | |
| C, Capital | 1,250 | |
| D, Capital | | $8,750 |

After D has contributed to the business his $5,000 of assets, the total assets of the partnership will be $35,000. One-quarter of that amount is $8,750. Of the $8,750 of D's capital, $5,000 of it represents his cash contribution. The balance or $3,750 must be distributed among the partners as a loss, and since this transaction represents an investment and not the purchase of an interest, this loss is to be recorded directly on the books through the capital accounts of the former partners. Furthermore, the amount of loss to be distributed is $3,750 and not $2,500. Twenty-five hundred dollars is the difference between the former value of a one-quarter interest and the investment made to acquire one-quarter of the new capital; the $3,750 is the excess of one-quarter of the total capital of the new partnership over D's payment. It is this latter amount which must be distributed among the former partners as a loss.

The total net worth of the new partnership is $35,000. The combined new capital balances of the former partners represent three-quarters of that value, or $26,250. D's contribution fails to equal the other quarter by the amount of $3,750. It is that amount, therefore, which must be absorbed by the former partners.

The former partners do not contribute to the new partner any of their capital directly. They do contribute to his capital in effect, however, by absorbing the recognized loss of net worth value in their accounts, and their loss is the new partner's gain.

A loss of this kind could have come about by a reduction of earning power and its amount could be determined by a capitalization of the earnings. It could also have come about by reason of some extraordinary misfortune to the business as, for example, legislation making the sale of its product illegal in a previously profitable market.

*Second Method*

D makes an investment of $5,000 for a one-quarter interest in the business.

| | | |
|---|---|---|
| A, Capital | $5,000 | |
| B, Capital | 5,000 | |
| C, Capital | 5,000 | |
| Assets (segregated) | | $15,000 |
| Cash | 5,000 | |
| D, Capital | | 5,000 |

SUMMARY

| | A | B | C | D | Total |
|---|---|---|---|---|---|
| Old capital balances | $5,000 | $10,000 | $15,000 | $ .... | $30,000 |
| Write down of assets | 5,000 | 5,000 | 5,000 | ...... | 15,000 |
| Adjusted balances | $..... | $ 5,000 | $10,000 | $ .... | $15,000 |
| D's contribution | ..... | ...... | ...... | 5,000 | 5,000 |
| New capital balances | $..... | $ 5,000 | $10,000 | $5,000 | $20,000 |

This method reflects the opinion that the assets are overvalued. From the former value of $30,000, they are therefore written down to their true value of $15,000. The loss must be absorbed by the former partners. The new partner is in no way responsible for the fact that book value is in excess of actual value. As in the case of any other loss, the former partners must share it in their loss-sharing ratios.

After the assets have been written down to their true value, D's investment represents exactly book value in the problem as it is stated, and D's entry can be recorded by crediting his capital account with the amount of his contribution.

*Third Method*

D makes an investment of $5,000 for a one-quarter interest in the business. This method assumes that D brings goodwill with him into the business.

| | | |
|---|---|---|
| Cash | $5,000 | |
| Goodwill | 5,000 | |
| D, Capital | | $10,000 |

SUMMARY

| | A | B | C | D | Total |
|---|---|---|---|---|---|
| Old capital balances........... | $5,000 | $10,000 | $15,000 | $ ..... | $30,000 |
| D's cash contribution.......... | ..... | ...... | ...... | 5,000 | 5,000 |
| D's goodwill contribution...... | ..... | ...... | ...... | 5,000 | 5,000 |
| New capital balances.......... | $5,000 | $10,000 | $15,000 | $10,000 | $40,000 |

The total value of the assets of the new partnership is $40,000 when this method is used. No change whatever is made in the capital accounts of the former partners either through their being required to give up a part of their capital to D or to absorb losses on his account.

The total capital of the former partners is $30,000 and when D contributes an amount equal to the fractional value of the $30,000, he will have contributed a quarter of the capital of the new partnership. When there were three partners, one-third of the total capital was $10,000, and when there are four partners, one-fourth of the capital is the same value.

D contributes his $10,000 partly in cash and the balance in the goodwill which he is bringing to the business. It will be remembered that if D had bought an interest and paid for it in part by bringing goodwill into the business, that goodwill would not be set up on the books.

NOTE.—Part II of this article will appear in the March issue of THE JOURNAL.