Study Unit 14 – Equity

Pages 521-523, Subunit 14.10: Questions 22-25 were moved to Subunit 14.11, questions 26-28 were moved to Subunit 14.12, and questions 29 and 30 were moved to Subunit 14.10. All questions were renumbered accordingly. This update was made to reassign the questions to the correct subunits.

14.10 Quasi-Reorganization

22. The primary purpose of a quasi-reorganization is to give a corporation the opportunity to

A. Obtain relief from its creditors.
B. Revalue understated assets to their fair values.
C. Eliminate a deficit in retained earnings.
D. Distribute the stock of a newly created subsidiary to its shareholders in exchange for part of their stock in the corporation.

Answer (C) is correct.

REQUIRED: The purpose of a quasi-reorganization.

DISCUSSION: A quasi-reorganization is undertaken to reduce a deficit in retained earnings to zero. The purpose is to permit the corporation to pay dividends in the near future. Answer (A) is incorrect. A quasi-reorganization is an accounting adjustment. Answer (B) is incorrect. Assets are usually written down to fair value. Answer (D) is incorrect. A quasi-reorganization does not entail an exchange of stock.

23. The equity section of Brown Co.’s December 31, Year 3, balance sheet consisted of the following:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Common stock, $30 par, 10,000 shares authorized</td>
<td>$300,000</td>
</tr>
<tr>
<td>and outstanding</td>
<td></td>
</tr>
<tr>
<td>Additional paid-in capital</td>
<td>150,000</td>
</tr>
<tr>
<td>Retained earnings (deficit)</td>
<td>(210,000)</td>
</tr>
</tbody>
</table>

On January 2, Year 4, Brown put into effect a shareholder-approved quasi-reorganization by reducing the par value of the stock to $5 and eliminating the deficit against additional paid-in capital. Immediately after the quasi-reorganization, what amount should Brown report as additional paid-in capital?

A. $(60,000)
B. $150,000
C. $190,000
D. $400,000

Answer (C) is correct.

REQUIRED: The amount reported as additional paid-in capital following a quasi-reorganization.

DISCUSSION: In many states, a corporation with negative retained earnings is not permitted to pay dividends. Thus, when it reverses a negative trend, it may effect a quasi-reorganization to eliminate the deficit. Brown’s reduction of the par value results in a credit to additional paid-in capital of $250,000 [10,000 shares × ($30 – $5)]. Hence, additional paid-in capital is $400,000 ($150,000 + $250,000) before a $210,000 debit to eliminate the retained earnings deficit. The ending balance in additional paid-in capital is $190,000 ($400,000 – $210,000). Answer (A) is incorrect. The amount of $(60,000) does not reflect the $250,000 credit for the change in par value. Answer (B) is incorrect. The amount of $150,000 is the 12/31/Year 3 balance. Answer (D) is incorrect. The amount of $400,000 does not include the $210,000 debit to eliminate the retained earnings deficit.
14.10 Quasi-Reorganization
14.11 Partnerships -- Formation and Allocation

22 24. Gow and Cubb formed a partnership on March 1 and contributed the following assets:

<table>
<thead>
<tr>
<th></th>
<th>Gow</th>
<th>Cubb</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>$80,000</td>
<td>$50,000</td>
</tr>
<tr>
<td>Equipment (fair value)</td>
<td>$50,000</td>
<td>$80,000</td>
</tr>
</tbody>
</table>

The equipment was subject to a chattel mortgage of $10,000 that was assumed by the partnership. The partners agreed to share profits and losses equally. Cubb’s capital balance at March 1 should be

A. $40,000  
B. $45,000  
C. $50,000  
D. $60,000  

Answer (A) is correct.

REQUIRED: The capital account balance of a partner who contributed equipment subject to a mortgage.

DISCUSSION: Cubb’s capital balance should represent the fair value of the assets contributed. The equipment is measured net of the mortgage for this purpose. Thus, Cubb’s capital balance should be $40,000 ($50,000 fair value of equipment – $10,000 mortgage assumed by the partnership).

Answer (B) is incorrect. The amount of $45,000 assumes that half the mortgage is a reduction of Gow’s capital. Answer (C) is incorrect. The amount of $50,000 does not consider the mortgage. Answer (D) is incorrect. The amount of $60,000 assumes capital is shared equally.

23 25. Hayes and Jenkins formed a partnership, each contributing assets to the business. Hayes contributed inventory with a current fair value in excess of its carrying amount. Jenkins contributed real estate with a carrying amount in excess of its current fair value. At what amount should the partnership record each of the following assets?

A. Fair value  
B. Fair value  
C. Carrying amount  
D. Carrying amount  

Answer (A) is correct.

REQUIRED: The amount at which nonmonetary assets contributed to a partnership should be recorded.

DISCUSSION: When partners invest nonmonetary assets in the business, those assets should be recorded at their current fair value at the date they are contributed.

24 26. On January 2, Smith purchased the net assets of Jimmy’s Cleaning, a sole proprietorship, for $350,000 and commenced operations of Spiffy Cleaning, a sole proprietorship. The assets had a carrying amount of $375,000 and a market value of $360,000. In Spiffy’s cash-basis financial statements for the year ended December 31, Spiffy reported revenues in excess of expenses of $60,000. Smith’s distributions during the year were $20,000. In Spiffy’s financial statements, what amount should be reported as Capital -- Smith?

A. $390,000  
B. $400,000  
C. $410,000  
D. $415,000  

Answer (A) is correct.

REQUIRED: The amount to be reported as the capital of a sole proprietor.

DISCUSSION: In accordance with the historical-cost principle, the assets should be recorded at their $350,000 cost. Given that Spiffy had a net cash inflow of $40,000 ($60,000 excess of revenues over expenses – $20,000 of drawings), Smith’s capital balance should be reported as $390,000 ($350,000 + $40,000).

Answer (B) is incorrect. The amount of $400,000 assumes that the assets are recorded at fair value. Answer (C) is incorrect. The amount of $410,000 assumes no distributions. Answer (D) is incorrect. The amount of $415,000 assumes that the assets are recorded at their carrying amount.
25. The partnership agreement of Donn, Eddy, and Farr provides for annual distribution of profit or loss in the following sequence:

- Donn, the managing partner, receives a bonus of 10% of profit.
- Each partner receives 6% interest on average capital investment.
- Residual profit or loss is divided equally.

Average capital investments for the current year were

<table>
<thead>
<tr>
<th></th>
<th>Donn</th>
<th>Eddy</th>
<th>Farr</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>$80,000</td>
<td>50,000</td>
<td>30,000</td>
</tr>
</tbody>
</table>

What portion of the $100,000 partnership profit for the year should be allocated to Farr?

A. $28,600  
B. $29,800  
C. $34,933  
D. $41,600

Answer (A) is correct.

**REQUIRED:** The share of partnership profits to be distributed to a partner.

**DISCUSSION:** The partnership agreement provides for a bonus to one partner and payment of interest on each partner's average capital investment. The bonus and the interest must be allocated and included in the calculation of the residual profit or loss. Donn's bonus is $10,000 ($100,000 × 10%), and total interest is $9,600 ($160,000 total capital × 6%). Hence, the residual profit following the allocation of bonus and interest is $80,400 ($100,000 partnership profits – $10,000 bonus – $9,600 of interest on capital). Sharing the residual profit equally among the partners results in an allocation to Farr of $28,600 ($30,000 × 6%) interest + ($80,400 ÷ 3) residual profit.

<table>
<thead>
<tr>
<th></th>
<th>Donn</th>
<th>Eddy</th>
<th>Farr</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bonus</td>
<td>$10,000</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Interest on capital</td>
<td>4,800</td>
<td>3,000</td>
<td>1,800</td>
</tr>
<tr>
<td>Residual</td>
<td>26,800</td>
<td>26,800</td>
<td>26,800</td>
</tr>
<tr>
<td>Totals</td>
<td>41,600</td>
<td>29,800</td>
<td>28,600</td>
</tr>
</tbody>
</table>

Answer (B) is incorrect. The amount of $29,800 is the profit allocated to Eddy. Answer (C) is incorrect. The amount of $34,933 would be the profit allocated to Donn if no bonus were paid. Answer (D) is incorrect. The amount of $41,600 is the profit allocated to Donn.

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14.11 Partnerships -- Formation and Allocation  
14.12 Partnerships -- Changes and Liquidation  

26. Max Blau and Harry Rubi are partners who share profits and losses in the ratio of 6:4, respectively. On May 1, their respective capital accounts were as follows:

<table>
<thead>
<tr>
<th></th>
<th>Blau</th>
<th>Rubi</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>$60,000</td>
<td>50,000</td>
</tr>
</tbody>
</table>

On that date, Joe Lind was admitted as a partner with a one-third interest in capital and profits for an investment of $40,000. The new partnership began with total capital of $150,000. Immediately after Lind's admission, Blau's capital should be

A. $46,000  
B. $50,000  
C. $54,000  
D. $60,000

Answer (C) is correct.

**REQUIRED:** The capital balance of an existing partner following the admission of a new partner.

**DISCUSSION:** Following the entrance of Lind, the partnership began with total capital of $150,000, the sum of the capital balances of Blau and Rubi and Lind's investment. Thus, no goodwill was recognized. Lind received a one-third interest, and his capital balance must be credited for $50,000 ($150,000 × 33 1/3%). But Lind contributed only $40,000, so the $10,000 bonus ($50,000 – $40,000) must be allocated to the existing partners in the ratio of 6:4. The result will be debits to the capital accounts of Blau and Rubi of $6,000 ($10,000 × 60%) and $4,000 ($10,000 × 40%), respectively. Consequently, immediately after Lind's admission, Blau's capital is $54,000 ($60,000 – $6,000). Answer (A) is incorrect. The amount of $46,000 is Rubi's capital balance after the admission of Lind. Answer (B) is incorrect. The amount of $50,000 is Lind's initial capital balance. Answer (D) is incorrect. The amount of $60,000 is Blau's initial capital balance.
The partnership of Metcalf, Petersen, and Russell shared profits and losses equally. When Metcalf withdrew from the partnership, the partners agreed that there was unrecorded goodwill in the partnership. Under the bonus method, the capital balances of Petersen and Russell were

A. Not affected.

B. Each reduced by one-half of the total amount of the unrecorded goodwill.

C. Each reduced by one-third of the total amount of the unrecorded goodwill.

D. Each reduced by one-half of Metcalf’s share of the total amount of the unrecorded goodwill.

Answer (D) is correct.

REQUIRED: The effect of a retirement under the bonus method.

DISCUSSION: If the partnership had unrecorded goodwill, Metcalf would have received the balance in her capital account plus one-third of the unrecorded goodwill. Under the bonus method, revaluation of assets to reflect goodwill is not permitted. Hence, given that the partners shared profits and losses equally, the payment to Metcalf of one-third of the unrecorded goodwill would have resulted in equal reductions of the capital balances of the remaining partners, that is, in the payment of a bonus to Metcalf. Thus, one-sixth \(\frac{1}{6} \times (1 \div 2)\) of the unrecorded goodwill would have been subtracted from both Petersen’s and Russell’s accounts.

Jay & Kay partnership’s balance sheet at December 31, Year 3, reported the following:

<table>
<thead>
<tr>
<th>Total assets</th>
<th>$100,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total liabilities</td>
<td>20,000</td>
</tr>
<tr>
<td>Jay, capital</td>
<td>40,000</td>
</tr>
<tr>
<td>Kay, capital</td>
<td>40,000</td>
</tr>
</tbody>
</table>

On January 2, Year 4, Jay and Kay dissolved their partnership and transferred all assets and liabilities to a newly formed corporation. At the date of incorporation, the fair value of the net assets was $12,000 more than the carrying amount on the partnership’s books, of which $7,000 was assigned to tangible assets and $5,000 was assigned to goodwill. Jay and Kay were each issued 5,000 shares of the corporation’s $1 par-value common stock. Immediately following incorporation, additional paid-in capital in excess of par should be credited for

A. $68,000

B. $70,000

C. $77,000

D. $82,000

Answer (D) is correct.

REQUIRED: The additional paid-in capital in excess of par credited after incorporation.

DISCUSSION: The net assets of the partnership, including goodwill, are transferred at fair value. Hence, the $92,000 fair value of the net assets ($100,000 carrying amount of partnership assets + $12,000 excess of fair value over carrying amount – $20,000 liabilities) measures the amount credited to contributed capital. The credit to common stock is $10,000 (5,000 shares × $1 par × 2), and the credit to additional paid-in capital is $82,000 ($92,000 – $10,000).

Answer (A) is incorrect. This figure equals carrying amount of total assets minus total liabilities minus $12,000. Answer (B) is incorrect. This figure equals carrying amount of total assets minus total liabilities minus par value of the stock issued. Answer (C) is incorrect. The amount of $77,000 assumes that the goodwill is not recorded.

Study Unit 20 – Not-for-Profit Accounting and Reporting

Page 736, Subunit 20.1, 5.a.: This edit was made to correct a cross-reference.

5. Statement of Cash Flows

a. The guidance in Study Unit 3 17 for reporting a statement of cash flows applies to all businesses and NFPs. For example, the terms “income statement” and “net income” apply to “statement of activities” and “change in net assets,” respectively.