ISSUES IN ACCOUNTING EDUCATION
Vol. 25, No. 2
2010
pp. 323–329
American Accounting Association
DOI: 10.2308/iace.2010.25.2.323

Integrative Case in Advanced Accounting

Hugo Nurnberg and Thomas F. Schaefer

ABSTRACT: This instructional resource case presents an integrative approach to developing critical thinking and problem solving skills in the areas of partnership accounting and consolidated financial statements, including financial reporting for companies under common control—two subjects typically studied independently. The case shows that, in the presence of related-party transactions, a conventional partnership income statement may not be useful for assessing either the reasonableness of partnership income distributions or partnership profitability. The case enhances critical thinking by requiring the student to seek an alternative financial reporting solution to a related-party transaction of entities under common control typically not addressed in textbooks and college courses on advanced financial accounting. It can also be expanded to show how accounting may play a role in confronting ethical issues among partners.

INTRODUCTION

Most advanced accounting courses (and related textbooks) include separate sections on partnership accounting and consolidated financial statements, including financial reporting for companies under common control. Typically, these sections are taught as separate and distinct topics. This instructional resource case presents an integrative approach to these topics.[1] It enhances critical thinking and problem solving skills by asking students to (1) identify both the similarities and the differences between partnership and corporate entities; (2) examine the similarities and differences in accounting that flow from such distinctions; and (3) recommend an appropriate financial reporting solution for related-party transactions across entities under common control. In particular, in the presence of related-party transactions, a conventional partnership income statement may be insufficient for determining the reasonableness of partnership income distributions or evaluating partnership profitability; a combined income statement may be better suited for these purposes. The case may also be used to introduce accounting-related ethical issues in the negotiations among partners.

Hugo Nurnberg is a Professor at Baruch College–CUNY, and Thomas F. Schaefer is a Professor at University of Notre Dame.

The authors gratefully acknowledge the helpful comments of Kevin Misiewicz (University of Notre Dame), Jan Sweeney (Baruch College–CUNY), and an anonymous reviewer. Of course, any errors are the authors' sole responsibility.

[1] This instructional resource is an adaptation of the Granger Eagles Baseball case problem in Hoyle et al. (2009, 242). However, it is *intended for a significantly different purpose.* The Granger Eagles Baseball case problem provides a useful introduction to consolidated income statements. This instructional resource addresses a related-party disclosure issue in assessing partnership income distribution and profitability. More importantly, it integrates this aspect of partnership accounting with the use of combined financial statements to assess a partnership income distribution and profitability when a partnership rents property from a partner-controlled entity.

Published Online: April 2010

PARTNERSHIP VERSUS CORPORATE ENTITY

A partnership and a corporation are two different legal forms of business entities. There are several well-known legal distinctions between partnerships and corporations. But as Moonitz and Jordan (1964, 6) note, from a financial accounting perspective, the similarities outweigh the differences. Although the accounting for owners' equity differs between partnerships and corporations, the accounting for assets, liabilities, revenues, and expenses are largely the same.[2] The characteristic feature of both partnerships and corporations is that two or more persons have a joint undertaking for profit. From this characteristic feature flows the commonality of a business or economic entity, separate and distinct from its owners for financial reporting purposes, notwithstanding differences in legal form as discussed below.

Limited Life

Under the law, corporations have an unlimited life, whereas most partnerships legally cease to exist upon the admission, withdrawal, retirement, or death of a partner. However, many large partnerships continue to operate in economic substance over more than a century notwithstanding changes in partnership composition. Several large international accounting and law firms are good examples of such long-lived partnerships.

Absence of Legal Entity Status

Similarly, the absence of legal entity status of some partnerships in some states to enter into some transactions is of little relevance to financial accounting unless legal form is emphasized over economic substance. As Moonitz and Jordan (1964, 4–5) observe, a partnership has the characteristics of a separate entity in that it may hold title to property in its own name, may enter into contracts, and in some states may sue or be sued as an entity.

Unlimited Liability

Stockholders are not personally liable for the debts of the corporation, whereas individual partners are personally liable for the debts of a partnership, but this distinction is largely irrelevant for financial accounting purposes. For one thing, many creditors require stockholders to guarantee personally any loans to a corporation, yet the corporation still functions as a separate entity. Furthermore, partners may obtain limited liability by making separate agreements to that effect with each creditor, without altering the separate entity status of the partnership for financial accounting purposes. Finally, the personal liability of partners for partnership debt does not become significant until the partnership is insolvent; from the standpoint of a going concern, a partnership is surrounded by a wall separating it from the partners in the same sense that a wall separates the corporation from its stockholders.

Moonitz and Jordan (1964, 7) go on to note that it is the intimate relationship between ownership and management that gives rise to most of the financial accounting differences between partnerships and corporations. However, it is here that we part company with Moonitz and Jordan (1964), for they (and most advanced accounting textbooks) are implicitly comparing a publicly

[2] Two well-known exceptions are income taxes and owner salaries. Unlike corporations, partnerships are not subject to income taxes at the entity level in the U.S., hence do not report income tax expense for financial reporting purposes. Corporate income is subject to tax at the corporate entity level and again at the stockholder level when distributed as dividends; partnership income is allocated to and subject to income taxes only at the individual partner level. For financial reporting purposes, partner salaries are treated as a distribution of partnership income, not an expense, whereas salaries of stockholders acting as employees are treated as an expense, not a distribution of corporate income. As a result, partnership income is not reduced by the cost of services rendered by the partner-manager, whereas corporate income is reduced by the cost of services rendered by the stockholder-manager. However, we ignore these exceptions in this case.

owned corporation with a privately owned partnership. Although there is a separation of ownership and control of many large publicly owned corporations, there is also a separation of ownership and control of many large publicly owned partnerships (as well as many large privately owned professional service firm partnerships). Similarly, although there is an intimate relationship between ownership and control of most privately owned partnerships, there is an intimate relationship between ownership and control of most privately owned corporations.

This instructional resource case deals with a privately owned partnership and a privately owned corporation. For both, income statements are prepared for the same multiplicity of purposes, including the two purposes addressed in this case: (1) to facilitate adherence to legal contracts, including the distribution of income among its owners; and (2) to help the owners and management assess past performance, future prospects, debt paying ability, solvency, etc. The case calls for the student to act as a financial advisor, sort through the issues, and advise the parties.

THE SETTING—AN INCOME DISTRIBUTION DISPUTE

Modern Cardiology Group LLP is a privately owned medical partnership. Simon Naïve, MD, and John Sophisticate, MD, the managing partner, have an income-sharing dispute while negotiating the renewal of Dr. Naïve's initial one-year agreement with the medical partnership. Dr. Naïve, a recent board-certified cardiologist, is the newest of five partners in Modern Cardiology. The partners share profits and losses equally. Dr. Sophisticate gives Dr. Naïve Exhibit 1, an income statement of Modern Cardiology, which shows that his one-fifth equal share of the $1,000,000 partnership income is $200,000.

Dr. Naïve argues that his $200,000 share of partnership income is inadequate given his four years of college, four years of medical school, five years of cardiology residency, and the fact that he is seeing at least one-fifth of the patients and generating at least one-fifth of the patient revenues. Although he does not question his one-fifth share of the partnership's profit, he questions what appears to him to be an unusually high rent expense—72 percent of total revenues. Dr. Sophisticate counters that the rent reflects current market rentals for comparable equipment and facilities, that Modern Cardiology's profit is only $1,000,000, and that Dr. Naïve receives his one-fifth equal share; until he generates substantially more patient revenues and the partnership becomes more profitable, an increase is out of the question.

EXHIBIT 1

Modern Cardiology Group, LLP
Income Statement

Patient revenues		$5,000,000
Office and equipment rent expense	$3,600,000	
Technician, nurses, and staff salaries	300,000	
Non-owner administrative salaries and miscellaneous	100,000	4,000,000
Net income (loss)		$1,000,000
Dr. Naive's share		$200,000

As it turns out, Dr. Sophisticate and two other senior partners of Modern Cardiology own all the voting stock of Technology Properties, Inc. In turn, Technology Properties owns the building in which Modern Cardiology has its practice office and owns the medical equipment that Modern Cardiology uses to conduct various patient tests; it also owns a medical laboratory that operates in the building with the cardiology patients as the principal customers.

However, Dr. Sophisticate does not wish to consider Technology Properties' profits in the negotiations with the cardiology partners. He claims that "the building and equipment are assets of a separate business entity that were purchased independently from the cardiology practice and financed by the investment of just the three senior partners, and therefore do not concern the other two cardiology partners." As indicated in Exhibit 2, Technology Properties' income statement shows a $4,000,000 net income.

HOMEWORK QUESTIONS

(a) What is an accounting entity? Is an accounting entity defined differently for a corporation than for a partnership?
(b) How useful is Modern Cardiology's income statement as presented in Exhibit 1 in resolving this income-sharing dispute? What are its limitations? Does it conform to U.S. generally accepted accounting principles (GAAP)? Does the FASB Accounting Standards Codification Related-Party Disclosures Topic (FASB 2009) provide any guidance?
(c) What is the appropriate entity for assessing the reasonableness of Modern Cardiology's income distribution and profitability?
(d) What is the appropriate entity for assessing the reasonableness of Technology Properties' income distribution and profitability?
(e) What advice would you provide the negotiating parties about considering Technology Properties' income statement in their discussions?
(f) What does *control* mean? Does the FASB Accounting Standards Codification Consolidation Topic (FASB 2009) provide any guidance on commonly controlled entities that might help resolve this income-sharing dispute?
(g) Why might Dr. Sophisticate insist on only considering the income statement of Modern Cardiology?
(h) What advice would you give Dr. Naïve prior to renewing the partnership agreement?

EXHIBIT 2

Technology Properties, Inc.
Income Statement

Building and equipment rent revenue	$3,600,000	
Laboratory fees	1,300,000	$4,900,000
Depreciation	$500,000	
Laboratory salaries	250,000	
Non-owner administrative salaries and miscellaneous	150,000	900,000
Net income (loss)		$4,000,000

(i) What other pertinent information would you need to assess the reasonableness of the income distribution and profitability of the two companies?
(j) From an ethical perspective, should the senior partners make Technology Properties' income statement available to Dr. Naïve now? Should they have made it available prior to his admission into the partnership?

CASE LEARNING OBJECTIVES AND IMPLEMENTATION GUIDANCE

This instructional resource serves to integrate two major topics in most advanced financial accounting textbooks and advanced financial accounting courses—partnership accounting and consolidated financial statements, including financial reporting for companies under common control—that are usually discussed and taught separately. The instructional resource itself shows how a conventional partnership income statement may not adequately reflect partnership operating performance when the partnership rents property owned by some of the partners. More importantly, the instructional resource enhances student critical thinking skills and integrates subject matter by requiring the student to (1) examine the limitations of conventional reporting in the presence of related-party transactions in a setting beyond the usual parent-subsidiary relationship, and (2) formulate a solution to the problem for a partnership. The case also provides a setting where the financial reporting directly brings into question several ethical issues. Finally, student research skills can be utilized in developing the solution to the case.

Learning Validation

This instructional resource was designed to be a convenient vehicle to integrate combined financial statements and partnership accounting either through an instructor led presentation and class discussion or in a homework assignment. Both of us have successfully used this version (and earlier versions) of this instructional resource case at two different universities, one using the class presentation and the other as a homework assignment. We find that both approaches enhance the learning experience in both undergraduate and graduate advanced financial accounting courses. The undergraduate students are from a public urban university, usually 21 to 23 years old, with SAT scores between 1000 and 1200. The graduate students are from one public urban university and one private suburban university, and typically just one or two years older, with GMAT scores between 500 and 680.

The case's educational objectives were also assessed directly. In reviewing written responses to the questions in the case, the instructor assigned each student's work a score of 1 to 5 for each objective (listed below) where 1 indicates little achievement and 5 indicates that the objective has been achieved. The direct assessment of the students' work produced the following averages:

Objective 1: Students should be able to critically analyze the limitations of the separate partnership income statement, present alternatives for consideration, and identify other information needed for a conclusion. Average score = 4.34

Objective 2: Students should provide advice to the partners consistent with their overall critical analysis. Average score = 4.00

The first objective was designed to capture evidence of students' critical thinking skills while the second looked to assess problem-solving skills.

TEACHING NOTES

Teaching Notes are available through the American Accounting Association's electronic publications system at http://aaapubs.aip.org/tnae/. Full members can use their personalized usernames and passwords for entry into the system where the Teaching Notes can be reviewed and printed.

If you are a full member of AAA and have any trouble accessing this material, please contact the AAA headquarters office at office@aaahq.org or (941) 921–7747.

REFERENCES

Financial Accounting Standards Board. 2009. *FASB Accounting Standards Codification*. Norwalk, CT.: Financial Accounting Standards Board.

Hoyle, J. B., T. F. Schaefer, and T. S. Doupnik. 2009. *Advanced Accounting*. 9th edition. New York, NY: McGraw-Hill/Irwin.

Moonitz, M., and L. H. Jordan. 1964. *Accounting: An Analysis of Its Problems*. Revised edition/Volume 2. New York, NY: Holt, Rinehart and Winston, Inc.