CASE

B & T AUTO PARTS STORE

B. Greenwald
Missouri Western
State College
St. Joseph, Missouri

HISTORY AND BACKGROUND

Fifteen years ago, Terry Hamilton started the B & T Auto Parts Store, having had an interest in the auto business since he was a child. His father, Bob, was a hard-working auto mechanic who had as his major business interest the repair and rebuilding of automobiles. Terry, on the other hand, was more interested in commerce and chose to open an auto parts store across the street from his father's service shop. Bob, a natural pessimist, was somewhat sceptical about the success of an auto parts store in the area, and about his son's abilities. But he knew that a store of this nature could help him, as he needed auto parts for his repair work and through Terry he would have access to these parts at wholesale prices.

In the early days of B & T Auto Parts, Terry realized that he would have to raise working capital to meet his (somewhat excessive) need for auto parts and accessories. Bob supplied this working capital from the service work that he was performing, keeping detailed records of the capital flowing to Terry. Terry's store continued to prosper, somewhat to the disbelief of the father, who was working very hard at service work. But he was delighted to see his son develop, in what seemed to be a hit or miss fashion, a thriving business. The staff of the store consisted of about half a dozen people who worked in sales and inventory management. Through dealing with this staff, Terry was learning necessary management skills.

B & T Auto Parts had now expanded to the extent that the inventory control system had to be computerized. Being in the early stages of development, the computer system that was installed was bulky, slow and very expensive. Bob was glad to see this needed change, but he still carefully watched the progress of his son. Meanwhile, more and more capital seemed to be needed to finance the daily operations of the business, not to mention an $800 per month payment on the new computer. The capital continued to come from Bob, while Terry continued to contribute his time and efforts.

As time passed Bob's health began to deteriorate, and he decided to close his service shop and join forces with his son. Bob saw that the move would decrease many of the fixed costs in maintaining a service shop, and it would give him some much-needed rest and free time. Terry had doubts about this move, but he went to the bank with his father to borrow $100,000 to finance a building expansion program, one that would enable the store to accommodate more inventory and modernize a spare room for the service shop.

Bob and his son both signed the note at the bank and gave as collateral first mortgages on their homes. The banker who arranged the loan suggested a partnership agreement which would spell out the terms of the arrangements that had been taking place for the last years. These arrangements had evolved from the funds supplied by Bob for working capital and the joining of the two in the parts business with the new loan. However, no specific legal documents had been signed between them to signify the joint business activities that now existed.

Benny Green was hired as B & T's new accountant, serving in an advisory position. He also suggested that Bob and Terry sign a partnership agreement. Bob and Terry obtained the services of a lawyer to draw up an agreement, but somehow it never was signed.

Benny, along with Bob's wife (now acting as the bookkeeper for the store), prepared payroll records, reports, and financial statements, mainly for the Bank's outside auditor. Benny prepared the partnership tax returns for the ensuing years and always showed Bob as having a 2/3 interest in capital and Terry a 1/3 interest in capital. This was on the instructions of Bob, who by his own statement gave a 1/3 interest in capital to Terry for his time and hard work.

In the meantime, the partners were drawing on a fifty-fifty basis, mainly to satisfy their needs for personal expenditures. In the computer-generated financial statements, Bob and Terry were shown as having an equal interest in capital, then $100,000 each in the net equity of the business. Barbara, Bob's wife, was earning a salary along with Terry's sister Teresa. Barbara's salary was paid for her services as a bookkeeper. Teresa was an inventory clerk and occasionally a salesperson who received a salary but no sales commission.

THE PROBLEM

For the tax year ending December, 1986, Bob and Barbara insisted that Terry pay tax on half of the profits of the business. Up to this point, the profit-sharing ratio had followed the 1/3 interest and 2/3 interest in capital shown in the partnership tax returns. Terry was not happy with the new profit sharing arrangement, as he would not only have to pay income tax on this pro-rata amount, but he would also have to pay self-employment tax. Bob, however, contended that if the draws were equal, then each should have to pay on their equal distributions.

During the next year, Bob's health worsened and Terry became increasingly responsible for operation of the service shop as well as the parts store. Then in July of 1987, he discovered a problem in the bookkeeping of the store's books. His father had taken $300 per week out of the company for personal use, and his mother had charged this amount to the inventory account. Even though this practice had only continued for three months, Terry felt that he had been wronged. Already dissatisfied with the day-to-day operation of his business, Terry walked out of the store in a fit of anger and went to work for a local auto distributor's parts store.

Bob and his wife, now left with a store that they could not manage on their own, decided to sell B & T Auto Parts to a willing buyer who was sure that he could make a go of it. Bob's plan was to retire and enjoy the proceeds of the sale after paying off the note at the local bank. Terry, when he learned of his father's intention, obtained the services of a local lawyer and filed suit for one-half of the proceeds of the sale. Terry's lawsuit prevented the sale from being completed, and Terry continued to pursue his share of the capital, which he considered to be one-half.

For the past year there has been much negotiation between Bob and Terry about disposition of B & T, but to no avail. Bob insists that Terry is only entitled to one-third of the capital, the gift that he had intended originally. Terry insists that he acted as a fifty-fifty partner: making equal business decisions, using partnership property on an equal basis, and spending equal time in the business. The settlement of the lawsuit will involve some decision about capital sharing arrangements. It seems that Terry and Bob cannot reach agreement and the court will have to decide this issue.

CASE REQUIREMENTS

1. Why is the lack of a partnership agreement causing such problems for Terry and Bob?
2. Discuss the validity of the two positions:
   (a) 50 – 50 sharing
   (b) 1/3 – 2/3 sharing
   and the factors that help decide which is the correct position.
3. There was a change in the profit sharing effected in 1986. What is the position of the accountant in making this change? Is he partly responsible for the lawsuit?
4. How should 1987 profits be shared?
5. What management problems do you envision from Terry's exit and the new manager, Bob, who had no previous experience at running an auto parts store? Note that Bob and Terry worked together in the business in a cordial manner, but Terry was never sure about Bob's knowledge of the parts business. He was also not sure of Bob's handling of business affairs in his service shop. These doubts were not allayed by the events that followed and by day-to-day operations whereby Bob left everything to Terry as he puttered around in the service shop.
6. What are the appropriate financial records to keep in this business?
7. What kinds of financial controls are needed in the business?