

PARTNERSHIP LIQUIDATION

LEARNING OBJECTIVES

- 1 Describe the steps used to distribute available partnership assets in liquidation under the Uniform Partnership Act (UPA).
- 2 List the order of priority for each class of creditors in partnership liquidation under the UPA.
- 3 Prepare a liquidation schedule to settle debts and allocate assets.
- 4 Prepare a “safe payment approach” liquidation schedule.
- 5 Describe the four steps in the preparation of an advance plan for the distribution of cash in a partnership liquidation.
- 6 Prepare the journal entries to incorporate a partnership.

IN THE NEWS

In an article entitled “How to Achieve a Productive Partnership—Accounting Firms,” suggestions are provided on how to avoid or resolve problems in a partnership. One suggestion is to have clear agreements about the business relationship. For instance, focusing on the partnership’s goal is more practical than attempting to change someone’s personality. The key to managing personality differences is respect. Respect is shown by listening to partners and trying to understand them.¹

In the preceding chapter, dissolution of a partnership in which the business affairs were continued without interruption was discussed. In this chapter, we will consider dissolutions in which the partnership is terminated. The phase of partnership operations that begins after dissolution and ends with the termination of partnership activities is referred to as “winding up the affairs.” During this period the partnership’s unfinished business is completed, some of the firm’s noncash assets may be converted into cash (realization), liabilities are settled to the extent possible, and any remaining assets are distributed to the partners in settlement of their residual interest. These events may occur over a relatively short period of time (for example, there may be a lump-sum sale of the assets, and the liabilities may be assumed by the purchaser or discharged with the cash received), or over a period of several years if the assets are sold individually as the business affairs are gradually terminated.

In the first part of this chapter, we will assume that all noncash assets are converted into cash before any assets are distributed to creditors and partners; this procedure is referred to as a *simple liquidation*. In the second part of the chapter,

¹ *Journal of Accountancy*, “How to Achieve a Productive Partnership—Accounting Firms,” by David Coleman, May 1992.

we assume instead that noncash assets are sold in installments and cash is distributed to the various equity interests as it becomes available.

During the liquidation process, the accountant can provide service to the partners in a number of areas. He or she may assist in preparing financial statements and providing guidance to the partners to ensure that the liquidation proceeds in accordance with legal requirements and the partnership agreement. Much of the accounting for partnership liquidations depends on interpretation of the partnership agreement and the legal provisions governing partnership liquidation. The accountant needs to be familiar with pertinent statutory provisions, which may include the UPA and federal and state bankruptcy laws. In addition, for the protection of all parties concerned, it is advisable to seek legal counsel.



“Long before your business partnership is dissolved, the handling of the breakup or transfer of ownership should be planned. Astonishingly, 80% of new businesses fail to spell out the mechanism for a divorce. Why? The very idea introduces a seed of suspicion into an otherwise happy union.”²

STEPS IN THE LIQUIDATION PROCESS

LO 1 Steps in the liquidation process.

The first step in the liquidation process is to compute any net income or loss up to the date of dissolution. The closing process should be completed and, as part of it, any net income or loss should be allocated to the partners in accordance with their profit and loss agreement.

In the next step of the liquidation process, assets that are not acceptable for distribution in their present form are converted into cash. If the sales price of an asset is greater than (less than) the recorded book value, there is a gain (loss) from the sale. Procedurally, gains and losses on the realization of assets may be collected in one account and then closed to the capital accounts of the individual partners. The allocation of realization gains or losses should be based on the residual profit and loss ratio, unless specific provisions for such allocation are made in the partnership agreement.³ The rationale for this procedure is that since the changes in asset values are the result of risk assumed by the partnership, the gain or loss should be shared in the agreed profit and loss ratio. In addition, it may be difficult to separate gains and losses that result from liquidation from the under- or overstatement of book values that results from accounting policies followed in prior years. For example, a gain on the sale of an item of equipment could reflect the fact that the firm had used a conservative depreciation policy and recorded excessive depreciation in prior years. Other adjustments could result from the failure to recognize changes in market values in the appropriate year. Furthermore, any agreement as to interest and salaries in the income allocation formula is ignored when allocating realization gains and losses. The use of the residual ratio is justified, since interest and salaries

² *Forbes*, “Planning for Divorce,” by Leigh Gallagher, 3/22/99, pp. 94–95.

³ Section 18 of the UPA provides a list of rights and duties of partners, “subject to any agreement between them.” Section 18(a) provides that “each partner must contribute toward the losses, whether of capital or otherwise, sustained by the partnership according to his share in the profits.”

To illustrate the marshaling of assets rules, assume that ABCD Partnership reports the following balance sheet after the sale of all noncash assets:

<i>Debits</i>		<i>Credits</i>	
Cash	\$ 50,000	Liabilities	\$ 75,000
Bill Baker, Capital	15,000	Alice Amos, Capital	15,000
Carol Carter, Capital	35,000	Don Davis, Capital	10,000
Total	<u>\$100,000</u>		<u>\$100,000</u>

The partners share profits and losses equally. The personal and partnership status of each partner is as follows:

<i>Partner</i>	<i>Personal</i>			<i>Partnership</i>
	<i>Assets</i>	<i>Liabilities</i>	<i>Assets Greater Than (Less Than) Liabilities</i>	<i>Capital Balance (Cr.) Dr.</i>
Alice Amos	\$20,000	\$50,000	\$(30,000)	\$(15,000)
Bill Baker	33,000	30,000	3,000	15,000
Carol Carter	90,000	40,000	50,000	35,000
Don Davis	40,000	10,000	30,000	(10,000)

The personal assets of each partner must be applied to the settlement of his or her personal liabilities before personal assets can be used to satisfy any partnership claims. Thus, the maximum amount that the partnership creditors and other partners could recover from the personal assets is \$83,000 (\$3,000 + \$50,000 + \$30,000). Because the personal liabilities of Amos exceed her personal assets, partnership claims cannot be enforced against her personal assets even though she has a credit interest in the partnership. However, her unsettled personal creditors in the amount of \$30,000 can look for full or partial settlement of their claims from final distribution of partnership assets in settlement of her capital interest. At this time, the partnership has a claim of \$15,000 and \$35,000 against Baker and Carter, respectively. Baker, however, will have only \$3,000 left for investment in the partnership to reduce his capital deficit. Carter has sufficient personal assets to satisfy her personal liabilities and invest in the partnership to cover her share of partnership losses. Davis is personally solvent and has a credit capital interest in the partnership.

The liquidation of the partnership is summarized in Illustration 16-1. Although formal journal entries are not shown, they would be recorded in a journal in accordance with the tabular arrangement summarized in the liquidation schedule. The steps in the liquidation process may proceed in any order as long as the rights of the partners, partnership creditors, and personal creditors are recognized. In this example, the following sequence of events occurs.

1. Baker invests \$3,000 in the partnership and his remaining deficit of \$12,000 is a liquidation loss that is allocated to the remaining partners in their relative profit and loss ratio, one-third each. (Note that because Carter has sufficient assets to cover her share of additional losses, \$4,000 loss is allocated to her, even though she currently has a deficit capital balance.)

Marshaling of Assets

ILLUSTRATION 16-1

	Schedule of Partnership Liquidation					
	Cash	Liabilities	Capital and Loan Balances			
Amos 1/4			Baker 1/4	Carter 1/4	Davis 1/4	
Balance before cash distributions	50,000	(75,000)*	(15,000)	15,000	35,000	(10,000)
Investment by Baker	3,000			(3,000)		
	53,000	(75,000)	(15,000)	12,000	35,000	(10,000)
Allocation of Baker's deficit			4,000	(12,000)	4,000	4,000
	53,000	(75,000)	(11,000)	—0—	39,000	(6,000)
Payment to creditors	(53,000)	53,000				
	—0—	(22,000)	(11,000)	—0—	39,000	(6,000)
Investment by Carter	39,000				(39,000)	
	39,000	(22,000)	(11,000)	—0—	—0—	(6,000)
Payment to creditors	(22,000)	22,000				
	17,000	—0—	(11,000)	—0—	—0—	(6,000)
Payment to partners	(17,000)		11,000			6,000
	—0—	—0—	—0—	—0—	—0—	—0—

* In this chapter, () means that an account has a credit balance or a credit posted to an account.

- Cash of \$53,000 is distributed to the creditors.
- The partnership creditors obtain judgment against Carter. (The creditors could have proceeded to recover their claims from any solvent partner individually, including Davis, who has a credit capital interest, or from the partners jointly.) Since Carter has a personal net asset position of \$50,000, she will invest an additional \$39,000 in the partnership, \$22,000 of which will go to partnership creditors and \$17,000 to the other partners.
- The cash is distributed first to liquidate partnership liabilities and then to satisfy partner's capital interests.

Observe that the cash distribution to partners is based on their capital balances, not their profit and loss ratio. The unpaid personal creditors of Amos have a claim against her \$11,000 partnership distribution.

If, in the illustration above, Carter was able to invest only \$20,000 from her personal assets and Davis as well as Amos are personally insolvent, then the creditors and partners Amos and Davis would have unrecoverable losses of \$19,000 as shown next.

	Cash	Liabilities	Amos	Baker	Carter	Davis
From Illustration 16-1	—0—	(22,000)	(11,000)	—0—	39,000	(6,000)
Investment by Carter	20,000				(20,000)	
Payment to creditors	(20,000)	20,000				
	—0—	(2,000)	(11,000)	—0—	19,000	(6,000)

SIMPLE LIQUIDATION ILLUSTRATED

In a simple liquidation, all of a partnership's noncash assets are converted into cash and the resulting gain or loss allocated before any distribution is made to the creditors and to the partners. To illustrate the accounting for a simple liquidation, assume that the condensed balance sheet of ABC Partnership that follows was prepared just before the liquidation:

4. In transactions (4) and (5), the principles concerning the marshaling of assets are applied to determine if additional investments can be expected. In this case, Carter with a deficit capital interest is also personally insolvent. Thus, her deficit is allocated to the other partners on the basis of their relative loss-sharing ratio: to Amos, to Baker.
5. Baker invests \$10,500 in the partnership to eliminate his deficit after his personal assets were applied to the settlement of his personal liabilities.
6. Cash is distributed to Amos to satisfy her capital claim against the partnership assets.

**TEST
YOUR KNOWLEDGE**

16.1

NOTE: Solutions to *Test Your Knowledge* questions are found at the end of each chapter before the end-of-chapter questions.

The trial balance for the ABC Partnership before bankruptcy is as follows:

<u>Cash</u>	<u>Noncash Assets</u>	<u>Liabilities</u>	<u>A Capital</u>	<u>B Capital</u>	<u>C Capital</u>
\$20,000	\$200,000	\$30,000	\$100,000	\$60,000	\$30,000

The partners share profits and losses in the ratio 40:40:20.

1. If the noncash assets are sold for \$100,000 cash, determine the amount of cash, if any, that partner A will receive upon liquidation.
2. If the noncash assets are sold for \$50,000 cash and assuming that partners with a deficit balance cannot contribute additional assets, determine the amount of cash, if any, that partner A will receive upon liquidation.

INSTALLMENT LIQUIDATION

Instead of the immediate conversion of noncash partnership assets to cash under a simple liquidation, it is sometimes advantageous for a partnership to extend the conversion over several months. For example, in certain types of businesses, such as land development, more cash may be generated if a company completes construction projects it has started. In other situations, the partnership may receive a greater cash price for the noncash assets if they are not sold at a forced liquidation. If the liquidation extends over a period of time, the partners will probably prefer that cash be distributed as it becomes available. If partners are to receive cash in installments before the total liquidation losses and the total cash available are known, safeguards must be taken to protect the interests of the creditors and the respective interest of each partner. In addition, the individual in charge of the liquidation must use safeguards to avoid potential liability for wrongful distributions. The remainder of this chapter focuses on the problems associated with a liquidation in installments and the general rules governing such liquidations. Once again, many of the procedures followed are necessary to satisfy legal requirements and to protect the person in charge of the liquidation and the residual partners' interests.

Safe Payment Approach

In computing how cash is to be distributed to the partners before all assets are disposed of, care must be taken to ensure that the partners' remaining capital balances will be adequate to absorb any potential loss. However, at this point, the amount of cash to be generated from the sale of noncash assets and the resulting gain or loss is not known. Therefore, the partners should view each cash distribution as if it were the final distribution.

One approach used to calculate a safe cash distribution is based on three assumptions:

1. A loan to or from an individual partner will be combined with the respective partner's capital account to determine his or her net interest in the partnership assets.
2. The remaining noncash assets will not provide any additional cash. In other words, the maximum potential loss is equal to the book value of noncash assets. (This assumption will be modified later in the chapter.)
3. A partner with a debit balance in his or her capital account will be unable to pay amounts owed to the partnership (that is, each partner is personally insolvent).

LO 4 Safe payment approach.

The result of applying these assumptions is that cash will not be distributed to a partner whose capital account balance (including loan balance and drawing account) is insufficient to absorb his or her share of potential losses either from the write-off of assets or from the failure of a deficit partner to cover a debit capital balance. Of course, no partner should receive cash until the liabilities have been liquidated or provided for through the retention of adequate cash.

Computation of Safe Payment before Each Distribution To illustrate the safe payment approach when a partnership is liquidated in installments, assume that the following condensed balance sheet was prepared before the partners' agreement to liquidate the partnership.

Cash	\$ 10,000	Liabilities	\$ 28,000
Noncash Assets	100,000	Alice Amos, Capital (30%)	34,000
		Bill Baker, Capital (50%)	30,000
		Carol Carter, Capital (20%)	18,000
Total	<u>\$110,000</u>	Total	<u>\$110,000</u>

The partners' income- and loss-sharing percentages are stated in parentheses. The noncash assets were converted into cash over a period of time as follows:

	Sales Price	Book Value	(Loss)
Sale No. 1	\$20,000	\$30,000	(10,000)
Sale No. 2	15,000	25,000	(10,000)
Sale No. 3	10,000	30,000	(20,000)
Sale No. 4	2,000	10,000	(8,000)
Sale No. 5	—0—	5,000	(5,000)

The realization of the partnership assets and liquidation of the partnership are summarized in Illustration 16-3. A safe payment schedule is prepared *each time cash is to be distributed*. After the first sale of assets and all creditors have been paid, \$2,000 cash remains to be distributed to partners. Schedule I in Illustration 16-3 demonstrates how the \$2,000 will be distributed. In this case, the assumption that the remaining noncash assets of \$70,000 are worthless results in a debit balance in Baker's capital account. Another assumption is that all partners are personally insolvent. Therefore, the hypothetical deficit is allocated to the remaining partners with credit balances on the basis of their relative profit and loss ratio: 3/5 to Amos, 2/5 to Carter. This allocation results in a hypothetical debit balance in Carter's capital account, which is assigned to Amos. Thus, if \$2,000 is paid to Amos, this will leave her with a capital balance sufficient to absorb her share of the potential remaining losses. Amos will not be required to make an additional investment in the partnership unless significant amounts of unrecorded liabilities are discovered or significant amounts of liquidation expenses are incurred. But if it became necessary for Amos to make an additional investment, the other two partners would also be required to do so.

After the second sale of assets, \$15,000 cash is available for distribution. The allocation of the \$15,000 is shown in schedule II of Illustration 16-3. Note that, if the fair value of the remaining assets is zero, Baker's capital balance of \$20,000 would be inadequate to absorb his share of the losses, which would be \$22,500 ($\$45,000 \times .50$). Accordingly, at this time, Baker does not receive any of the cash to be distributed, since he could end up with a debit capital balance. After the third cash distribution, the partners' capital balances are in their profit and loss ratio of 3:5:2. Once their capital interests are in accordance with the profit and loss ratio, any subsequent distribution of assets will be based on the profit and loss ratio. Note that each partner's capital account is now sufficient to absorb the final potential loss of \$5,000.

A safe payment schedule is prepared to compute the amount of cash to be distributed and to determine which partner(s) will receive cash. The series of computations is not recorded in the accounts, since they are based upon certain assumed events that have not yet occurred. Only the actual transactions as they occur, such as the sale of assets and distribution of cash, are recorded in the accounts.

Additional Losses, Discovery of Liabilities, and Liquidation Expense Up to this point in this chapter, all available cash was distributed to (1) the partnership's creditors who were recorded on the partnership books or (2) the partners. In the calculation of a safe payment, it was assumed that the potential loss was equal to the book value of the remaining noncash assets. In addition, no liquidation expenses were incurred. As the liquidation proceeds, some liabilities that had not been recorded previously may be reported. These creditors have claims that must be satisfied from the available cash before payments are made to partners for their capital interest.

Certain expenses, such as the reasonable cost of carrying out the liquidation, have priority over payments to creditors. Furthermore, the disposal cost of assets may exceed the proceeds from the sale of the assets so that the resulting loss is greater than the assets' recorded book value. Such items can be considered in the safe payment schedule by adding the estimated liquidation expenses, disposal cost, and unrecorded liabilities to the book value of noncash assets. To illustrate, assume the facts presented in Illustration 16-3 except that it is estimated that added

ILLUSTRATION 16-3

Schedule of Partnership Realization and Liquidation

Installment Liquidation

	<i>Capital and Loan Balances</i>					
	<i>Cash</i>	<i>Other Assets</i>	<i>Liabilities</i>	<i>Amos .3</i>	<i>Baker .5</i>	<i>Carter .2</i>
Balance before realization	10,000	100,000	(28,000)	(34,000)	(30,000)	(18,000)
Sale of assets	20,000	(30,000)		3,000	5,000	2,000
	<u>30,000</u>	<u>70,000</u>	<u>(28,000)</u>	<u>(31,000)</u>	<u>(25,000)</u>	<u>(16,000)</u>
Payment to creditors	(28,000)		28,000			
	<u>2,000</u>	<u>70,000</u>	<u>—0—</u>	<u>(31,000)</u>	<u>(25,000)</u>	<u>(16,000)</u>
Payment to partners						
Safe payment Schedule I (below)	(2,000)			2,000		
	<u>—0—</u>	<u>70,000</u>	<u>—0—</u>	<u>(29,000)</u>	<u>(25,000)</u>	<u>(16,000)</u>
Sale of assets	15,000	(25,000)		3,000	5,000	2,000
	<u>15,000</u>	<u>45,000</u>	<u>—0—</u>	<u>(26,000)</u>	<u>(20,000)</u>	<u>(14,000)</u>
Payment to partners						
Safe payment Schedule II (below)	(15,000)			11,000		4,000
	<u>—0—</u>	<u>45,000</u>	<u>—0—</u>	<u>(15,000)</u>	<u>(20,000)</u>	<u>(10,000)</u>
Sale of assets	10,000	(30,000)		6,000	10,000	4,000
	<u>10,000</u>	<u>15,000</u>	<u>—0—</u>	<u>(9,000)</u>	<u>(10,000)</u>	<u>(6,000)</u>
Payment to partners						
Safe payment Schedule III (below)	(10,000)			4,500	2,500	3,000
	<u>—0—</u>	<u>15,000</u>	<u>—0—</u>	<u>(4,500)</u>	<u>(7,500)</u>	<u>(3,000)</u>
Sale of assets	2,000	(10,000)		2,400	4,000	1,600
	<u>2,000</u>	<u>5,000</u>	<u>—0—</u>	<u>(2,100)</u>	<u>(3,500)</u>	<u>(1,400)</u>
Payment to partners	(2,000)			600	1,000	400
	<u>—0—</u>	<u>5,000</u>	<u>—0—</u>	<u>(1,500)</u>	<u>(2,500)</u>	<u>(1,000)</u>
Write-off of assets		(5,000)		1,500	2,500	1,000
	<u>—0—</u>	<u>—0—</u>	<u>—0—</u>	<u>—0—</u>	<u>—0—</u>	<u>—0—</u>

Schedule I

Computation of Safe Payments

	<i>Amos .3</i>	<i>Baker .5</i>	<i>Carter .2</i>
Capital and loan balances	(31,000)	(25,000)	(16,000)
Allocation of potential loss—\$70,000	21,000	35,000	14,000
	<u>(10,000)</u>	<u>10,000</u>	<u>(2,000)</u>
Allocation of Baker's potential deficit	6,000	(10,000)	4,000
	<u>(4,000)</u>	<u>—0—</u>	<u>2,000</u>
Allocation of Carter's potential deficit	2,000		(2,000)
Safe payment	<u>(2,000)</u>	<u>—0—</u>	<u>—0—</u>

Schedule II

Computation of Safe Payments

	<i>Amos .3</i>	<i>Baker .5</i>	<i>Carter .2</i>
Capital and loan balances	(26,000)	(20,000)	(14,000)
Allocation of potential loss—\$45,000	13,500	22,500	9,000
	<u>(12,500)</u>	<u>2,500</u>	<u>(5,000)</u>
Allocation of Baker's potential deficit	1,500	(2,500)	1,000
Safe payment	<u>(11,000)</u>	<u>—0—</u>	<u>(4,000)</u>

Schedule III

Computation of Safe Payments

	<i>Amos .3</i>	<i>Baker .5</i>	<i>Carter .2</i>
Capital and loan balances	(9,000)	(10,000)	(6,000)
Allocation of potential loss—\$15,000	4,500	7,500	3,000
Safe payment	<u>(4,500)</u>	<u>(2,500)</u>	<u>(3,000)</u>

expenses of \$1,000 will be incurred in completing the liquidation. The safe payment calculation for the first cash distribution would be modified as follows:

	<i>Amos</i>	<i>Baker</i>	<i>Carter</i>
Capital and loan balances	(31,000)	(25,000)	(16,000)
Allocation of potential losses (\$70,000 + \$1,000)	<u>21,300</u>	<u>35,500</u>	<u>14,200</u>
Balances	(9,700)	10,500	(1,800)
Allocation of Baker's potential deficit	<u>6,300</u>	(10,500)	<u>4,200</u>
Balances	(3,400)	—0—	2,400
Allocation of Carter's potential deficit	<u>2,400</u>	—	<u>(2,400)</u>
Safe payment	<u>(1,000)</u>	<u>—0—</u>	<u>—0—</u>

As can be seen, the effect of the adjustment is to hold back cash equal to the estimated expenses, which results in a corresponding reduction in the cash distributed to Amos.

Advance Plan for the Distribution of Cash

LO 5 Four steps in an advance plan.

In the preceding illustration, a safe payment to each partner was calculated before each cash distribution. This process was necessary until the capital accounts were in the profit- and loss-sharing ratio. Although this method is feasible, it is more informative and efficient to prepare an advance schedule that specifies the order in which each partner will participate and the amount of cash each partner will receive as it becomes available for distribution. For example, from such a schedule, the personal creditors of an insolvent partner would be able to compute how much cash would have to be generated from the sale of the partnership assets before any cash is distributed to the insolvent partner.

To illustrate the procedures for the preparation of an advance cash distribution plan, assume the set of facts employed in Illustration 16-3. The objective of the procedure is to derive the order and the amount of cash that should be distributed to each partner such that no partner receiving a cash distribution will have to make an additional investment in the firm. Such a distribution plan will bring the balances of the partners' capital accounts into their profit and loss ratio as soon as possible. The rationale for this procedure is that once the capital balances are in the profit and loss ratio, no one partner is in any better position than any other partner to absorb losses.

Steps in the development of an advance cash distribution plan are presented in Illustration 16-4 and explained below.

Step 1 Determine the net capital interest of each partner by combining the balance in the partner's capital account with obligations to or receivables from the partner.

	<i>Amos</i>	<i>Baker</i>	<i>Carter</i>
Capital balance	\$34,000	\$30,000	\$18,000
Loan balance	<u>—0—</u>	<u>—0—</u>	<u>—0—</u>
Net capital interest	<u>\$34,000</u>	<u>\$30,000</u>	<u>\$18,000</u>

Step 2 Determine the order in which the partners are to participate in cash distributions. The objective of this step is to provide an order of cash distribution in which the ratio of the partners' capital interest will eventually be equal to their

ILLUSTRATION 16-4

Preparation of an Advance Plan for the Distribution of Cash

<i>Step 1</i>						
	<i>Amos</i>	<i>Baker</i>	<i>Carter</i>			
Capital balances	\$ 34,000	\$ 30,000	\$18,000			
Loan balances	—	—	—			
Net capital interest	<u>\$ 34,000</u>	<u>\$ 30,000</u>	<u>\$18,000</u>			
Profit and loss ratio	.30	.50	.20			
<i>Step 2</i>						
Loss necessary to reduce net capital balance to zero	\$113,333	\$ 60,000	\$90,000			
Order of cash distribution	1	3	2			
<i>Step 3</i>						
	<i>Loss Absorption Potential</i>			<i>Asset Distribution</i>		
	<i>Amos</i>	<i>Baker</i>	<i>Carter</i>	<i>Amos</i>	<i>Baker</i>	<i>Carter</i>
Profit and loss ratio	.30	.50	.20	.30	.50	.20
Loss absorption potential	\$113,333	\$60,000	\$90,000			
Net capital interest				\$34,000	\$30,000	18,000
Distribution to Amos to reduce her capital interest so that her loss absorption potential is the same as Carter's ($\$113,333 - \$90,000 = \$23,333$) \times .30	23,333			7,000		
Balances after distribution to Amos	<u>90,000</u>	<u>60,000</u>	<u>90,000</u>	<u>27,000</u>	<u>30,000</u>	<u>18,000</u>
Distribution to Amos and Carter to reduce their capital interest so that their loss absorption potential is the same as Baker's ($\$90,000 - \$60,000 = \$30,000$) \times .30 ($\$90,000 - \$60,000 = \$30,000$) \times .20	30,000		30,000	9,000		
Balances after distribution to Amos and Carter	<u>60,000</u>	<u>60,000</u>	<u>60,000</u>	<u>18,000</u>	<u>30,000</u>	<u>6,000</u>
Remainder of asset distributions				.30	.50	.20
<i>Step 4</i>						
<i>Cash Distribution Plan</i>						
<i>Order of Cash Distribution</i>	<i>Liabilities</i>	<i>Amos</i>	<i>Baker</i>	<i>Carter</i>		
1. First \$28,000	100%	.3	.5	.2		
2. Next \$7,000		100%				
3. Next \$15,000		60%		40%		
4. Remainder		30%	50%	20%		

profit and loss ratio. Once this is accomplished, all partners will have an equal ability to absorb their share of partnership losses. Several approaches can be used to accomplish this objective. One systematic approach is to determine the loss absorption potential of each partner by dividing the net capital interest of each partner by his or her respective profit and loss ratio.

	<i>Amos</i>	<i>Baker</i>	<i>Carter</i>
Net capital interest	\$ 34,000	\$30,000	\$18,000
Profit and loss ratio	.30	.50	.20
Loss absorption potential	\$113,333	\$60,000	\$90,000
Order of cash distribution	1	3	2

This computation determines the maximum amount of loss each partner is capable of absorbing and provides a basis for ranking the partners in terms of each partner's capital interest relative to his or her loss ratio. The partner with the largest loss absorption potential has the ability to absorb a greater share of losses before his or her capital account would be reduced to a zero balance. Thus, Amos will receive the first distribution of assets after the creditors' claims have been satisfied. The partner with the lowest loss absorption potential (Baker) will be the last partner to participate in the distribution of assets from the partnership.

Step 3 In Step 2, the order in which each partner is to participate in cash distributions was determined. The next step is to compute the amount of cash each partner is to receive as it becomes available for distribution. The objective is to determine the *amount* of cash to distribute to each partner to bring the ratios of their capital interests in the partnership into alignment with their profit and loss ratios. One way to do this is to consider the loss absorption potential computed in Step 2. It was determined in Step 2 that Amos is in the strongest position relative to the other partners and is to receive the first cash distribution. Amos is capable of absorbing her share of \$113,333 in losses, which is \$23,333 greater than the loss potential of Carter (\$113,333 - \$90,000), who is the next partner to participate in cash distributions. However, Amos must absorb only 30% or \$7,000 ($\$23,333 \times .30$) of such potential losses. Thus, a payment to Amos of \$7,000 reduces her loss absorption potential to Carter's (the next closest loss potential) level ($\$34,000 - \$7,000 = \$27,000 / .30 = \$90,000$). Amos and Carter now have the same absorption potential for future losses. Also, note that a payment of \$7,000 to Amos brings her capital interest into a ratio of 3:2 to that of Carter (\$27,000:\$18,000), which is the same as their relative profit and loss ratio.

The next step in the process is to bring the loss absorption potential of Amos and Carter into balance with that of Baker, who is the last partner to participate in the distribution of cash. Using the same rationale, Amos and Carter are now capable of absorbing losses of \$30,000 ($\$90,000 - \$60,000$) greater than Baker. Since they must absorb 30% and 20% of the losses, respectively, the distribution to each partner is computed as follows:

$$\text{To Amos: } \$30,000 \times .30 = \$9,000$$

$$\text{To Carter: } \$30,000 \times .20 = \$6,000$$

Of the next \$15,000, Amos is to receive \$9,000 and Carter is to receive \$6,000. Now all partners' capital balances are in the same ratio as their profit and loss sharing ratio.⁶

⁶ An alternative method of determining the amount to be distributed at each level is to compute the capital account balances needed by each partner so as to bring the partners' capital balances into their agreed profit- and loss-sharing ratio. This approach is simpler in certain cases, but the approach in the text is more systematic when there are numerous partners. The alternative works by bringing the ratio of the partners' capital account balances into their profit- and loss-sharing ratio in the order in which the partners are to participate in the distribution. In this case, the first step is to compute what the capital account balance of Amos should be so that her capital balance is in the profit- and loss-sharing ratio with that of Carter (3:2). This can be computed as follows:

(Continues next page)

Step 4 A cash distribution plan is then prepared as follows:

<i>Order of Cash Distribution</i>	<i>Liabilities</i>	<i>Amos</i>	<i>Baker</i>	<i>Carter</i>
1. First \$28,000	100%			
2. Next \$7,000		100%		
3. Next \$15,000		60%		40%
4. Remainder		30%	50%	20%

The first \$28,000 available is, of course, paid to the creditors. Cash may be held back from distribution if it is anticipated that unrecorded liabilities will be discovered or if additional liquidation expenses will be incurred. The distribution of cash in excess of this reserve amount proceeds as determined. Amos will receive all of any additional cash up to \$7,000. Additional cash in excess of \$7,000 and up to \$22,000 is distributed 60:40 to Amos and Carter. After \$22,000 (\$15,000 + \$7,000) has been distributed to the partners, the capital accounts are in the desired profit and loss ratio of 3:5:2. Any further distributions to the partners are made according to the profit and loss ratio.

The advance distribution plan developed before will yield the same cash distribution as the process of computing a safe payment each time cash is available. As proof, in Illustration 16-5, the advance plan for distributing cash as developed in Illustration 16-4 is applied to determine the cash distribution in Illustration 16-3. Even though both methods produce the same results, the advance plan is more informative to both personal and partnership creditors, and to the partners. Interested parties now know the order in which individual partners will receive cash and the amounts that each may receive at each stage of the distribution process.

One requirement that must be satisfied in the development of the advance plan is that the partners must share income in the same ratio that they share losses. If this were not the case, the potential amount of a new loss would need to be computed after every allocation to the partners' capital accounts. This occurs because the

Let X = desired capital balance

$$\frac{\text{Loss ratio of Amos}}{\text{Loss ratio of Carter}} = \frac{X}{\text{Capital balance of Carter}}$$

$$\frac{3}{2} = \frac{X}{\$18,000}$$

$$2X = \$54,000$$

$$X = \$27,000$$

Since Amos has a capital balance of \$34,000, it would take a distribution of \$7,000 to reduce the balance to \$27,000. The next level of payments should reduce the capital balances of Amos and Carter in such a way that their capital balances will be in the loss ratio to that of Baker, which is 3:5 and 2:5, respectively.

$$\frac{3}{5} = \frac{X}{\$30,000} \quad \frac{2}{5} = \frac{X}{\$30,000}$$

$$5X = \$90,000 \quad 5X = \$60,000$$

$$X = \$18,000 \quad X = \$12,000$$

A distribution of \$9,000 to Amos (\$27,000 - \$18,000) and \$6,000 to Carter (\$18,000 - \$12,000) will produce capital balances in the ratio of 3:5:2 (\$18,000: \$30,000: \$12,000).

ILLUSTRATION 16-5
Cash Distribution per Advance Plan

	<i>Liabilities</i>	<i>Amos</i>	<i>Baker</i>	<i>Carter</i>	<i>Total</i>
First Distribution: \$30,000					
First—\$28,000	\$28,000				\$28,000
Next—\$2,000		\$2,000			2,000
	<u>\$28,000</u>	<u>\$2,000</u>	<u>—</u>	<u>—</u>	<u>\$30,000</u>
Second Distribution: \$15,000					
First—\$5,000 (Remainder of \$7,000 level)		\$5,000			\$5,000
Next—\$10,000		6,000		\$4,000	10,000
	<u>—</u>	<u>\$11,000</u>	<u>—</u>	<u>\$4,000</u>	<u>\$15,000</u>
Third Distribution: \$10,000					
First—\$5,000 (Remainder of \$15,000 level)		\$3,000		\$2,000	\$5,000
Next—\$5,000		1,500	\$2,500	1,000	5,000
	<u>—</u>	<u>\$4,500</u>	<u>\$2,500</u>	<u>\$3,000</u>	<u>\$10,000</u>
Last Distribution: \$2,000					
First—\$2,000		\$600	\$1,000	\$400	\$2,000
	<u>—</u>	<u>\$600</u>	<u>\$1,000</u>	<u>\$400</u>	<u>\$2,000</u>

allocation of liquidation gains alters the order of cash distribution computed in the advance plan. To illustrate, assume that Amos, Baker, and Carter, with capital balances of \$45,000, \$24,000, and \$20,000, respectively, share losses in the ratio of 5:3:2, but share income in the ratio of 3:5:2. The order of cash distribution based on the ratio of losses would be as follows:

	<i>Amos</i>	<i>Baker</i>	<i>Carter</i>
Net capital interest	\$45,000	\$24,000	\$20,000
Loss ratios	.50	.30	.20
Loss absorption potential	\$90,000	\$80,000	\$100,000
Order of cash distribution	2	3	1

Now assume that the partnership realizes a \$50,000 gain. The allocation of the gain in the ratio of 3:5:2 and computation of the order of cash distribution follow:

	<i>Amos</i>	<i>Baker</i>	<i>Carter</i>
Net capital interest	\$(45,000)	\$(24,000)	\$(20,000)
Allocation of \$50,000 gain	(15,000)	(25,000)	(10,000)
Net capital interest	<u>\$(60,000)</u>	<u>\$(49,000)</u>	<u>\$(30,000)</u>
Loss ratios	.50	.30	.20
New loss absorption potential	\$120,000	\$163,333	\$150,000
New order of cash distribution	3	1	2

In this illustration an allocation of the \$50,000 gain moved Baker from being the last partner to receive cash to being the first partner to receive cash.

It is also necessary to recompute an advance plan if a certain classification of losses is shared in a different ratio from the one used in preparing the advance plan, or if adjustments are made to the capital balances in other than the loss ratio.

For example, assume that it has been discovered that a cash withdrawal by a partner had been expensed instead of debited to his drawing account. The correction of the error would modify the loss absorption potential of that partner. If such adjustments occur frequently, then the computation of a safe payment may be less time-consuming and easier to use than the development of an advance cash distribution plan.

**TEST
YOUR KNOWLEDGE**

16.2

NOTE: Solutions to *Test Your Knowledge* questions are found at the end of each chapter before the end-of-chapter questions.

Short Answer

1. The capital balances for partners A and B are \$120,000 and \$60,000, respectively. They share profits and losses in the ratio 60:40. The partnership has \$15,000 in liabilities. Prepare a cash distribution plan.

INCORPORATION OF A PARTNERSHIP

LO 6 Incorporation of a partnership.

After a partnership has been operating for a period of time, the partners may find that the partnership form of business is no longer satisfactory. The corporation, with its limited liability, continuity of existence, and ability to raise needed resources, may become more attractive. Upon incorporation, the assets and liabilities are transferred to the corporation and the partners receive capital stock in settlement of their interests. The partnership accounts should be restated to fair values to assure that the partners receive an equitable distribution of stock for their interests.

The partnership books may be retained for use by the corporation, or a new set of books may be established.

Retention of Partnership Books by Corporation

Assuming that the partnership books are used by the corporation, the steps to record the incorporation are as follows:

1. Assets and liabilities are adjusted to fair value. Frequently, a valuation adjustment account is created to accumulate the gains and losses.
2. The valuation adjustment account is closed to the partners' capital accounts in accordance with their profit and loss ratio.
3. The partners' capital accounts are closed upon the transfer of capital stock. Since the books are retained, offsetting credits are made to Capital Stock at par value for the number of shares issued. If the debit to partners' capital accounts exceeds the credit to Capital Stock, the difference is a credit to Additional Paid-in Capital.

To illustrate, assume that AB Partnership is to incorporate. The new corporation is authorized to issue 5,000 shares of \$10 par value stock. Book values of the partnership accounts and fair values for the assets are determined to be:

	<i>Book Value</i>		<i>Fair Values</i>
	<i>Debit</i>	<i>Credit</i>	
Cash	\$ 5,000		\$ 5,000
Accounts Receivable	4,000		3,600
Inventory	5,000		7,000
Land	10,000		15,000
Equipment (net of depreciation)	6,000		5,000
Accounts Payable		\$ 7,000	
Notes Payable		10,000	
Art, Capital		8,000	
Beck, Capital		5,000	
Total	\$30,000	\$30,000	

Other facts are: (1) Liabilities are assumed to be fairly valued; (2) Art and Beck share profits equally; (3) Art and Beck are to receive par value stock equal to their adjusted ending capital balances. The journal entries to incorporate are:

(1) Inventory	2,000	
Land	5,000	
Equipment		1,000
Accounts Receivable		400
Valuation Adjustment		5,600
(2) Valuation Adjustment	5,600	
Art, Capital		2,800
Beck, Capital		2,800
(3) Art, Capital	10,800	
Beck, Capital	7,800	
Capital Stock—\$10 par		18,600

New Books Established by Corporation

If the corporation establishes a new set of books, then all accounts on the partnership books will end with a zero balance. The only difference as compared to the illustration above is that on receipt of the stock, asset and liability accounts are closed on the partnership books and transferred to the corporation. To balance the entry, an asset account is created for the capital stock received in the amount of \$18,600. This balance should also equal the sum of the balances in the remaining capital accounts. The entry to record the distribution of the capital stock is:

Art, Capital	10,800	
Beck, Capital	7,800	
Capital Stock (from Corporation)		18,600

The corporation records the assets received and the liabilities assumed on the new books at the net cost of the stock issued (\$18,600), which is also equal to the adjusted value of the net assets on the partnership books. A credit of \$18,600 to balance the entry is made to capital stock issued.

SUMMARY

1. Describe the steps used to distribute available partnership assets in liquidation under the Uniform Partnership Act (UPA). The first step in the liquidation process is to compute any net income or loss up to the date of dissolution. The closing process should be completed and any net income or loss allocated to the partners in accordance with their profit and loss agreement. Next the assets that are not acceptable for distribution in their present form are converted into cash, and any gains or losses realized are allocated as specified in the partnership agreement (usually according to the profit and loss ratio). Finally, the available assets are distributed to creditors and partners.
2. List the order of priority for each class of creditors in partnership liquidation under the UPA. The liabilities are settled in the following order: (1) those owing to creditors other than partners, (2) those owing to partners other than for capital and profits, (3) those owing to partners in respect to capital, and (4) those owing to partners in respect to profits.
3. Prepare a liquidation schedule to settle debts and allocate assets. The liquidation schedule begins with a listing, generally in columns, of the partnership's assets, liabilities, and partners' capital balances. Any additional investments made by individual partners are recorded first, including those made by partners with debit balances and those resulting from a judgment of partnership creditors against individual partners. Cash is distributed first to liquidate partnership liabilities and then to satisfy partners' capital interests. The cash distribution is based on the partners' capital balances, not their profit and loss ratios.
4. Prepare a "safe payment approach" liquidation schedule. To calculate a safe cash distribution, the following three assumptions may be made: (1) A loan to or from an individual partner is combined with the partner's capital balance to determine his or her interest in the partnership assets. (2) The remaining noncash assets will not provide any additional cash (the worst-case scenario). (3) Any partner with a debit balance is assumed unable to pay the amounts owed to the partnership. The result of applying these assumptions is that cash will not be distributed to any partner whose capital balance is insufficient to absorb his or her share of potential losses.
5. Describe the four steps in the preparation of an advance plan for the distribution of cash in a partnership liquidation. Determine the net capital interest of each partner by combining the balance in the partner's capital account with any obligations to, or receivables from, that partner. Determine the order in which the partners are to participate in cash distributions. Compute the amount of cash each partner is to receive as it becomes available for distribution. Prepare a cash distribution plan. This plan will yield the same distribution as a safe payment plan computed each time cash becomes available, but it is more informative to both creditors and partners, as they know the plan in advance.
6. Prepare the journal entries to incorporate a partnership. Assets and liabilities are adjusted to fair values, often using a valuation adjustment account to accumulate gains and losses. The valuation adjustment account (or gains/losses) is closed to the partners' capital accounts in accordance with their profit and loss ratios. The partners' capital accounts are closed upon the transfer of capital stock. Since the books are retained, offsetting credits are made to the capital stock account at par for the number of shares issued. If the debit to partners' capital accounts is greater than the credit to the capital stock account, the difference is credited to additional paid-in capital.

TEST YOUR KNOWLEDGE SOLUTIONS

- 16-1 1. Partner A will receive \$60,000 cash.
2. Partner A will receive \$40,000 cash.

16-2	Order of Cash Distribution	Liabilities	A (.6)	B (.4)
	1. First \$15,000	100%		
	2. Next \$30,000		100%	
	3. Remainder		60%	40%

QUESTIONS

- LQ1** 1. Why are realization gains or losses allocated to partners in their profit and loss ratios?
- LQ3** 2. In what manner should the final cash distribution be made in partnership liquidation?
- LQ2** 3. Why does a debit balance in a partners' capital account create problems in the UPA order of payment for a partnership liquidation?
- LQ2** 4. Is it important to maintain separate accounts for a partner's outstanding loan and capital accounts? Explain why or why not.
- LQ5** 5. Discuss the possible outcomes in the situation where the equity interest of one partner is inadequate to absorb realization losses.
- LQ3** 6. During a liquidation, at which point may cash be distributed to any of the partners?
- LQ3** 7. What is "marshaling of assets"?
- LQ3** 8. To what extent can personal creditors seek recovery from partnership assets?
- LQ4** 9. In an installment liquidation, why should the partners view each cash distribution as if it were the final distribution?
- LQ4** 10. Discuss the three basic assumptions necessary for calculating a safe cash distribution. How is this safe cash distribution computed?
- LQ4** 11. How are unexpected costs such as liquidation expenses, disposal costs, or unrecorded liabilities covered in the safe distribution schedule?
- LQ5** 12. What is the objective of the procedures used for the preparation of an advance cash distribution plan?
- LQ5** 13. What is the "loss absorption potential"?
- LQ2** 14. In what order must partnership assets be distributed?

Business Ethics

You and two of your former college friends, Freeman and Oxyman, formed a partnership called FOB, which builds and installs fabricated swimming pools. The business has been operating for 15 years and has become one of the top swimming pool companies in the area. Typically, you have been providing the on-site estimates for the pools, while your partners do most of the on-site construction. While visiting one of the sites, you hear a conversation between one of your partners and a customer. Your partner is explaining that the cost will increase by \$10,000 because of unexpected rock removal. You are a bit surprised by this, since you had tested the area for rocks. Later, back at the office, you review the core-sample results done on that job, which did not reveal any rock. You decide to talk to the partner when he returns to the office. When the partner returns to the office, he is arguing with someone from a local bank concerning an outstanding personal loan.

1. What do you see as your duty with respect to the partnership?
2. What should you do? Explain your reasoning.

EXERCISES

EXERCISE 16-1 Simple Liquidation **LQ3**

The CPA Partnership operated by Cook, Parks, and Argo is being liquidated. A balance sheet prepared at this stage in their liquidation process is presented below.

Cash	\$40,000	Liabilities	\$25,000
Other Assets	50,000	Parks, Loan	10,000
		Cook, Capital	30,000
		Parks, Capital	10,000
		Argo, Capital	15,000
Total	<u>\$90,000</u>	Total	<u>\$90,000</u>

The partners share profits and losses 30% (Cook), 50% (Parks), and 20% (Argo). The partners are all personally insolvent.

Required:

- A. The partners wish to distribute the \$40,000 in cash. Record in journal entry form the distribution of the available cash.
- B. Record in journal entry form the completion of the liquidation process, assuming that the other assets of \$50,000 are sold for \$15,000.

EXERCISE 16-2 Simple Liquidation **LO3**

John, Jake, and Joe are partners with capital accounts of \$90,000, \$78,000, and \$64,000 respectively. They share profits and losses in the ratio of 30:40:30. When the partners decide to liquidate, the business has \$70,000 in cash, noncash assets totaling \$260,000, and \$98,000 in liabilities. The noncash assets are sold for \$270,000, and the creditors are paid.

Required:

- A. Prepare a schedule of partnership liquidation.
- B. Prepare journal entries to record each of the following transactions.
 - (1) The sale of the noncash assets.
 - (2) The payment to the creditors.
 - (3) The distribution of cash to the partners.

EXERCISE 16-3 Cash Distribution Schedule **LO3**

The unsuccessful partnership of the Jones Brothers is about to undergo liquidation. They have asked you to estimate the amount of cash that each brother will receive. They share profits and losses equally.

Cash	\$ 22,000	Liabilities	\$ 35,000
Noncash Assets	110,000	Doug, Capital	55,000
		Dave, Capital	50,000
		Dan, Capital	(8,000)
	<u>\$132,000</u>		<u>\$132,000</u>

Both Doug and Dave are personally solvent, but Dan is not. They estimate that they will receive \$65,000 from the sale of the noncash assets.

Required:

Prepare a schedule to estimate the amount of cash each brother will receive.

EXERCISE 16-4 Cash Distribution Schedule **LO3**

The ABC Partnership is in the process of liquidation. The account balances prior to liquidation are given below:

<i>Debits</i>		<i>Credits</i>	
Cash	\$ 72,000	Liabilities	\$ 40,000
Amos, Drawing	10,000	Boone, Loan	8,000
Boone, Drawing	15,000	Childs, Loan	25,000
Childs, Drawing	20,000	Amos, Capital	49,000
Operating Loss	21,000	Boone, Capital	18,000
Liquidation Loss	12,000	Childs, Capital	10,000
	<u>\$150,000</u>		<u>\$150,000</u>

The partners share profits in the following ratio: Amos, 1/5; Boone, 2/5; Childs, 2/5.

Required:

Prepare a schedule showing the calculations of the distribution of cash under the Uniform Partnership Act, assuming that all three partners have personal liabilities in excess of their personal assets.

EXERCISE 16-5 Partnership Liquidation—Safe Payment Approach **LO4**

Following is the balance sheet of the BDO Partnership:

Cash	\$ 10,000	Liabilities	\$ 18,000
Accounts Receivable	40,000	Brink, Capital	45,000
Inventory	30,000	Davis, Capital	27,000
Equipment	60,000	Olsen, Capital	50,000
	<u>\$140,000</u>		<u>\$140,000</u>

The partners share income 40:40:20, respectively. Assume that 70% of the receivables are collected and that inventory with a book value of \$15,000 is sold for \$10,000. All cash available at this time is to be distributed.

Required:

Determine the proper distribution of cash, using the safe payment approach.

EXERCISE 16-6 Partnership Liquidation with Personal Asset Information **LO3**

Pete, Tom, and Zack have operated a laundromat for 10 years. The partners, who share profits 4:3:3, respectively, decide to liquidate the partnership. The firm's balance sheet just before the partners sell the other assets for \$30,000 is as follows:

<i>Assets</i>		<i>Liabilities and Capital</i>	
Cash	\$ 15,000	Liabilities	\$ 42,000
Other Assets	110,000	Pete, Capital	55,000
		Tom, Capital	14,000
		Zack, Capital	14,000
	<u>\$125,000</u>		<u>\$125,000</u>

The personal status of each partner just before liquidation is as follows:

	<i>Personal Assets</i>	<i>Personal Liabilities</i>
Pete	\$55,000	\$80,000
Tom	30,000	10,000
Zack	30,000	50,000

The partnership operates in a state that has adopted the Uniform Partnership Act.

Required:

- Determine the amount of cash each partner will receive in liquidation and how much cash each partner must invest in the firm, given their personal positions.
- Determine the amounts that the personal creditors will receive from personal assets and any distribution from the partnership.

EXERCISE 16-7 Multiple Choice **LO3 LO4**

Select the best answer for each of the following items:

- In accordance with the marshaling of assets provision of the Uniform Partnership Act, rank the following liabilities of a partnership in order of payment.
 - \$20,000 loan from B. Barry who is a partner.
 - \$30,000 of profits from the last year of operations.
 - \$3,000 payable to a supplier.
 - \$100,000 in capital balances of the partners.
 - 2,3,4,1.
 - 4,2,1,3.
 - 3,1,4,2.
 - 3,1,2,4.
- Personal assets are first allocated to partnership creditors and then to personal creditors.
 - This statement is true.
 - True if partner has debit balance in his/her capital account.
 - This statement is false.

3. The following condensed balance sheet is presented for the partnership of Lisa, Lori, and Lucy, who share profits and losses in the ratio of 5:3:2, respectively:

Cash	\$ 80,000	Liabilities	\$140,000
Other Assets	280,000	Lisa, Capital	100,000
		Lori, Capital	100,000
		Lucy, Capital	20,000
Total	<u>\$360,000</u>	Total	<u>\$360,000</u>

The partners agreed to liquidate the partnership after selling the other assets. If the other assets are sold for \$160,000, how much should Lisa receive upon liquidation?

- (a) \$37,500
 (b) \$38,500
 (c) \$40,000
 (d) \$100,000

Questions 4 and 5 are based on the following balance sheet for the partnership of Allen, Bob, and Cecil:

Cash	\$ 20,000	Liabilities	\$ 50,000
Other Assets	180,000	Allen, Capital (40%)	37,000
		Bob, Capital (30%)	65,000
		Cecil, Capital (30%)	48,000
	<u>\$200,000</u>		<u>\$200,000</u>

Figures shown parenthetically reflect agreed profit and loss sharing percentages.

4. If the firm, as shown on the original balance sheet, is dissolved and liquidated by selling assets in installments, the first sale of noncash assets having a book value of \$90,000 realizes \$50,000, and all cash available after settlement with creditors is distributed, the respective partners would receive (to the nearest dollar)
- (a) Allen, \$8,000; Bob, \$6,000; Cecil, \$6,000.
 (b) Allen, \$6,667; Bob, \$6,667; Cecil, \$6,666.
 (c) Allen, \$0; Bob, \$10,000; Cecil, \$10,000.
 (d) Allen, \$0; Bob, \$18,500; Cecil, \$1,500.
5. If the facts are as in item 4 above except that \$3,000 cash is to be withheld, the respective partners would then receive (to the nearest dollar)
- (a) Allen, \$6,800; Bob, \$5,100; Cecil, \$5,100.
 (b) Allen, \$5,667; Bob, \$5,667; Cecil, \$5,666.
 (c) Allen, \$0; Bob, \$8,500; Cecil, \$8,500.
 (d) Allen, \$0; Bob, \$17,000; Cecil, \$0.

(AICPA adapted)

EXERCISE 16-8 Multiple Choice **LO2** **LO3** **LO6**

Select the best answer for each of the following items. Questions 1 and 2 are based on the following condensed balance sheet for the partnership of Caine, Davis, and Jones.

Cash	\$ 90,000	Accounts Payable	\$220,000
Other Assets	820,000	Jones, Loan	40,000
Caine, Receivable	40,000	Caine, Capital	300,000
		Davis, Capital	200,000
		Jones, Capital	190,000
Total	<u>\$950,000</u>	Total	<u>\$950,000</u>

The partners share income and loss in the ratio of 5:3:2, respectively.

1. Assume that the assets and liabilities are fairly valued in the balance sheet and the partnership decides to admit Kuman as a new partner with a one-fourth capital interest. No goodwill or bonus is to be recorded. How much should Kuman invest in cash or other assets?
 - (a) \$172,500.
 - (b) \$175,000.
 - (c) \$230,000.
 - (d) \$233,333.
2. Assume that instead of admitting a new partner, the partners decide to liquidate the partnership. If the other assets are sold for \$600,000, how much of the available cash should be distributed to Caine?
 - (a) \$170,000.
 - (b) \$150,000.
 - (c) \$190,000.
 - (d) \$300,000.
3. A, B, C, and D are partners sharing profits and losses equally. The partnership is insolvent and is to be liquidated. The status of the partnership and each partner is as follows:

	<i>Partnership Capital Balance</i>	<i>Personal Assets (Exclusive of Partnership Interest)</i>	<i>Personal Liabilities (Exclusive of Partnership Interest)</i>
A	\$15,000 Credit	\$100,000	\$40,000
B	10,000 Credit	30,000	60,000
C	20,000 Debit	80,000	5,000
D	30,000 Debit	1,000	28,000

Assuming the Uniform Partnership Act applies, the partnership creditors

- (a) Must first seek recovery against C because he is personally solvent and he has a negative capital balance.
 - (b) Will not be paid in full regardless of how they proceed legally because the partnership assets are less than the claims of the partnership creditors.
 - (c) Will have to share B's interest in the partnership on a pro-rata basis with B's personal creditors.
 - (d) Have first claim to the partnership assets before any partner's personal creditors have rights to the partnership assets.
4. If a partner with a debit capital balance during liquidation is insolvent, the following results:
 - (a) The partner must borrow money to invest in the partnership.
 - (b) The partnership will give the partner cash to the extent of the partners' debit balance.
 - (c) The partner's debit balance will be allocated to the other partners.
 - (d) None of the above.
 5. If a partnership is undergoing a transformation to a corporation, which of the following is a result?
 - (a) Assets and liabilities are adjusted to fair value.
 - (b) The net assets are distributed to the partners in their profit and loss ratio.
 - (c) The partners receive stock in the new corporation.
 - (d) Both (a) and (c) are correct.

EXERCISE 16-9 Rights of Various Parties LO3

Q, R, S, and T are partners, sharing profits and losses 40%:20%:20%:20%, respectively. After sale of firm assets and payment of the available cash to the partnership creditors, a partnership trial balance and the personal status of each partner are as follows:

<i>Partnership Trial Balance</i>		<i>Personal Status Exclusive of Partnership Interest</i>			
	<i>Debit</i>	<i>Credit</i>	<i>Partner</i>	<i>Assets</i>	<i>Liabilities</i>
Creditors		\$ 2,000			
Q, Capital		500	Q	\$15,000	\$10,000
R, Capital		7,500	R	8,000	20,000
S, Capital	\$ 6,000		S	15,000	4,000
T, Capital	4,000		T	6,000	8,000
	<u>\$10,000</u>	<u>\$10,000</u>			

The partnership operates in a state that has adopted the Uniform Partnership Act.

Required:

- What are the rights of the partnership creditors on the unpaid balance of \$2,000?
- What are the rights of the individual creditors of each partner?
- Assuming that Q pays the partnership creditors, prepare a schedule to show how the settlement by the partners will be completed.
- Indicate the amount of assets that will be available to the personal creditors of R after the settlement by the partners.
- Indicate the amount of assets that will be available to the personal creditors of T after the settlement by the partners.

EXERCISE 16-10 Rights of Various Parties LO3

The trial balance for the MAD Partnership is as follows just before declaring bankruptcy.

<i>Cash</i>	<i>Other Assets</i>	<i>Liabilities</i>	<i>Matt Loan</i>	<i>Matt Capital</i>	<i>Allen Capital</i>	<i>Dave Capital</i>
\$20,000	\$100,000	= \$18,000	\$10,000	\$44,000	\$30,000	\$18,000

Partners share profits in the ratio 45:30:25.

Required:

- Prepare a schedule to show how available cash would be distributed to the partners after creditors are paid in full. State which partner would receive the first cash available and at what point and to what degree each of the remaining partners would participate in cash distributions.
- Cash of \$30,000 is available to partners after the creditors have been paid in full. Prepare the general journal entry to record the distribution of \$30,000.

ASC Exercises:

For all ASC exercises indicate as part of your answer: the Codification topic, subtopic, section, and/or paragraph upon which your answer is based (unless otherwise specified). All ASC questions require access to the FASB Codification.

- ASC16-1** **Presentation** Describe the conditions under which a firm can change one of its accounting principles. What is the preferred accounting treatment for a change in accounting principle? List the relevant paragraphs in the Codification.
- ASC16-2** **Recognition** Where in the Codification are the conditions listed that allow an entity that sells a product to recognize revenue on an accrual basis?
- ASC16-3** **Scope** Is a debt restructuring always classified as a troubled debt restructuring if the entity is experiencing some financial difficulties? Explain.
- ASC16-4** **Recognition** In a limited partnership with multiple general partners, the determination of which, if any, general partner within the group controls and consolidates the limited partnership is based on an analysis of the relevant facts and circumstances. List the rights of a limited partner that would indicate that the general partners do not control the limited partnership.

PROBLEMS

PROBLEM 16-1 **Simple Liquidation** **LO3**

The Discount Partnership is being liquidated. The current balance sheet is shown here.

Discount Partnership
Balance Sheet
January 14, 2008

Assets

Cash	\$ 25,000
Other assets	120,000
Total assets	\$145,000

Liabilities and Partners' Equity

Accounts payable	\$ 40,000
Dawson, capital	31,000
Feeney, capital	65,000
Hardin, capital	9,000
Total liabilities and partners' equity	\$145,000

Dawson, Feeney, and Hardin share profits and losses in a 30:40:30 ratio.

Required:

- A.** Prepare a schedule of partnership liquidation for each of the following three independent cases.
- (1) The noncash assets are sold for \$60,000, and any partner with a deficit is unable to eliminate any of the deficit.
 - (2) The noncash assets are sold for \$60,000, and any partner with a deficit is able to invest cash equal to the amount of the deficit.
 - (3) The noncash assets are sold for \$50,000, and any partner with a deficit is able to invest up to \$8,000 cash in the partnership.
- B.** Prepare all necessary journal entries for case 2 above.

PROBLEM 16-2 Installment Liquidation LO4

Nelson, Parker, and Rice are partners who share profits 4:3:3, respectively. Parker decides that it would be more profitable for him to operate as a sole proprietor. Nelson and Rice are in agreement that life would be more rewarding if Parker were to enter into direct competition with them. Nelson and Rice make repeated attempts to acquire Parker's interest in the partnership. Unable to reach an agreement, the partners mutually agree that their association should be dissolved. A condensed balance sheet before realization of assets shows the following balances:

Assets		Liabilities and Capital	
Cash	\$ 5,000	Liabilities	\$20,000
Other Assets	60,000	Nelson, Capital	20,000
		Parker, Capital	12,000
		Rice, Capital	13,000
Total	<u>\$65,000</u>	Total	<u>\$65,000</u>

Asset realization is accomplished in four stages as follows:

Stage	Sales Price	Book Value
1	\$16,000	\$12,000
2	12,000	10,000
3	10,000	20,000
4	2,000	18,000

The partners prefer that cash be distributed as soon as it is available.

Required:

Prepare a summary in columnar form of the partnership realization and liquidation. You should prepare supporting schedules of safe payments before each cash distribution.

PROBLEM 16-3 Installment Liquidation LO4

Hann, Murphey, and Ryan have operated a retail furniture store for the past 30 years. Their business has been unprofitable for several years, since several large discount furniture stores opened in their sales territory. The partners recognize that they will be unable to compete with the larger chain stores and decide that since all the partners are near retirement, they should liquidate their business before it is necessary to declare bankruptcy. Account balances just before the liquidation process began were as follows:

Cash	\$ 10,000	Liabilities	\$110,000
Other Assets	218,000	Hann, Capital	50,000
		Murphey, Capital	42,000
		Ryan, Capital	26,000
	<u>\$228,000</u>	Total	<u>\$228,000</u>

The partners share profits in the ratio of 5:3:2, respectively.

Rather than selling all the assets in a forced liquidation and incurring selling expenses, the partners agree that some of the noncash assets may be withdrawn in partial settlement of their capital interest. The partners agree that if the market value of a withdrawn asset is less than book value, the difference should be allocated to all partners in their loss ratio. If market value is greater than book value, the asset is to be adjusted to its market value before recording the withdrawal. All the partners are personally solvent and can make additional cash investment in the partnership up to \$20,000 each. The following is a schedule of transactions that occurred during 2008 in the liquidation process.

March 15, 2008	During liquidation sale, noncash assets with a book value of \$90,000 were sold for \$80,000.
March 16, 2008	Sold accounts receivable with a book value of \$30,000 to a factory for \$26,000.
March 16, 2008	Paid all recorded partnership creditors.
March 18, 2008	Distributed all but \$1,000 of available cash to partners.
March 19, 2008	Murphey withdrew from inventory furniture with a book value of \$10,000 and a market value of \$13,000 to satisfy part of his capital interest.
March 21, 2008	Sold remainder of inventory with a book value of \$50,000 to a discount furniture store for \$30,000 cash.
March 25, 2008	Assigned for \$12,000 cash the remaining term of the lease on the warehouse. The lease was accounted for as an operating lease.
March 25, 2008	Distributed all available cash to partners.
April 1, 2008	Hann agreed to accept two vehicles with a book value of \$10,000 and a market value of \$8,000 in partial settlement of his capital interest.
April 5, 2008	All remaining assets were sold for \$4,000.
April 6, 2008	Received additional cash from partners with debit capital balances.
April 6, 2008	Distributed available cash to partners.

Required:

Prepare a schedule of partnership realization and liquidation in accordance with the sequence of the foregoing events. Compute a safe payment to support your cash distribution to partners.

PROBLEM 16-4 Simple Liquidation with Personal Asset Information **LQ3**

Mary, Paula, and Ray have operated a retail store for 20 years. The partners share profits and losses in the ratio of 4:3:3, respectively. The partnership is unable to meet its obligations and the partners decide to liquidate the partnership. The firm's balance sheet just before the partners sell the other assets for \$20,000 is as follows.

<i>Assets</i>		<i>Liabilities and Partners' Equities</i>	
Cash	\$ 10,000	Liabilities	\$ 40,000
Other Assets	100,000	Mary, Capital	50,000
		Paula, Capital	10,000
		Ray, Capital	10,000
	<u>\$110,000</u>		<u>\$110,000</u>

After the sale of the noncash assets, the personal assets and liabilities of each partner are determined to be the following:

	<i>Personal Assets</i>	<i>Personal Liabilities</i>
Mary	\$50,000	\$80,000
Paula	30,000	10,000
Ray	30,000	50,000

The partnership operates in a state that has adopted the Uniform Partnership Act.

Required:

- Determine the amount of cash each partner will receive in liquidation and how much cash each partner must contribute to the firm, given their personal positions.
- Determine the amounts that the personal creditors will receive from personal assets and any distribution from the partnership.

PROBLEM 16-5 Advance Cash Distribution Plan L05**Part A**

Baker, Strong, and Weak have called on you to assist them in winding up the affairs of their partnership. You are able to gather the following information.

1. The trial balance of the partnership at June 30, 2008, is as follows.

	<i>Debit</i>	<i>Credit</i>
Cash	\$ 6,000	
Accounts Receivable	22,000	
Inventory	14,000	
Plant and Equipment (net)	99,000	
Baker, Advance	12,000	
Weak, Advance	7,500	
Accounts Payable		\$ 17,000
Baker, Capital		67,000
Strong, Capital		45,000
Weak, Capital		31,500
Total	<u>\$160,500</u>	<u>\$160,500</u>

2. The partners share profits and losses as follows: Baker, 40%; Strong, 40%; and Weak, 20%.
3. The partners are considering an offer of \$100,000 for the accounts receivable, inventory, and plant and equipment as of June 30. The \$100,000 would be paid to the partners in installments, the number and amounts of which are to be negotiated.

Required:

Prepare an advance cash distribution plan as of June 30, 2008. Prepare a schedule to show how the potential cash (\$106,000) would be distributed as it becomes available.

Part B

Assume the facts in Part A except that the partners liquidate in stages instead of accepting the offer of \$100,000. Cash is distributed to the partners at the end of each month.

A summary of the liquidation transactions follows.

July

\$16,500—collected on accounts receivable; balance is uncollectible.

\$10,000—received for the entire inventory.

\$ 1,000—liquidation expenses paid.

\$ 8,000—cash retained in the business at the end of the month.

August

\$ 1,500—liquidation expenses paid.

As part payment of his capital interest, Weak accepted a piece of special equipment that he developed that had a book value of \$4,000. The partners agreed that a value of \$10,000 should be placed on the machine for liquidation purposes.

\$ 2,500—cash retained in the business at the end of the month.

September

\$75,000—received on sale of remaining plant and equipment.

\$ 1,000—liquidation expenses paid.

No cash retained in the business.

Required:

Prepare a schedule of cash payments as of September 30, 2008, showing how the cash was actually distributed. Use the advance cash distribution plan developed in Part A where appropriate. (AICPA adapted)

PROBLEM 16-6 Statement of Changes in Partners' Capital and Liquidation **LO3**

Mark Malone, Pete Patton, and Sally Spencer formed a partnership on January 1, 2008. Their original capital investments (all cash) were \$140,000, \$160,000, and \$100,000, respectively. During the first year of operations, Mark withdrew \$30,000, and the partnership reported a net income of \$60,000. The partnership agreement stipulates that all income and losses are to be divided in the ratio of the original capital investments.

At the beginning of the second year, the partners decided to liquidate the business because of a disagreement. The assets and liabilities on January 2, 2009, were as follows: Cash, \$37,000; Accounts Receivable, \$129,000; Inventory, \$188,000; Land, \$85,000; Building (net), \$180,000; Furniture and Fixtures (net), \$30,000; Accounts Payable, \$74,000; and Mortgage Payable, \$145,000. The inventory was sold for three-quarters of its book value, the furniture and fixtures brought in \$10,000, and \$92,000 of the accounts receivable were collected. The remaining receivables were uncollectible. After the losses were allocated according to the partnership agreement and the accounts payable were paid in full, Pete accepted the land and building at book value and assumed the mortgage payable at book value as partial settlement of his capital interest. The cash balance was then distributed to the partners.

Required:

- Prepare a statement of changes in partners' capital for the year ended December 31, 2008.
- Prepare the journal entries to close the Drawing and Income Summary accounts for 2008.
- Prepare a schedule of partnership liquidation.
- Prepare the journal entries to record the liquidation activities.

PROBLEM 16-7 Incorporation of a Partnership **LO6**

Jan and Sue have engaged successfully as partners in their law firm for a number of years. Soon after their state's incorporation laws are changed to allow professionals to incorporate, the partners decide to organize a corporation to take over the business of the partnership.

The after-closing trial balance for the partnership is as follows:

**After-Closing Trial Balance
December 31, 2008**

	<i>Debit</i>	<i>Credit</i>
Cash	\$15,000	
Accounts Receivable	32,400	
Allowances for Uncollectibles		\$ 2,000
Prepaid Insurance	800	
Office Equipment	30,200	
Accumulated Depreciation		12,600
Jan, Loan (outstanding since 2000, at 5%)		6,400
Jan, Capital (50%)		29,400
Sue, Capital (50%)		28,000
	\$78,400	\$78,400

Figures shown parenthetically reflect agreed profit- and loss-sharing ratios.

The partners have hired you as an accountant to adjust the recorded assets and liabilities to their market values and to close the partners' capital accounts to the new corporate capital

stock. The corporation is to retain the partnership's books, and the assets of the partnership should be taken over by the corporation in the following amounts:

Cash	\$15,000
Accounts receivable	32,400
Allowance for uncollectibles	2,900
Prepaid insurance	800
Office equipment	16,000

Jan's loan is to be transferred to her capital account in the amount of \$6,600.

Required:

- A. Prepare the necessary journal entries to express the agreement described.
- B. Prepare the entries to record the issuance of shares to Jan and Sue, assuming the issuance of 400 shares (par value \$100) of stock to Jan and Sue.

PROBLEM 16-8 Discussion Case with Ethical Issue 106

Alan Norwood is currently a senior associate with the law firm of Butler, Starns, and Madden (BSM). His compensation currently includes a salary of \$155,000, and benefits valued at \$5,000. BSM is considered among the strongest of local firms, with assets of \$10 million (cash \$2,000,000, and accounts receivables \$8,000,000), liabilities of \$7.5 million, and 11 partners.

Alan anticipates admission to the partnership on July 1 of this year. The senior managing partner, Jane Butler, has had preliminary discussions with Alan in which the senior partner proposed the following:

1. A 5% interest in BSM capital and profits in recognition of Alan's commitment to the firm and in exchange for a capital investment by Alan of \$150,000. This 5% interest would be acquired from the other partners.
2. Alan's compensation will consist of a monthly withdrawal of \$18,000 and benefits valued at \$5,000 annually. Monthly withdrawals approximate firm profits, but any unpaid profits will be distributed as a bonus to Alan after the end of each partnership year.

On March 1, only one month prior to Alan's final negotiation meeting for entry into the partnership, Mary, one of the junior associates, discreetly informed Alan that the firm was drawing up documents for Hugh Starns' retirement. Hugh has a 5% interest in the firm's capital and profits with a book value of \$125,000. The partners have agreed upon a \$75,000 cash settlement of the interest held by Mr. Starns. (Of the other 10 partners, numbers 1 through 9 hold 10% interests, and number 10 holds a 5% interest).

Required:

- A. Assume Mr. Starns retires with his \$75,000 settlement, and Alan is admitted to the partnership as proposed.
 - (1) Prepare journal entries to record the retirement and admission.
 - (2) Discuss the factors Alan needs to consider in evaluating whether he has improved his annual compensation from the firm. Although this is not a tax course, include a discussion of the various tax issues.
 - (3) Should Alan be concerned regarding the impending retirement and settlement of Mr. Starns' capital account assuming Alan is confident that he will be able to match the revenue-generating ability of Mr. Starns?
- B. Assume instead that Alan is so disturbed by the impending departure of Mr. Starns that he decides to join Mary, the junior associate, in leaving the firm to form their own law partnership. Both Alan and Mary feel confident that during their tenures at BSM they

have developed such good working relationships with their clients that the majority of their clients will follow them to the new firm.

- (1) Should Alan and Mary have any hesitation in quietly recruiting BSM clients to “follow them” to the new law firm?
 - (2) Can the partners of BSM prevent such recruiting of clients based on the claim that these clients are BSM “property”?
- C. Assume instead that the firm encounters difficulties from which it is unable to recover, and in April, the decision is made to liquidate the firm. It is discovered that Mr. Starns has (in violation of the partnership agreement) taken draws which reduced firm cash and his capital account by \$130,000. However, BSM owes Mr. Starns \$10,000 for a separate loan made to the firm some 10 years ago. As of May 1, the firm had unallocated profits of \$25,000, and cash had also increased by \$25,000.
- (1) Assuming that the provisions of UPA Section 40(b) are adhered to strictly, prepare entries to record the distributions. Assume that Mr. Starns is insolvent.
 - (2) If the other 10 partners are aware that Starns’ capital account will take on a debit balance, can they rightfully hold repayment of the balance due to Starns for the \$10,000 loan contingent on his reimbursement of his capital account’s debit balance? Does this violate UPA Section 40(b)? On what basis can the partners justify their action (if challenged)?