

Chapter Sixteen

Partnerships: Liquidation

Multi-Corporate
Entities

Multinational
Entities

Reporting
Requirements

Partnerships

Formation, Operation,
Changes

Liquidation

Governmental and
Not-for-Profit Entities

Corporations in
Financial Difficulty

THE DEMISE OF LAVENTHOL & HORWATH

In 1990, when the “Big Six” accounting firms dominated the profession, Laventhol & Horwath was the seventh largest accounting firm with more than 3,400 employees and a firm record revenue of \$345.2 million. The Philadelphia-based accounting partnership had been in operation since 1915 and its prospects could not have seemed brighter. However, serious problems had begun in October 1989 when Laventhol was forced to pay more than \$30 million to nine banks that had relied on Laventhol’s audit of a real estate corporation. Five months later, the firm negotiated a \$13 million settlement with another group of plaintiffs. As the lawsuits continued to pile up, the strain on Laventhol increased.

In an effort to stay afloat following these large settlements, Laventhol announced a 10 percent across-the-board salary cut in October 1990. In fact, in a press release accompanying the cut, the firm was said it was “optimistic” about the future. Sadly, “the future” lasted only about a month. In November 1990, the firm fired the majority of its employees and filed for Chapter 11 bankruptcy protection in New York. At the time of the filing, Laventhol had 110 pending lawsuits and \$75 million in debt.

LAVENTHOL & HORWATH

Because of the normal risks of doing business, the majority of partnerships begun in any year fail within three years and require dissolution and liquidation. The ending of a partnership’s business is often an emotional event for the partners. They may have had high expectations and invested a large amount of personal resources and time in the business. The end of the partnership often is the end of those business dreams. Accountants usually assist in the winding-up and liquidation process and must recognize the legitimate rights of and any amounts due to the many parties involved in the partnership: its individual partners, creditors, and customers as well as others doing business with it.

The Uniform Partnership Act of 1997 has 71 sections, 7 of which deal specifically with the dissolution and winding-up of a partnership. Several sections discuss the specific rights of the partnership’s creditors. They have first claim to the partnership’s assets. After the creditors are fully satisfied, any remaining assets are distributed to the partners based on the balances in their capital accounts. This chapter presents the concepts that accountants must know if they offer professional services to partnerships undergoing winding-up and liquidation.

LEARNING OBJECTIVES

When you finish studying this chapter, you should be able to:

- LO 16-1 Understand and explain terms associated with partnership liquidations.
- LO 16-2 Make calculations related to lump-sum partnership liquidations.
- LO 16-3 Make calculations related to installment partnership liquidations.

OVERVIEW OF PARTNERSHIP LIQUIDATIONS

LO 16-1

Understand and explain terms associated with partnership liquidations.

Most states have adopted the major provisions of the UPA 1997, which is used for the illustrations in this chapter. The chapter first presents the UPA 1997's major provisions regarding events and processes associated with partnership liquidations. After this overview, the chapter illustrates the winding-up process in both a lump-sum liquidation and an installment liquidation.

Dissociation, Dissolution, Winding-Up, and Liquidation of a Partnership

Dissociation is the legal description of a partner's withdrawal, including the following:

1. A partner's death.
2. A partner's voluntary withdrawal (i.e., a retirement).
3. A judicial determination, including (a) the partner engaged in wrongful conduct that materially and negatively affected the partnership, (b) the partner willfully committed a material breach of the partnership agreement, (c) the partner became a debtor in bankruptcy, or (d) a partner cannot perform his or her duties under the partnership agreement.

Not all dissociations result in a partnership liquidation. Many involve only a buyout of the withdrawing partner's interest rather than a winding-up and liquidation of the partnership's business.

Dissolution is the termination of a partnership. Events that cause its dissolution and winding-up are presented in section 801 of the UPA 1997, as follows:

1. A partner gives notice of his or her intention to leave the partnership. An *at-will partnership* is one in which there is, at most, only an oral understanding among the partners and no definite term or specific task undertaking. A partnership agreement can eliminate this event as a cause for dissolution by including, for example, a provision for a buyout of that partner's interest in the partnership.
2. A dissolution of a partnership created for a definite term or specific undertaking takes place when (a) after a partner's death or wrongful dissociation, at least half of the remaining partners decide to wind up the partnership business, (b) all partners agree to wind up the partnership business, or (c) the term or specific undertaking has expired or been completed.
3. An event occurs that makes carrying on a substantial part of the partnership business unlawful.
4. A judicial determination that (a) the partnership's economic purpose is unlikely to be achieved, (b) a partner has engaged in conduct relating to the partnership that makes continuing the business impracticable, or (c) carrying on the partnership in conformity with the partnership agreement is not reasonably practicable.

On dissolution, the partnership begins the winding-up of its business.

Winding-Up and Liquidation

Winding-up and liquidation of the partnership begins after its dissolution. The partnership continues for the limited purpose of winding-up the business and completing work in process. The winding-up process includes the transactions necessary to liquidate the partnership such-as the collection of receivables, including any receivables from partners; conversion of the noncash assets to cash; payment of the partnership's obligations; and the distribution of any remaining net balance to the partners, in cash, according to their capital interests. If the partnership agreement does not provide for a special liquidation ratio, profits or losses are distributed during liquidation in the normal profit and loss ratio used during the partnership's operation.

Some terminating partnerships change to the liquidation basis of accounting once they no longer consider the business to be a going concern. When the liquidation basis of accounting is adopted, the partnership's assets are valued at their estimated net realizable liquidation values and liabilities at their estimated settlement amounts. Because of the apparent uncertainties in practice of specifically defining the point at which an entity is no longer a going concern, the FASB, decided (in March 2010) not to specifically define a going concern. Instead, the Board decided to require detailed disclosures when management, applying commercially reasonable business judgment, is aware of conditions and events that indicate, based on current facts and circumstances, that it is reasonably foreseeable that an entity may not be able to meet its obligations as they become due.

Loans to or from Partners Under the UPA 1997, liabilities to partners for loans they have made to the partnership ("inside debt") have the same status as liabilities to the partnerships' third-party creditors ("outside debt"). In effect, UPA 1997 removes previous rules formally subordinating inside debt to outside debt. However, a partner ultimately is personally liable for any outside debt that is still unsatisfied if the partnership has insufficient funds to satisfy all claims of outside creditors. The result is that the obligation to satisfy partnership debts effectively ends in the equitable subordination of inside debt to outside debt when the partnership assets are insufficient to satisfy all obligations to non-partners. Even though the UPA 1997 indicates that partnership obligations to the individual partners must normally be paid during its winding-up on the same proportional basis as the firm's other liabilities, outside creditors frequently require partners to subordinate their receivables from the partnership. Thus, in all examples, we assume partners have agreed to subordinate their receivables from the partnership to outside debt. Therefore, we typically illustrate examples in which liquidation payments are made in the following order: (1) outside debt, (2) inside debt, and (3) partner's capital.

Deficits in Partners' Capital Accounts As part of the liquidation process, each partner with a deficit in his or her capital account must make a contribution to the partnership to remedy that capital deficit. The partnership makes a liquidating distribution, in cash, to each partner with a capital credit balance. The UPA 1997 specifies cash for these liquidating distributions. If a partner fails to make a required contribution to remedy his or her capital deficit, all other partners must contribute the additional amount necessary to pay the partnership's obligations in the proportion to which those partners share partnership losses.

Although the UPA 1997 does not provide for a formal offset of a loan payable to an individual partner with a deficit in his or her capital account, a failure to do so can result in inequalities. For example, assume a partnership owes a partner \$10,000. If it pays

the partner the \$10,000, he or she could spend the money and subsequently become personally insolvent. Then, if the allocation of losses incurred on the sale of assets later results in a deficit balance in that partner's capital account, the other partners would have to absorb the deficit. Therefore, the legal doctrine of setoff effectively treats loans from partners to the partnership as additional capital investments that can be offset against a deficit capital account balance to avoid inequalities in the liquidation process.



STOP & THINK

Assume partner Z lends \$10,000 to the XYZ Partnership during a time when the partnership is short on cash to pay its obligations. At a subsequent date, the partnership sells some of its assets at a loss and allocates the loss to the partners' capital accounts, resulting in a deficit balance in Z's \$2,000 capital account of \$2,000. Assume Z's only source of additional cash to remedy her deficit balance is the savings account she established years before to fund her son's college education. Should Z be required to remove the \$2,000 in her son's college savings account to wipe out the deficit in her capital account?

Although the UPA 1997 states that Z would need to contribute cash to dispose of her deficit balance, the courts have dealt with similar situations. As a result, the legal doctrine of setoff suggests that Z's deficit balance can be offset against her loan balance. Instead of making her write a check to pay the partnership \$2,000 so that it can then write a check to pay her \$10,000, the partnership can simply write off her deficit against the loan balance so that it will only have to pay her \$8,000 to satisfy her loan.

Statement of Partnership Realization and Liquidation

To guide and summarize the partnership liquidation process, a *statement of partnership realization and liquidation* may be prepared. The statement, often called a "statement of liquidation," is the basis of

the journal entries made to record the liquidation. It presents in worksheet form the effects of the liquidation on the partnership's balance sheet accounts. The statement summarizes the conversion of assets into cash, the allocation of any gains or losses to the partners, and the distribution of cash to creditors and partners. This statement is a basic feature of accounting for a partnership liquidation and is presented and illustrated in the remainder of the chapter.

LUMP-SUM LIQUIDATIONS

LO 16-2

Make calculations related to lump-sum partnership liquidations.



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A ***lump-sum liquidation*** of a partnership is one in which all assets are converted into cash within a very short time, creditors are paid, and a single, lump-sum payment is made to the partners for their capital interests. Although most partnership liquidations take place over an extended period, as illustrated later, the lump-sum liquidation is an excellent focal point for presenting the major concepts of partnership liquidation.

Realization of Assets¹

Typically, a partnership experiences losses on the disposal of its assets. It may have a “Going out of Business” sale in which its inventory is marked down well below normal selling price to encourage immediate sale. Often the firm sells the remaining inventory to companies that specialize in acquiring assets of liquidating businesses. The partnership's furniture, fixtures, and equipment also may be offered at a reduced price or sold to liquidators. Any goodwill on the partnership's books is generally written off when the partnership begins a liquidation because it is no longer a going concern.

The partnership attempts to collect its accounts receivable. Sometimes it offers a large cash discount for the prompt payment of any remaining receivables whose collection may otherwise delay terminating the partnership. Alternatively, the receivables may be sold to a *factor*, a business that specializes in acquiring accounts receivable and immediately paying cash to the seller. The partnership records the sale of the receivables as it would any other asset. Typically, the factor acquires only the best of a business's receivables at a price below face value, but some factors are willing to buy all receivables at a price significantly lower than face value.

A partnership's assets, including any receivables from the partners and any contributions required of partners to remedy their capital deficits, are applied to pay the firm's creditors. Loans to or from partners must be settled during the winding-up process. Any remaining amount is then paid, in cash, as required by Section 807 of the UPA 1997 to the partners in accordance with their rights to liquidating distributions.

Liquidation Expenses

The liquidation process usually begins with scheduling the partnership's known assets and liabilities. The names and addresses of creditors and the amounts owed to each are specified. As diligent as the effort usually is, additional, unscheduled creditors may become known during the liquidation process, which also involves some expenses, such as additional legal and accounting costs. The partnership also may incur costs of disposing of the business, such as special advertising and locating specialized equipment dealers. These expenses are allocated to partners' capital accounts in the profit and loss distribution ratio.

Illustration of a Lump-Sum Liquidation

The following illustration presents the liquidation of the ABC Partnership, whose partners, Alt, Blue, and Cha, decide to terminate the business on May 1, 20X5. The ABC Partnership was formed on January 1, 20X1. Cha was admitted into the partnership on January 1, 20X3, and the name of the business was changed to the ABC Partnership. For purposes of this illustration, assume that Alt remained in the partnership and, in 20X4,

¹ To view a video explanation of this topic, visit advancedstudyguide.com.

the partners agreed to a realignment of their profit and loss-sharing percentages to more closely conform with each partner's efforts. The profit and loss-sharing percentages after realignment in 20X4 were as follows: Alt, 40 percent; Blue, 40 percent; and Cha, 20 percent. The company's condensed trial balance on May 1, 20X5, the day the partners decide to liquidate the business, follows:

ABC PARTNERSHIP		
Trial Balance		
May 1, 20X5		
Cash	\$ 10,000	
Noncash Assets	90,000	
Liabilities		\$ 42,000
Alt, Capital (40%)		34,000
Blue, Capital (40%)		10,000
Cha, Capital (20%)		14,000
Total	<u>\$100,000</u>	<u>\$100,000</u>

The basic accounting equation, Assets – Liabilities = Owners' equity, applies to partnership accounting. In this case, owners' equity is the sum of the partners' capital accounts, as follows:

$$\begin{aligned}\text{Assets} - \text{Liabilities} &= \text{Partners' equity} \\ \$100,000 - \$42,000 &= \$58,000\end{aligned}$$

The following three cases illustrate the partnership liquidation concepts used most commonly. Each case begins with ABC's May 1, 20X5, trial balance. The amount of cash realized from the disposal of the noncash assets is different for each of the three cases, and the effects of the different realizations are shown in the statement of partnership realization and liquidation presented for each case.

Case 1: Partnership Solvent and No Deficits in Partners' Capital Accounts

The noncash assets are sold for \$80,000 on May 15, 20X5, at a \$10,000 loss. The partnership's creditors are paid their \$42,000 on May 20, and the remaining \$48,000 cash is distributed to the partners on May 30, 20X5.

Refer to Figure 16-1 for the statement of realization and liquidation for Case 1. The statement includes only balance sheet accounts across the columns, with all noncash assets presented together as a single total. Note that each row in the spreadsheet must balance (i.e., Assets = Liabilities + Partners' equity). Once a business has entered liquidation, the balance sheet accounts are the only relevant ones; the income statement is for a going concern. The liquidation process is presented in the order of occurrence in the rows of the worksheet. Thus, the worksheet includes the entire realization and liquidation process and is the basis for the journal entries to record the liquidation.

Other important observations are as follows:

1. The preliquidation balances are obtained from the May 1, 20X5, trial balance.
2. When the partnership's noncash assets are sold, the \$10,000 loss is allocated to the partners' capital accounts.
3. Creditors, including individual partners who have made any loans to the partnership, are paid before any cash is distributed to partners.
4. Payments to partners are made for their positive capital balances.
5. The postliquidation balances are all zero, indicating the accounts are all closed and the partnership is fully liquidated and terminated.

FIGURE 16–1 Case 1: Partnership Solvent; No Deficits in Partners' Capital Accounts

ABC PARTNERSHIP Statement of Partnership Realization and Liquidation Lump-Sum Liquidation						
	Noncash			Capital Balance		
	Cash	+ Assets	= Liabilities	+ Alt, 40%	+ Blue, 40%	+ Cha, 20%
Preliquidation balances, May 1	10,000	90,000	42,000	34,000	10,000	14,000
Sales of assets and distribution of \$10,000 loss	80,000	(90,000)		(4,000)	(4,000)	(2,000)
	90,000	0	42,000	30,000	6,000	12,000
Payment to creditors	(42,000)		(42,000)			
	48,000	0	0	30,000	6,000	12,000
Lump-sum payment to partners	(48,000)			(30,000)	(6,000)	(12,000)
Postliquidation balances	0	0	0	0	0	0

The statement of partnership realization and liquidation is the basis for the following journal entries to record the liquidation process:

- May 15, 20X5
- | | | | |
|-----|----------------|--------|--------|
| (1) | Cash | 80,000 | |
| | Alt, Capital | 4,000 | |
| | Blue, Capital | 4,000 | |
| | Cha, Capital | 2,000 | |
| | Noncash Assets | | 90,000 |
- Realization of all noncash assets of the ABC Partnership and distribution of \$10,000 loss using profit and loss ratio.
- May 20, 20X5
- | | | | |
|-----|-------------|--------|--------|
| (2) | Liabilities | 42,000 | |
| | Cash | | 42,000 |
- Pay creditors.
- May 30, 20X5
- | | | | |
|-----|---------------|--------|--------|
| (3) | Alt, Capital | 30,000 | |
| | Blue, Capital | 6,000 | |
| | Cha, Capital | 12,000 | |
| | Cash | | 48,000 |
- Lump-sum payments to partners.



Case 2: Partnership Solvent and Deficit Created in Partner's Capital Account

A deficit in a partner's capital account can occur if its credit balance is too low to absorb his or her share of losses. A capital deficit may be created at any time in the liquidation process. Such deficits may be remedied by either of the following means:

1. The partner invests cash or other assets to eliminate the capital deficit.
2. The partner's capital deficit is distributed to the other partners in their resulting loss-sharing ratio.

The approach used depends on the solvency of the partner with the capital deficit. A partner who is personally solvent and has sufficient net worth to eliminate the capital deficit must make an additional investment in the partnership to cover the deficit. On the other hand, if the partner is personally insolvent—that is, personal liabilities exceed

personal assets—section 807 of the UPA 1997 requires the remaining partners to absorb the insolvent partner's deficit by allocating it to their capital accounts in their resulting loss-sharing ratio.

The following lump-sum distribution illustrates these points:

1. The three partners' personal financial statements are as follows:

	Alt	Blue	Cha
Personal assets	\$150,000	\$ 12,000	\$ 42,000
Personal liabilities	(86,000)	(16,000)	(14,000)
Net worth (deficit)	\$ 64,000	\$ (4,000)	\$ 28,000

Blue is personally insolvent; Alt and Cha are personally solvent.

2. The partnership's noncash assets are sold for \$35,000 on May 15, 20X5, and the \$55,000 loss is allocated to the partners' capital accounts.
3. The partnership pays its creditors \$42,000 on May 20, 20X5.
4. Because Blue is personally insolvent, her \$12,000 capital deficit is allocated to the other partners.
5. The remaining \$4,000 cash is distributed as a lump-sum payment on May 30, 20X5.

Review the statement of partnership realization and liquidation for Case 2 in Figure 16–2. Note the following from this illustration:

1. The \$55,000 loss on the realization of noncash assets is allocated in the partners' loss-sharing ratio of 40 percent for Alt, 40 percent for Blue, and 20 percent for Cha. Blue's \$22,000 share of the loss on disposal creates a \$12,000 deficit in her capital account. Blue is personally insolvent and is unable to make an additional investment to remove the capital deficit.

FIGURE 16–2 Case 2: Partnership Solvent; Deficit Created in Personally Insolvent Partner's Capital Account

ABC PARTNERSHIP Statement of Partnership Realization and Liquidation Lump-Sum Liquidation						
	Cash	Noncash + Assets	= Liabilities	Capital Balance		
				+ Alt, 40%	+ Blue, 40%	+ Cha, 20%
Preliquidation balances, May 1	10,000	90,000	42,000	34,000	10,000	14,000
Sales of assets and distribution of \$55,000 loss	35,000	(90,000)		(22,000)	(22,000)	(11,000)
	45,000	0	42,000	12,000	(12,000)	3,000
Payment to creditors	(42,000)		(42,000)			
	3,000	0	0	12,000	(12,000)	3,000
Allocation of insolvent partner's deficit:					12,000	
40/60 × \$12,000				(8,000)		
20/60 × \$12,000						(4,000)
	3,000	0	0	4,000	0	(1,000)
Contribution by Cha to remedy capital deficit	1,000					1,000
	4,000	0	0	4,000	0	0
Lump-sum payment to partners	(4,000)			(4,000)		
Postliquidation balances	0	0	0	0	0	0

- The partnership pays its creditors before making any distributions to the partners.
- Blue's \$12,000 deficit is distributed to Alt and Cha in their resulting loss-sharing ratio. Note that the UPA 1977 specifies use of the loss-sharing ratio for this allocation. Alt absorbs two-thirds (40/60) of Blue's deficit, and Cha absorbs one-third (20/60).
- The distribution of Blue's deficit creates a deficit in Cha's capital account. Because Cha is personally solvent, she must contribute \$1,000 to remedy her capital deficit.
- Alt receives a lump-sum payment for his \$4,000 capital balance.
- All postliquidation balances are zero, indicating the completion of the liquidation process.



Case 3: Partnership Is Insolvent and Deficit Created in Partner's Capital Account

A partnership is insolvent when existing cash and cash generated by the sale of the assets are not sufficient to pay the partnership's liabilities. In this case, the individual partners are liable for the remaining unpaid partnership liabilities. The following illustration presents an insolvent partnership and a deficit in one of the partner's capital accounts.

- Alt and Cha are personally solvent, and Blue is personally insolvent as in Case 2.
- The firm sells noncash assets for \$20,000 on May 15, 20X5.
- The partnership pays creditors \$42,000 on May 20, 20X5.

See Figure 16–3 for the statement of partnership realization and liquidation for Case 3.

The following observations are made from this illustration:

- The \$70,000 loss is allocated to the partners in their loss-sharing ratio. This allocation creates a deficit of \$18,000 in Blue's capital account.
- Because Blue is personally insolvent, her \$18,000 deficit is distributed to Alt and Cha in their loss-sharing ratio of 40:60 for Alt and 20:60 for Cha. The distribution of Blue's deficit results in a \$6,000 deficit for both Alt and Cha.

FIGURE 16–3 Case 3: Partnership Insolvent; Deficit Created in Personally Insolvent Partner's Capital Account

ABC PARTNERSHIP						
Statement of Partnership Realization and Liquidation						
Lump-Sum Liquidation						
	Cash	Noncash + Assets	= Liabilities	Capital Balance		
				+ Alt, 40%	+ Blue, 40%	+ Cha, 20%
Preliquidation balances, May 1	10,000	90,000	42,000	34,000	10,000	14,000
Sales of assets and distribution of \$70,000 loss	20,000	(90,000)		(28,000)	(28,000)	(14,000)
	30,000	0	42,000	6,000	(18,000)	0
Allocation of insolvent partner's deficit:					18,000	
40/60 × \$18,000				(12,000)		
20/60 × \$18,000						(6,000)
	30,000	0	42,000	(6,000)	0	(6,000)
Contributions by Alt and Cha to remedy capital deficits	12,000			6,000		6,000
	42,000	0	42,000	0	0	0
Payment to creditors	(42,000)		(42,000)			
Postliquidation balances	0	0	0	0	0	0

3. Because Alt and Cha are personally solvent, they make additional capital contributions to remedy their respective capital deficits of \$6,000 and \$6,000.
4. The \$42,000 partnership cash now available is used to pay its creditors.
5. The postliquidation balances are zero, indicating completion of the partnership liquidation.

In Case 3, both Alt and Cha made additional capital contributions to eliminate their capital deficits. When a partner must remedy another partner's capital deficit, the partner making the remedy has cause to bring suit against the failing partner. Blue's failure in the amount of \$12,000 in Case 2 and \$18,000 in Case 3 required Alt and Cha to remedy Blue's deficit. Alt and Cha can sue Blue and be included in the list of her personal liabilities. Although Blue is personally insolvent, Alt and Cha may obtain a partial recovery of their amounts.

INSTALLMENT LIQUIDATIONS

LO 16-3

Make calculations related to installment partnership liquidations.

An *installment liquidation* typically requires several months to complete and includes periodic, or installment, payments to the partners during the liquidation period because they require funds for personal purposes. Most partnership liquidations take place over an extended period in order to obtain the largest possible amount from the realization of the assets.

Some partnerships using installment liquidations prepare a Plan of Liquidation and Dissolution prior to beginning the liquidation. This plan sets out the intended liquidation of its assets and the winding-up of its affairs. The partners discuss and perhaps modify the plan, but their agreement is expected. And some partnerships, upon obtaining the consent of the partners to proceed with the installment liquidation, adopt the liquidation basis of accounting under which assets are stated at their estimated net realizable value, and liabilities, including projected costs of liquidation, are stated at their estimated settlement amounts. These partnerships may prepare a statement of net assets in liquidation and a statement of changes in net assets in liquidation. However, partnerships using GAAP apply **ASC 360** to value their long-lived assets to be disposed of by sale. **ASC 360** states that these assets are to be classified separately and valued at the lower of carrying amount or fair value less costs to sell. And **ASC 20** requires that costs associated with an exit activity be recognized and measured at fair value in the period in which the liability is incurred, not in earlier periods when, for example, a restructuring plan is adopted. Most partnerships use the statement of partnership realization and liquidation during the installment liquidation process and recognize gains or losses from the liquidation events.

Installment liquidations involve distributing cash to partners before complete liquidation of the assets occurs. The accountant must be especially cautious when distributing available cash because future events may change the amounts to be paid to each partner. We illustrate two methods for ensuring fairness and equality in making cash distributions in an installment liquidation: (1) the *schedule of safe payments to partners* and (2) the *cash distribution plan*. A new schedule of safe payments must be prepared each time cash becomes available for distribution to the partners whereas the cash distribution plan is prepared only once at the beginning of the liquidation process. We first demonstrate the use of schedules of safe payments and later illustrate the use of a cash distribution plan. Either method is acceptable. The following practical guidelines should be followed in preparing schedules of safe payments to the partners:

1. Distribute no cash to the partners until all outside liabilities and actual plus potential liquidation expenses have been paid or provided for by reserving the necessary cash.
2. Anticipate the worst, or most restrictive, possible case before determining the amount of cash installment each partner receives. Make the following *hypothetical* assumptions to determine how much excess capital (if any) the partners have in their capital accounts:

**STOP & THINK**

Why would these hypothetical “worst-case” assumptions lead to the optimal cash distributions to partners at any particular point in time? Picture the accounting equation after all outside loans have been paid (and assuming no inside loans):

$$\text{Cash} + \text{Noncash assets} = \text{Partners' capital accounts}$$

By hypothetically assuming that the noncash assets are worthless, we are essentially assuming this is the last cash we'll ever collect. To whom should it be distributed? The hypothetical loss would be written off to the partners' capital accounts, leaving the following accounting equation:

$$\text{Cash} = \text{Partners' capital accounts}$$

Once hypothetical deficits created by the assumed write-off of the noncash assets have been absorbed by partners with positive capital balances, the cash on hand equals the amount of “extra capital” remaining in partner's accounts after absorbing the most extreme losses possible. Partners with this much “extra” capital riding in their capital accounts deserve to receive the cash that is available.

a. Assume that all remaining noncash assets will be written off as a loss; that is, assume that nothing will be realized on future asset disposals.

b. Assume that any deficits created in the partners' capital accounts by the hypothetical assumption that all noncash assets are worthless will be absorbed by the remaining partners with positive hypothetical capital balances; that is, assume that hypothetical deficits will not be eliminated by additional partner capital contributions.

3. After the accountant has assumed these two hypothetical worst possible cases, the remaining credit balances in capital accounts represent safe distributions of cash that may be distributed to partners in those amounts.



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Illustration of Installment Liquidation

We now use the same illustration in the lump-sum liquidation of the ABC Partnership to illustrate liquidation in installments. Alt, Blue, and Cha decide to liquidate their business over a period of time and to receive installment distributions of available cash during the liquidation process.

ABC Partnership's condensed trial balance on May 1, 20X5, the day the partners decide to liquidate the business, follows. Each partner's profit and loss-sharing percentage is also shown.

ABC PARTNERSHIP			
Trial Balance			
May 1, 20X5			
Cash	\$ 10,000		
Noncash Assets	90,000		
Liabilities		\$ 42,000	
Alt, Capital (40%)		34,000	
Blue, Capital (40%)		10,000	
Cha, Capital (20%)		14,000	
Total	<u>\$100,000</u>	<u>\$100,000</u>	

The following information describes this case in more detail.

1. The partners' net worth statements on May 1, 20X5, are as follows:

	Alt	Blue	Cha
Personal assets	\$150,000	\$12,000	\$42,000
Personal liabilities	(86,000)	(16,000)	(14,000)
Net worth (deficit)	<u>\$ 64,000</u>	<u>\$ (4,000)</u>	<u>\$28,000</u>

Blue is personally insolvent; Alt and Cha are personally solvent.

2. The noncash assets are sold as follows:

Date	Book Value	Proceeds	Loss
5/15/X5	\$55,000	\$45,000	\$10,000
6/15/X5	30,000	15,000	15,000
7/15/X5	5,000	5,000	

FIGURE 16-4 Installment Liquidation Worksheet

ABC PARTNERSHIP Statement of Partnership Realization and Liquidation Installment Liquidation						
				Capital Balance		
	Cash	+ Noncash Assets	= Liabilities	+ Alt, 40%	+ Blue, 40%	+ Cha, 20%
Preliquidation balances, May 1	10,000	90,000	42,000	34,000	10,000	14,000
May 20X5:						
Sale of assets and distribution of \$10,000 loss	45,000	(55,000)		(4,000)	(4,000)	(2,000)
	55,000	35,000	42,000	30,000	6,000	12,000
Payment to creditors	(42,000)		(42,000)			
	13,000	35,000	0	30,000	6,000	12,000
Payment to partners (Schedule 1, Figure 16-5)	(3,000)			(3,000)		
	10,000	35,000	0	27,000	6,000	12,000
June 20X5:						
Sale of assets and distribution of \$15,000 loss	15,000	(30,000)		(6,000)	(6,000)	(3,000)
	25,000	5,000	0	21,000	0	9,000
Payment to partners (Schedule 2, Figure 16-5)	(15,000)			(11,000)		(4,000)
	10,000	5,000	0	10,000	0	5,000
July 20X5:						
Sale of assets at book value	5,000	(5,000)				
	15,000	0	0	10,000	0	5,000
Payment of \$7,500 in liquidation costs	(7,500)			(3,000)	(3,000)	(1,500)
	7,500	0	0	7,000	(3,000)	3,500
Distribution of deficit of insolvent partner:					3,000	
40/60 × \$3,000				(2,000)		
20/60 × \$3,000						(1,000)
	7,500	0	0	5,000	0	2,500
Payment to partners	(7,500)			(5,000)		(2,500)
Postliquidation balances, July 31	0	0	0	0	0	0

- The partnership pays the creditors \$42,000 on May 20. Note that, given our assumption of subordination of all loans received from partner to outside liabilities, outside creditors must always be paid in full before any cash is distributed to the partners.
- The partners agree to maintain a \$10,000 cash reserve during the liquidation process to pay for any liquidation expenses.
- The partners agree to distribute the available cash at the end of each month; that is, installment liquidations will be made on May 31 and June 30. The final cash distributions to partners will be made on July 31, 20X5, the end of the liquidation process. The amounts to be distributed at the end of each month must be calculated using a schedule of safe payments to partners, as seen in Figure 16-5.

Refer to Figure 16-4 for the statement of partnership realization and liquidation for the ABC Partnership installment liquidation.

FIGURE 16-5 Schedule of Safe Payment to Partners for an Installment Liquidation

ABC PARTNERSHIP Schedule of Safe Payment to Partners			
	Partner		
	Alt 40%	Blue 40%	Cha 20%
Schedule 1, May 31, 20X5			
Computation of distribution of cash available on May 31, 20X5:			
Capital balances, May 31, before cash distribution	30,000	6,000	12,000
Assume full loss of \$35,000 on remaining noncash assets and \$10,000 in possible future liquidation expenses	(18,000)	(18,000)	(9,000)
	12,000	(12,000)	3,000
Assume Alt and Cha must absorb Blue's potential deficit:		12,000	
40/60 × \$12,000	(8,000)		
20/60 × \$12,000			(4,000)
	4,000	0	(1,000)
Assume Alt must absorb Cha's potential deficit	(1,000)		1,000
Safe payment to partners, May 31	3,000	0	0
Schedule 2, June 30, 20X5			
Computation of distribution of cash available on June 30, 20X5:			
Capital balances, June 30, before cash distribution	21,000	0	9,000
Assume full loss of \$5,000 on remaining noncash assets and \$10,000 in possible future liquidation expenses	(6,000)	(6,000)	(3,000)
	15,000	(6,000)	6,000
Assume Alt and Cha must absorb Blue's potential deficit:		6,000	
40/60 × \$6,000	(4,000)		
20/60 × \$6,000			(2,000)
Safe payment to partners, June 30	11,000	0	4,000

Transactions during May 20X5

The events during May 20X5 result in a distribution of \$3,000 to the partners. The procedure to arrive at this amount is as follows:

1. The sale of \$55,000 of assets results in a loss of \$10,000, which is distributed to the three partners in their loss-sharing ratio.
2. Payments of \$42,000 are made to the partnership's outside creditors for the known liabilities.
3. Available cash is distributed to the partners on May 31, 20X5, as calculated by the schedule of safe payments to partners (Figure 16-5).



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**FYI**

When a partner has a loan outstanding to the partnership, the legal doctrine of setoff essentially treats the loan as an additional cash contribution. Thus, loans to the partnership are added to the partner's capital balance at the start of the schedule of safe payments to accurately reflect the partner's total contributions.

Conversely, if a partner has borrowed from the partnership (i.e., the partnership has a receivable from that partner), the loan is subtracted from the partner's capital balance at the commencement of the schedule of safe payments.

To determine the safe payment of cash to be distributed to partners, the accountant must make some assumptions about the future liquidation of the remaining assets. Under the assumption of the worst possible situation, the remaining \$35,000 of assets will result in a total loss. Before making a cash distribution to the partners, the accountant prepares a schedule of safe payments to partners using the worst-case assumptions. See Schedule 1 in Figure 16-5 for the schedule of safe payments to partners as of May 31, 20X5.

The schedule of safe payments begins with the partners' capital balances as of May 31. The logic of using just the capital accounts comes from the accounting equation: Assets – Liabilities = Partners' capital balances. Thus, for example, if

there were an increase in a liability that reduced the net assets, the equality of the accounting equation would also result in a decrease in the total of partners' capital balances. Because the partners' capital accounts are the focus of the payments to partners, it is unnecessary to include the assets and liabilities in the schedule of safe payments to partners. The schedule includes all information partners need to know how much cash they will receive at each cash distribution date.

Alt, Blue, and Cha agree to withhold \$10,000 for possible liquidation expenses. In addition, the noncash assets have a remaining balance of \$35,000 on May 31. A worst-case assumption is a complete loss on the noncash assets and \$10,000 of liquidation expenses, totaling \$45,000 of charges to be distributed to the partners' capital accounts. The capital accounts of Alt, Blue, and Cha would be charged for \$18,000, \$18,000, and \$9,000, respectively, for their shares of the \$45,000 assumed loss. These assumptions result in a pro forma deficit in Blue's capital account. This is not an actual deficit that must be remedied! It is merely the result of applying the worst-case assumptions.

Continuing such worst-case planning, the accountant assumes that Blue is insolvent (which happens to be true in this example) and distributes the pro forma deficit in Blue's capital account to Alt and Cha in their *loss-sharing ratio* of 40:60 to Alt and 20:60 to Cha. The resulting credit balances indicate the amount of cash that may be safely distributed to the partners. Refer to Figure 16–4 for the May 31 cash distribution. The available cash of \$3,000 is distributed to Alt. The ending balances should satisfy the equality of assets and equities of the accounting equation. If the equality has been destroyed, an error has occurred that must be corrected before proceeding. As of May 31, after the installment distribution, the accounting equation is

$$\begin{aligned}\text{Assets} - \text{Liabilities} &= \text{Partners' equity} \\ \$45,000 - \$0 &= \$45,000\end{aligned}$$

Transactions during June 20X5

Transactions for June 20X5 continue in Figure 16–4 as follows:

1. The company sells noncash assets of \$30,000 on June 15 for a \$15,000 loss, which is distributed to the partners in their loss-sharing ratio, resulting in a zero capital balance for Blue.
2. On June 30, 20X5, available cash is distributed as an installment payment to the partners.

The schedule of safe payments to partners as of June 30, 20X5, in Figure 16–5 shows how to calculate the distribution amounts. A worst-case plan assumes that the remaining noncash assets of \$5,000 must be written off as a loss and that the \$10,000 cash in reserve will be completely used for liquidation expenses. This \$15,000 pro forma loss is allocated to the partners in their loss-sharing ratio, which creates a \$6,000 deficit in Blue's capital account. Continuing the worst-case scenario, it is assumed Blue will not eliminate this debit balance. Therefore, the \$6,000 potential deficit is allocated to Alt and Cha in their resulting loss-sharing ratio of 40/60 to Alt and 20/60 to Cha. The resulting credit balances in the partners' capital accounts show the amount of cash that can be distributed safely. Only \$15,000 of the available cash is distributed to Alt and Cha on June 30, (Figure 16–4).

Transactions during July 20X5

The last part of Figure 16–4 shows the completion of the liquidation transactions during July 20X5:

1. The firm sells its remaining assets at their book value of \$5,000.
2. The partnership pays actual liquidation costs of \$7,500 and allocates them to the partners in their loss-sharing ratio, creating a deficit of \$3,000 in Blue's capital account. The remaining \$2,500 of the \$10,000 reserved for the expenses is released for distribution to the partners.

3. Because Blue is personally insolvent and cannot contribute to the partnership, the \$3,000 deficit is distributed to Alt and Cha in their loss-sharing ratio. Note that this is an actual, not a pro forma, deficit.
4. The \$7,500 of remaining cash is paid to Alt and Cha to the extent of their capital balances. After this last distribution, all account balances are zero, indicating the completion of the liquidation process.

Cash Distribution Plan

At the beginning of the liquidation process, accountants commonly prepare a cash distribution plan, which gives the partners an idea of the installment cash payments each will receive as cash becomes available. The actual installment distributions are determined using the statement of realization and liquidation supplemented with the schedule of safe payments to partners as presented in the preceding section. The cash distribution plan is a pro forma projection of the application of cash as it becomes available.

Loss Absorption Potential

A basic concept of the cash distribution plan at the beginning of the liquidation process is **loss absorption potential (LAP)**. An individual partner's LAP is defined as the maximum loss that the partnership can realize before that partner's capital account balance is extinguished. The LAP is a function of two elements, as follows:

$$\text{LAP} = \frac{\text{Partner's capital account balance}}{\text{Partner's loss share}}$$



FYI

When a partner has a loan outstanding to the partnership, the legal doctrine of setoff essentially treats the loan as an additional cash contribution. Thus, loans to the partnership are added to the numerator of the LAP calculation, effectively increasing that partner's loss absorption potential. In other words, that partner is assumed to have "more skin in the game."

Conversely, if a partner has borrowed from the partnership (i.e., the partnership has a receivable from that partner), the loan is subtracted from the partner's capital in the numerator, decreasing that partner's loss absorption potential.

For example, on May 1, 20X5, Alt has a capital account credit balance of \$34,000 and a 40 percent share in the losses of ABC Partnership. Alt's LAP is

$$\text{LAP} = \frac{\$34,000}{0.40} = \$85,000$$

This means that \$85,000 in losses on disposing of noncash assets or from additional liquidation expenses would eliminate the credit balance in Alt's capital account, as follows:

$$\$85,000 \times 0.40 = \$34,000$$

Illustration of Cash Distribution Plan

The following illustration is based on the ABC Partnership example. A trial balance of its balance sheet accounts on May 1, 20X5, the day the partners decide to liquidate the business, is prepared.

ABC PARTNERSHIP			
Trial Balance			
May 1, 20X5			
Cash	\$	10,000	
Noncash Assets		90,000	
Liabilities			\$ 42,000
Alt, Capital (40%)			34,000
Blue, Capital (40%)			10,000
Cha, Capital (20%)			14,000
Total	\$100,000		\$100,000

FIGURE 16–6 Cash Distribution Plan for Liquidating Partnership

ABC PARTNERSHIP Cash Distribution Plan May 1, 20X5						
	Loss Absorption Potential			Capital Balance		
	Alt	Blue	Cha	Alt	Blue	Cha
Loss-sharing percentages				40%	40%	20%
Preliquidation capital balances, May 1, 20X5				34,000	10,000	14,000
Loss absorption potential (LAP) (Capital balance/Loss ratio)	85,000	25,000	70,000			
Decrease highest LAP to next-highest LAP: Decrease Alt by \$15,000 (cash distribution: $\$15,000 \times 0.40 = \$6,000$)	(15,000)			(6,000)		
	70,000	25,000	70,000	28,000	10,000	14,000
Decrease LAPs to next-highest level: Decrease Alt by \$45,000 (cash distribution: $\$45,000 \times 0.40 = \$18,000$)	(45,000)			(18,000)		
Decrease Cha by \$45,000 (cash distribution: $\$45,000 \times 0.20 = \$9,000$)			(45,000)			(9,000)
	25,000	25,000	25,000	10,000	10,000	5,000
Decrease LAPs by distributing cash in the loss-sharing percentages	40%	40%	20%			
Summary of Cash Distribution Plan						
Step 1: First \$42,000 to outside creditors						
Step 2: Next \$10,000 to liquidation expenses						
Step 3: Next \$6,000 to Alt				6,000		
Step 4: Next \$45,000 to Alt and Cha in their respective loss ratios (\$27,000 now available)				18,000		9,000
Step 5: Any additional distributions in the partners' loss-sharing ratios				40%	40%	20%

The partners ask for a cash distribution plan as of May 1, 20X5, to determine the distributions of cash as it becomes available during the liquidation process. Such a plan always provides for paying the partnership's outside creditors before making any distributions to the partners. See Figure 16–6 for the cash distribution plan as of May 1, the beginning date of the liquidation process.

The important observations from this illustration are as follows:

1. Each partner's loss absorption potential is computed as his or her capital balance divided by that partner's *loss-sharing percentage*. Alt has the highest LAP (\$85,000), Cha has the next highest (\$70,000), and Blue has the lowest (\$25,000). Each partner's LAP is the amount of loss that would completely eliminate his or her net capital credit balance. Alt is the least vulnerable to a loss, and Blue is the most vulnerable.
2. The least vulnerable partner is the first to receive any cash distributions after paying creditors. Alt is the only partner to receive cash until his LAP is decreased to the level of the next highest partner, Cha. To decrease Alt's LAP by \$15,000 requires paying Alt \$6,000 ($\$15,000 \times 0.40$). After payment of \$6,000 to Alt, his new loss absorption potential will be the same as Cha's, calculated as Alt's remaining capital balance of \$28,000 divided by his loss-sharing percentage of 40 percent ($\$28,000/0.40 = \$70,000$).

FIGURE 16–7 Confirmation of Cash Distribution Plan

ABC PARTNERSHIP Capital Account Balances May 1, 20X5, through July 31, 20X5			
	Partner		
	Alt 40%	Blue 40%	Cha 20%
Preliquidation balances, May 1	34,000	10,000	14,000
May loss of \$10,000 on disposal of assets	(4,000)	(4,000)	(2,000)
	30,000	6,000	12,000
May 31 distribution of \$3,000 available cash to partners:			
First \$3,000 (of \$6,000 priority to Alt)	(3,000)		
	27,000	6,000	12,000
June loss of \$15,000 on disposal of assets	(6,000)	(6,000)	(3,000)
	21,000	0	9,000
June 30 distribution of \$15,000 available cash to partners:			
Next \$3,000 (to complete Alt's \$6,000 priority)	(3,000)		
Remaining \$12,000:			
40/60 to Alt	(8,000)		
20/60 to Cha			(4,000)
	10,000	0	5,000
Liquidation cost of \$7,500	(3,000)	(3,000)	(1,500)
	7,000	(3,000)	3,500
Allocation of Blue's actual deficit	(2,000)	3,000	(1,000)
	5,000	0	2,500
Final payment of \$7,500 to partners on July 31, 20X5:			
40/60 to Alt	(5,000)		
20/60 to Cha			(2,500)
Postliquidation balances, July 31	0	0	0

- Alt's and Cha's LAPs are now equal, and they will receive cash distributions until the LAP of each decreases to the next highest level, the \$25,000 of Blue. Multiplying the loss absorption potential of \$45,000 (\$70,000 – \$25,000) by the two partners' loss-sharing ratios shows how much of the next available cash can be safely paid to each partner. Alt and Cha will receive cash distributions according to their loss-sharing ratios. As the next \$27,000 of cash becomes available, it will be distributed to Alt and Cha in the ratio of 40:60 to Alt and 20:60 to Cha.
- Finally, when all three partners have the same LAPs, any remaining cash is distributed according to their loss-sharing ratios.

The summary of the cash distribution plan at the bottom of Figure 16–6 is provided to the partners. From this summary, they are able to determine the relative amounts each will receive as cash becomes available to the partnership.

See Figure 16–7 for the capital balances for each partner in the ABC Partnership during the installment liquidation period from May 1, 20X5, through July 31, 20X5. The installment payments to partners are computed on the statement of partnership realization and liquidation (Figure 16–4) using a schedule of safe distributions to partners (Figure 16–5). The actual distributions of available cash conform to the cash distribution plan prepared at the beginning of the liquidation process (Figure 16–7), with adjustment because of Blue's actual deficit that Alt and Cha absorb.

ADDITIONAL CONSIDERATIONS

Incorporation of a Partnership

As a partnership continues to grow, the partners may decide to incorporate the business to have access to additional equity financing, to limit their personal liability, to obtain selected tax advantages, or to achieve other sound business purposes. At the incorporation, the partnership is terminated, and the assets and liabilities are revalued to their fair values. The gain or loss on revaluation is allocated to the partners' capital accounts in the profit and loss-sharing ratio.

Capital stock in the new corporation is then distributed in proportion to the partners' capital accounts. The separate business entity of the partnership should now close its accounting records and the corporation, as a new business entity, should open its own new accounting records to record the issuance of its capital stock to the partnership's previous partners.

We use the ABC Partnership's trial balance on May 1, 20X5, as shown previously, to illustrate incorporation of a partnership. Instead of liquidating the partnership as shown throughout the chapter, assume the partners agree to incorporate it.

The new corporation is to be called Peerless Products Corporation. At the time of conversion from a partnership to a corporation, all assets and liabilities should be appraised and valued at their fair values. Any gain or loss must be distributed to the partners in their profit and loss-sharing ratios. Assume that the noncash assets have an \$80,000 fair value. The \$10,000 loss to fair value is allocated to the partners' capital accounts before the incorporation, as follows:

(4)	Alt, Capital	4,000	
	Blue, Capital	4,000	
	Cha, Capital	2,000	
	Noncash Assets		10,000

Recognize loss on reduction of assets to fair values.

Of course, in practice, specific asset accounts are used instead of the general classification of noncash assets. Gains on asset revaluations also may occur when a successful partnership elects to incorporate.

The partnership's net assets have a fair value of \$48,000 (\$90,000 of assets less \$42,000 of liabilities). The corporation issues 4,600 shares of \$1 par common stock in exchange for ABC Partnership's assets and liabilities. Peerless Products Corporation makes this entry to acquire the partnership's assets and liabilities in exchange for the issuance of the 4,600 shares of stock

(5)	Cash	10,000	
	Noncash Assets	80,000	
	Liabilities		42,000
	Common Stock		4,600
	Paid-in Capital in Excess of Par		43,400

Issuance of stock for partnership's assets and liabilities.

The partners make the following entry on the partnership's books:

(6)	Investment in Peerless Products	48,000	
	Liabilities	42,000	
	Cash		10,000
	Noncash Assets		80,000

Receipt of stock in Peerless Products in exchange for partnership's net assets.

Recall that the noncash assets were reduced to their fair values in entry (4). To distribute the stock to the partners and close the partnership's books, the final entry is as follows:

(7)	Alt, Capital	30,000	
	Blue, Capital	6,000	
	Cha, Capital	12,000	
	Investment in Peerless		48,000

Distribution of Peerless Products stock to partners.

Summary of
Key Concepts

The process of terminating and liquidating a partnership is often traumatic for partners. The Uniform Partnership Act of 1997 provides guidance for the liquidation process and specifies the legal rights of the partners and of partnership creditors.

Dissociation of a partner is his or her withdrawal, either voluntarily or involuntarily, from the partnership. Dissolution is the ending of a partnership. Not all dissociations and dissolutions require termination, which is the cessation of normal business functions, or liquidation with the disposal of assets, payment of liabilities, and distribution of remaining cash to the partners. UPA 1997 defines a partnership as a legal entity apart from the individual partners. Therefore, unless required by judicial determination, termination and liquidation often can be avoided by carefully preparing the partnership agreement to allow continuation of the business when a partner retires or leaves the partnership. The most common reasons for involuntary liquidation are court decrees or the bankruptcy of the partnership.

Liquidation can involve a single lump-sum payment to partners. Most liquidations, however, take several months and involve installment payments to partners during the process. Items that facilitate liquidations are the statement of partnership realization and liquidation, and a worksheet summarizing the liquidation process and serving as a basis for the journal entries to record the events. Installment payments to partners are determined on a worst-case basis using a schedule of safe payments to partners, which assumes that all noncash assets will be written off and that partners with debit balances in their capital accounts will not be able to remedy the deficiencies.

A cash distribution plan provides information to partners about the installment payments they will receive as cash becomes available to the partnership. The plan is prepared at the beginning of the liquidation process. Actual cash distributions during the liquidation are determined with the statement of partnership realization and liquidation. The concept of loss absorption potential (LAP) is central to the development of the cash distribution plan. LAP is the amount of partnership loss required to eliminate a given partner's capital credit balance. The LAP is determined by dividing a partner's net capital credit balance by his or her loss-sharing percentage.

Key Terms

cash distribution plan, 812	loss absorption potential	statement of partnership
dissociation (of a partner), 805	(LAP), 817	realization and
dissolution	lump-sum liquidation, 807	liquidation, 806
(of a partnership), 805	schedule of safe payments to	
installment liquidation, 812	partners, 812	

Appendix 16A Partners' Personal Financial Statements

At the beginning of the liquidation process, partners are usually asked for personal financial statements to determine each partner's personal solvency. Guidelines for preparing personal financial statements are found in **ASC 274**.

Personal financial statements consist of the following:

1. Statement of financial condition, or personal balance sheet, that presents the partner's assets and liabilities at a point in time.
2. Statement of changes in net worth, or personal income statement, that presents the primary sources of changes in the partner's net worth.

In addition to presenting a partner's assets and liabilities, the statement of financial condition should include an estimate of the income taxes incurred as if all the assets were converted and the liabilities extinguished. The partner's net worth would then be computed as assets less liabilities less estimated taxes (see Figure 16–8). In general, the accrual basis of accounting should be used to determine the partner's assets and liabilities, and comparative statements are usually provided. However, unlike a balance sheet of a business that is based on historical cost, the assets in the personal statement of financial condition are stated at their estimated current values. The liabilities are stated at the lower of the discounted value of future cash payments or the current cash settlement amount. Included immediately below the liabilities are the estimated taxes that would be paid if all assets were converted to cash and all the liabilities were paid.

FIGURE 16–8
Personal Statement of
Financial Condition

C. ALT		
Statement of Financial Condition		
May 1, 20X5 and 20X4		
	Year	
	20X5	20X4
Assets		
Cash	\$ 4,000	\$ 2,500
Receivables	3,500	4,000
Investments:		
Marketable securities	5,000	4,000
ABC Partnership	34,000	26,000
Cash surrender value of life insurance	3,100	3,000
Residence	84,000	76,000
Personal effects	16,400	12,500
Total assets	<u>\$150,000</u>	<u>\$128,000</u>
Liabilities and Net Worth		
Charge accounts	\$ 2,000	\$ 3,000
Income taxes—current-year balance	1,200	800
10 percent note payable	6,000	10,000
Mortgage payable	60,000	62,000
Estimated income taxes on the difference between the estimated current values of assets & liabilities & their tax bases	16,800	12,200
Net worth	<u>64,000</u>	<u>40,000</u>
Total liabilities & net worth	<u>\$150,000</u>	<u>\$128,000</u>

Assets and liabilities are presented in their order of liquidity and maturity, not as current and noncurrent. **ASC 274** provides guidelines for determining the current value of a person's assets and liabilities. The primary valuation methods are the discounted value of future cash flows, current market prices of marketable securities or other investments, and appraisals of properties. An investment in a separate business entity (e.g., a partnership) should be reported as a one-line, combined amount valued at the net investment's market value. The liabilities are stated at their discounted cash flow value or current liquidation value. The accountant uses applicable tax laws, carryover provisions, and other regulations to compute the estimated tax liability from the assumed conversion of assets and the assumed extinguishment of liabilities.

The statement of changes in net worth presents the major sources of income. It recognizes both realized and unrealized income. The income statement of a commercial business may not recognize holding gains on some marketable securities, but an individual's statement of changes in net worth recognizes such gains.

ILLUSTRATION OF PERSONAL FINANCIAL STATEMENTS

The following illustration presents Alt's personal financial condition as of May 1, 20X5, the day the partners decide to liquidate the ABC Partnership. His net worth on this date is as follows:

Personal assets	\$150,000
Personal liabilities	(86,000)
Net worth	<u>\$ 64,000</u>

Statement of Financial Condition

Figure 16–8 included Alt's statement of financial condition on May 1, 20X5, as well as the prior-year statement. The 20X5 statement illustrates the following:

1. Receivables due to Alt from other people have a present value of \$3,500.
2. Alt has two investments, one of which is his interest in the ABC Partnership, valued at estimated current market value, which in this case also equals its book value of \$34,000. The marketable security investments are shown at market value.

FIGURE 16–9
Personal Statement of
Changes in Net Worth

C. ALT		
Statement of Changes in Net Worth		
For the Years Ended May 1, 20X5 and 20X4		
	Year Ended May 1	
	20X5	20X4
Realized increases in net worth:		
Salary	\$ 36,900	\$ 34,900
Dividends & interest income	800	400
Distribution from ABC Partnership	3,000	1,000
Cash surrender value of life insurance	100	100
Gains on sales of marketable securities	1,400	1,200
	<u>\$ 42,200</u>	<u>\$ 37,600</u>
Realized decreases in net worth:		
Income taxes	\$ 8,200	\$ 7,800
Interest expense	1,400	700
Real estate taxes	2,400	2,200
Insurance payments (including \$100 for increase in cash surrender value of life insurance)	400	300
Personal expenditures	18,800	18,600
	<u>\$(31,200)</u>	<u>\$(29,600)</u>
Net realized increase in net worth	<u>\$ 11,000</u>	<u>\$ 8,000</u>
Unrealized increases in net worth:		
Marketable securities	\$ 1,600	\$ 400
ABC Partnership	8,000	5,000
Residence	8,000	4,000
	<u>\$ 17,600</u>	<u>\$ 9,400</u>
Unrealized decreases in net worth:		
Increase in estimated income taxes on the difference between the estimated current values of assets & liabilities & their tax bases	(4,600)	(4,400)
Net unrealized increase in net worth	<u>\$ 13,000</u>	<u>\$ 5,000</u>
Net increase in net worth:		
Realized & unrealized	\$ 24,000	\$ 13,000
Net worth at beginning of period	40,000	27,000
Net worth at end of period	<u>\$ 64,000</u>	<u>\$ 40,000</u>

3. The cash surrender value of life insurance is presented net of any loans payable on the policies.
4. Alt's residence and personal effects are presented at their appraised values.
5. Liabilities are presented at their estimated current liquidation value or the discounted value of the future cash flows.
6. The estimated income taxes on the difference between the estimated current values of assets and liabilities and their tax bases represent the amount of income tax Alt would be liable for if all assets were converted to cash and all liabilities were paid.
7. Net worth is the difference between the estimated current value of Alt's assets and liabilities, including estimated tax.

Statement of Changes in Net Worth

Alt's statement of changes in net worth, shown in Figure 16–9, illustrates the following:

1. The statement separates the realized and unrealized changes in net worth. *Realized changes* are cash flows to or from Alt that have already taken place. *Unrealized changes* are equivalent to holding gains or losses. They have not yet been converted to cash. For example, Alt received \$3,000 from the ABC Partnership during the year ended May 1, 20X5. In addition, Alt's partnership interest increased by \$8,000 during the year.

2. Alt had \$42,200 of realized increases in net worth during the year ended May 1, 20X5. The primary source was a salary of \$36,900 from full-time employment outside the ABC Partnership.
3. The major realized decrease in net worth during the year ended May 1, 20X5, was for personal expenditures of \$18,800.
4. Unrealized increases of \$17,600 during the year were primarily from an increase in the value of Alt's personal residence (\$8,000) and an increase in the investment value of his partnership interest in the ABC Partnership (\$8,000). Unrealized holding gains of \$1,600 are available in Alt's investments in marketable securities.
5. The change in the estimated tax liability is an unrealized decrease because this amount is due only if Alt converts these assets to cash.
6. The net unrealized changes in net worth are added to the net realized changes in net worth to obtain the total change in Alt's net worth for each year. His net worth increased by \$13,000 during the year ended May 1, 20X4, and by \$24,000 during the year ended May 1, 20X5.

Footnote Disclosures

Sufficient footnote disclosures should accompany the two personal financial statements. The footnotes should describe the following:

1. The methods used to value the major assets.
2. The names and the nature of businesses in which the person has major investments.
3. The methods and assumptions used to compute the estimated tax bases and a statement that the tax provision in an actual liquidation will probably differ from the estimate because the actual tax burden will then be based on actual realizations determined by market values at the point of liquidation.
4. Maturities, interest rates, and other details of any receivables and debt.
5. Any other information needed to present fully the person's net worth.

Questions

- | | |
|---------------|--|
| LO 16-1 | Q16-1 What are the major causes of a dissolution? What are the accounting implications of a dissolution? |
| LO 16-1 | Q16-2 During a partnership liquidation, do a partnership's liabilities to individual partners have a lower priority than the partnership's obligations to other, third-party creditors? Explain. |
| LO 16-1 | Q16-3 X, Y, and Z are partners. The partnership is liquidating, and Partner Z is personally insolvent. What implications may this have for Partners X and Y? |
| LO 16-1 | Q16-4 May an individual partner simply decide to leave a partnership? Does the partnership have any legal recourse against that partner? Explain. |
| LO 16-2, 16-3 | Q16-5 Contrast a lump-sum liquidation with an installment liquidation. |
| LO 16-1 | Q16-6 How is a deficit in a partner's capital account eliminated if he or she is personally insolvent? |
| LO 16-2 | Q16-7 The DEF Partnership has total assets of \$55,000. Partner D has a capital credit of \$6,000, Partner E has a capital deficit of \$20,000, and Partner F has a capital credit of \$8,000. Is the DEF Partnership solvent or insolvent? |
| LO 16-1 | Q16-8 Assume that, because of a new law recently passed, the types of significant transactions in which a partnership engages are no longer lawful. Two of the five partners wish to wind up and terminate the partnership. Can these two partners require the partnership to terminate? Explain. |
| LO 16-3 | Q16-9 How are a partner's personal payments to partnership creditors accounted for on the partnership's books? |
| LO 16-3 | Q16-10 What is the purpose of the schedule of safe payments to partners? |
| LO 16-1 | Q16-11 In what ratio are losses during liquidation assigned to the partners' capital accounts? Is this ratio used in all instances? |
| LO 16-3 | Q16-12 The installment liquidation process uses a worst-case assumption in computing the payments to partners. What does <i>worst-case assumption</i> mean? |

- LO 16-3** **Q16-13** Define *loss absorption potential* and explain its importance in determining cash distributions to partners.
- LO 16-3** **Q16-14** Partner A has a capital credit of \$25,000. Partner B's capital credit is also \$25,000. Partners A and B share profits and losses in a 60:40 ratio. Which partner will receive the first payment of cash in an installment liquidation?
- LO 16-3** **Q16-15*** Explain the process of incorporating a partnership.

Cases

LO 16-3 **C16-1** **Cash Distributions to Partners**

Analysis

The partnership of Bull and Bear is in the process of termination. The partners have disagreed on virtually every decision and have decided to liquidate the present business with each partner taking his own clients from the partnership. Bull wants cash distributed as it becomes available; Bear wants no cash distributed until all assets have been sold and all liabilities settled. You are called in to aid in the termination and liquidation process.

Required

How would you respond to each of the partners' requests?

LO 16-1, 16-2 **C16-2** **Cash Distributions to Partners**

Analysis

Adam and Bard agreed to liquidate their partnership. Having been asked to assist them in this process, you prepare the following balance sheet for the date of the beginning of the liquidation. The loss-sharing percentages are in parentheses next to the capital account balances.

Cash	\$ 40,000
Loan Receivable from Adam	10,000
Other Assets	200,000
Total	<u>\$250,000</u>
Accounts Payable	\$ 30,000
Loan Payable to Bard	100,000
Adam, Capital (50%)	80,000
Bard, Capital (50%)	40,000
Total	<u>\$250,000</u>

Bard is demanding that the loan from him be paid before any cash is distributed to Adam. Adam believes the available cash should be paid to him until his capital account is reduced to \$40,000, the same as Bard's. Adam will then pay the loan receivable to the partnership with the cash received. You have been asked to reconcile the argument.

Required

What would you advise in this case?

LO 16-3 **C16-3*** **Incorporation of a Partnership**

After successfully operating a partnership for several years, the partners have proposed to incorporate the business and admit another investor. The original partners will purchase at par an amount of preferred stock equal to the book values of their capital interests in the partnership and common stock for the amount of the market value, including unrecognized goodwill, of the business that exceeds book value. The new investor will make an investment at a 5 percent premium over par value in both preferred and common stock equal to one-third of the total number of shares the original partners purchased. The corporation will acquire all the partnership's assets, assume its liabilities, and employ the original partners and the new investor.

Required

- Discuss the differences in accounts used and valuations expected in comparing the balance sheets of the proposed corporation and the partnership.
- Discuss the differences that would be expected in a comparison of the income statements of the proposed corporation with that of the partnership.

*Indicates that the item relates to "Additional Considerations."

LO 16-1

C16-4 Sharing Losses during Liquidation**Research**

Hiller, Luna, and Welsh are attempting to form a partnership to operate a travel agency. They have agreed to share profits in a ratio of 4:3:2 but cannot settle on the terms of the partnership agreement relating to possible liquidation. Hiller believes that it is best not to get into any arguments about potential liquidation now because the partnership will be a success and it is not necessary to think negatively now. Luna believes that in the event of liquidation, any losses should be shared equally because each partner would have worked equally for the partnership's success, or lack thereof. Welsh believes that any losses during liquidation should be distributed in the ratio of capital balances at the beginning of any liquidation because then the losses will be distributed based on a capital ability to bear the losses.

You have been asked to help resolve the differences and to prepare a memo to the three individuals including the following items.

Required

- Specify the procedures for allocating losses among partners stated in the Uniform Partnership Act of 1997 to be used if no partnership agreement terms are agreed upon regarding liquidation. (You may wish to access a copy of the UPA 1997 for this requirement.)
- Critically assess each partner's viewpoint, discussing the pros and cons of each.
- Specify another option for allocating potential liquidation losses not included in the positions the three individuals currently take. Critically assess the pros and cons of your alternative.

LO 16-1

C16-5 Analysis of a Court Decision on a Partnership Liquidation**Application**

The *Mattfield v. Kramer Brothers* court case presents a number of the interesting legal issues that often arise from the dissolution of a partnership. The case was heard in the Supreme Court of the State of Montana in 2005 and decided on May 31, 2005, as Case 03-796. The court's decision includes a summary of the disputes and lower court decisions.

The Montana State Supreme Court's decision is available at the FindLaw website. The easiest way to obtain the script of the decision is to search the Internet for the term "Mattfield v. Kramer Brothers" and then follow the link to the Court's 2005 decision. The legal briefs that each side presented to the Supreme Court may be obtained at the State Law Library of Montana website by searching the Internet for "State of Montana Law Library" or, using the URL: <http://courts.mt.gov/library>, click on Cases, and then search using case number 03-796, or a text term such as Mattfield. The briefs will then be made available.

Required

Obtain a copy of the Montana Supreme Court decision in the *Mattfield v. Kramer Brothers* case. Then answer each of the following questions regarding it.

- Prepare a short summary of the history of the Kramer Brothers Co-Partnership from formation through the appeal to the Montana Supreme Court.
- What type of partnership agreement existed? Recommend several provisions that you feel should have been included in a formal, written partnership agreement.
- When the case was appealed to the Supreme Court, did Bill Kramer still have an economic interest in the partnership? Explain.
- What legal recourse did the other partners have when Don Kramer dissociated from the partnership in 1994?
- In February 1997, why did Don Kramer's attorney, Floyd Brower, request copies of Ray Kramer's and Doug Kramer's personal tax returns?
- Select and discuss two key points regarding partnership liquidations that this case illustrates and that you feel are important.

Exercises

LO 16-2, 16-3

E16-1 Multiple-Choice Questions on Partnership Liquidations

Select the correct answer for each of the following questions.

(Note: The following information is for questions 1, 2, and 3.)

The balance sheet for the partnership of Joan, Charles, and Thomas, whose shares of profits and losses are 40, 50, and 10 percent, respectively is as follows:

Cash	\$ 50,000	Accounts Payable	\$150,000
Inventory	360,000	Joan, Capital	160,000
		Charles, Capital	45,000
		Thomas, Capital	55,000
Total Assets	<u>\$410,000</u>	Total Liabilities & Equities	<u>\$410,000</u>

Assume Charles is insolvent.

- If the inventory is sold for \$300,000, how much should Joan receive upon liquidation?
 - \$48,000.
 - \$100,000.
 - \$136,000.
 - \$160,000.
- If the inventory is sold for \$180,000, how much should Thomas receive upon liquidation?
 - \$28,000.
 - \$32,500.
 - \$37,000.
 - \$55,000.
- The partnership will be liquidated in installments. As cash becomes available, it will be distributed to the partners. If inventory costing \$200,000 is sold for \$140,000, how much cash should be distributed to each partner at this time?

	Joan	Charles	Thomas
a. \$56,000	\$70,000	\$14,000	
b. \$16,000	\$20,000	\$ 4,000	
c. \$32,000	\$ 0	\$ 8,000	
d. \$20,000	\$ 0	\$20,000	

- In accounting for partnership liquidation, cash payments to partners after all creditors' claims have been satisfied but before the final cash distribution should be according to
 - The partners' relative profit and loss-sharing ratios.
 - The final balances in partner capital accounts.
 - The partners' relative share of the gain or loss on liquidations.
 - Safe payments computations.
- After all noncash assets have been converted into cash in the liquidation of the Adam and Kay Partnership, the ledger contains the following account balances:

	Debit	Credit
Cash	\$47,000	
Accounts Payable		\$32,000
Loan Payable to Adam		15,000
Adam, Capital	7,000	
Kay, Capital		7,000

Available cash should be distributed with \$32,000 going to accounts payable and then

- \$15,000 to the loan payable to Adam.
- \$7,500 each to Adam and Kay.
- \$8,000 to Adam and \$7,000 to Kay.
- \$7,000 to Adam and \$8,000 to Kay.

(Note: The following information is for questions 6 and 7.)

F, A, S, and B are partners sharing profits and losses equally. The insolvent partnership is to be liquidated. The status of the partnership and each partner is as follows:

	Partnership Capital Balance	Personal Assets (exclusive of partnership interest)	Personal Liabilities (exclusive of partnership interest)
F	\$(15,000)	\$100,000	\$40,000
A	(10,000)	30,000	60,000
S	20,000 ^a	80,000	5,000
B	30,000 ^a	1,000	28,000
Total	<u>\$ 25,000^a</u>		

^a Deficit

6. The partnership creditors
 - a. Must first seek recovery against S because she is personally solvent and 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 its liabilities.
 - c. Will have to share A's interest in the partnership on a pro rata basis with A's personal creditors.
 - d. Have first claim to the partnership assets before any partner's personal creditors have rights to those assets.
7. The partnership creditors should seek recovery of their claims
 - a. From the partnership, including additional contributions from F and S.
 - b. From the personal assets of either F or A.
 - c. From the personal assets of either S or B.
 - d. From the personal assets of any of the partners for all or some of their claims.

LO 16-3

E16-2 Multiple-Choice Questions on Partnership Liquidation [AICPA Adapted]

Select the correct answer for each of the following questions.

1. On January 1, 20X7, the partners of Casey, Dithers, and Edwards, who share profits and losses in the ratio of 5:3:2, decided to liquidate their partnership. On this date, its condensed balance sheet was as follows:

Assets		Liabilities and Capital	
Cash	\$ 50,000	Liabilities	\$ 60,000
Other Assets	250,000	Casey, Capital	80,000
		Dithers, Capital	90,000
		Edwards, Capital	70,000
Total	<u>\$300,000</u>	Total	<u>\$300,000</u>

On January 15, 20X7, the first cash sale of other assets with a carrying amount of \$150,000 realized \$120,000. Safe installment payments to the partners were made on the same date. How much cash should be distributed to each partner?

	Casey	Dithers	Edwards
a. \$15,000	\$51,000	\$44,000	
b. \$40,000	\$45,000	\$35,000	
c. \$55,000	\$33,000	\$22,000	
d. \$60,000	\$36,000	\$24,000	

2. In a partnership liquidation, the final cash distribution to the partners should be made in accordance with the
 - a. Partners' profit and loss-sharing ratio.
 - b. Balances of the partners' capital accounts.

- c. Ratio of the capital contributions by the partners.
 d. Ratio of capital contributions less withdrawals by the partners.

(Note: The following information is for questions 3 through 5.)

The balance sheet for the Art, Blythe, and Cooper Partnership is as follows. Figures shown parenthetically reflect agreed profit and loss-sharing percentages.

Assets		Liabilities and Capital	
Cash	\$ 20,000	Liabilities	\$ 50,000
Other Assets	180,000	Art, Capital (40%)	37,000
		Blythe, Capital (40%)	65,000
		Cooper, Capital (20%)	48,000
Total	<u>\$200,000</u>	Total	<u>\$200,000</u>

3. If the firm, as shown on the balance sheet, is dissolved and liquidated by selling assets in installments and if 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)

	Art	Blythe	Cooper
a.	\$8,000	\$ 8,000	\$ 4,000
b.	\$6,667	\$ 6,667	\$ 6,666
c.	\$ 0	\$13,333	\$ 6,667
d.	\$ 0	\$ 3,000	\$17,000

4. If the facts are as in question 3 except that \$3,000 cash is to be withheld, the respective partners would then receive (to the nearest dollar)

	Art	Blythe	Cooper
a.	\$6,800	\$ 6,800	\$ 3,400
b.	\$5,667	\$ 5,667	\$ 5,666
c.	\$ 0	\$11,333	\$ 5,667
d.	\$ 0	\$ 1,000	\$16,000

5. If each partner properly received some cash in the distribution after the second sale, if the cash to be distributed amounts to \$12,000 from the third sale, and if unsold assets with an \$8,000 book value remain, ignoring questions 3 and 4, the respective partners would receive

	Art	Blythe	Cooper
a.	\$ 4,800	\$ 4,800	\$ 2,400
b.	\$ 4,000	\$ 4,000	\$ 4,000
c.	37/150 of \$12,000	65/150 of \$12,000	48/150 of \$12,000
d.	\$ 0	\$ 8,000	\$ 4,000

6. The following condensed balance sheet is for the partnership of Arnie, Bart, and Kurt, who share profits and losses in the ratio of 4:3:3, respectively:

Assets		Liabilities and Capital	
Cash	\$100,000	Liabilities	\$150,000
Other Assets	300,000	Arnie, Capital	40,000
		Bart, Capital	180,000
		Kurt, Capital	30,000
Total	<u>\$400,000</u>	Total	<u>\$400,000</u>

The partners agreed to dissolve the partnership after selling the other assets for \$200,000. On dissolution of the partnership, Arnie should receive

- \$0.
- \$40,000.
- \$60,000.
- \$70,000.

LO 16-2

E16-3 Computing Alternative Cash Distributions to Partners

Bracken, Loudon, and Menser, who share profits and losses in a ratio of 4:3:3, respectively are partners in a home decorating business that has not been able to generate the income the partners had hoped for. They have decided to liquidate the business and have sold all assets except for their decorating equipment. All partnership liabilities have been settled and all the partners are personally insolvent. The decorating equipment has a book value of \$40,000, and the partners have capital account balances as follows:

Bracken, capital	\$25,000
Louden, capital	5,000
Menser, capital	10,000

Required

Determine the amount of cash each partner will receive as a liquidating distribution if the decorating equipment is sold for the amount stated in each of the following independent cases:

- \$30,000.
- \$21,000.
- \$7,000.

LO 16-2

E16-4 Lump-Sum Liquidation

Matthews, Mitchell, and Michaels are partners in BG Land Development Company and share losses in a 5:3:2 ratio, respectively. The balance sheet on June 30, 20X1, when they decide to liquidate the business, is as follows:



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Assets		Liabilities and Capital	
Cash	\$ 20,000	Accounts Payable	\$ 30,000
Noncash Assets	150,000	Mitchell, Loan	10,000
		Matthews, Capital	80,000
		Mitchell, Capital	36,000
		Michaels, Capital	14,000
Total Assets	<u>\$170,000</u>	Total Liabilities & Equities	<u>\$170,000</u>

The noncash assets are sold for \$110,000.

Required

- Prepare a statement of partnership realization and liquidation.
- Prepare the required journal entries to account for the liquidation of BG Land Development Company.

LO 16-3

E16-5 Schedule of Safe Payments

After working for In the Kitchen remodeling business for several years, Terry and Phyllis decided to go into business for themselves and formed the Kitchens Just for You Partnership. Three years ago, they admitted Connie as a partner and recognized goodwill at that time because of her good client list for planned kitchen makeovers. However, they were not able to gain a sufficient market for new customers and on September 1, 20X9, they agreed to dissolve and liquidate the business. They decided on an installment liquidation to complete the projects already initiated. The balance sheet, with profit and loss-sharing percentages at the beginning of liquidation, is as follows:

KITCHENS JUST FOR YOU**Balance Sheet
September 1, 20X9**

Assets		Liabilities and Equities	
Cash	\$ 12,000	Accounts Payable	\$ 43,000
Receivables	63,000	Connie, Loan	15,000
Terry, Loan	9,000	Terry, Capital (30%)	12,000
Inventory	48,000	Phyllis, Capital (50%)	36,000
Goodwill	28,000	Connie, Capital (20%)	54,000
Total Assets	<u>\$160,000</u>	Total Liabilities & Equities	<u>\$160,000</u>

Connie's loan was for working capital; the loan to Terry was for his unexpected personal medical bills.

During September 20X9, the first month of liquidation, the partnership collected \$41,000 in receivables and decided to write off \$12,000 of the remaining receivables. Sales of one-half of the book value of the inventory realized a loss of \$4,000. The partners estimate that the costs of liquidating the business (newspaper ads, signs, etc.), are expected to be \$6,000 for the remainder of the liquidation process.

Required

Prepare a schedule of safe payments to partners as of September 30, 20X9, to show how the available cash should be distributed to the partners.

LO 16-3**E16-6 Schedule of Safe Payments to Partners**

Partners Maness and Joiner have decided to liquidate their business. The ledger shows the following account balances:

Cash	\$ 25,000	Accounts Payable	\$15,000
Inventory	120,000	Maness, Capital	65,000
		Joiner, Capital	65,000

Maness and Joiner share profits and losses in an 8:2 ratio. During the first month of liquidation, half the inventory was sold for \$40,000, and \$10,000 of the accounts payable was paid. During the second month, the rest of the inventory was sold for \$30,000, and the remaining accounts payable were paid. Cash was distributed at the end of each month, and the liquidation was completed at the end of the second month.

Required

Prepare a statement of partnership realization and liquidation with a schedule of safe payments for the two-month liquidation period.

LO 16-2**E16-7 Alternative Profit and Loss-Sharing Ratios in a Partnership Liquidation**

Nelson, Osman, Peters, and Quincy have decided to terminate their partnership because of recurrent arguments among the partners. The partnership's balance sheet when they decide to wind up follows:

Cash	\$ 17,000	Accounts Payable	\$ 12,000
Noncash Assets	190,000	Nelson, Capital	15,000
		Osman, Capital	75,000
		Peters, Capital	75,000
		Quincy, Capital	30,000
Total Assets	<u>\$207,000</u>	Total Liabilities & Equities	<u>\$207,000</u>

During the winding-up of the partnership, the other assets were sold for \$100,000 and the accounts payable were paid. Osman and Peters are personally solvent, but Nelson and Quincy are personally insolvent.

Required

Determine the amount of cash each partner will receive from the final distributions of the partnership for each of the following independent cases of profit and loss ratios for Nelson, Osman, Peters, and Quincy respectively,



- The partners share profits and losses in the ratio of 3:3:2:2.
- The partners share profits and losses in the ratio of 3:1:3:3.
- The partners share profits and losses in the ratio of 3:1:2:4.

LO 16-2**E16-8 Cash Distribution Plan**

Adams, Peters, and Blake share profits and losses for their APB Partnership in a ratio of 2:3:5. When they decide to liquidate, the balance sheet is as follows:

Assets		Liabilities and Equities	
Cash	\$ 40,000	Liabilities	\$ 50,000
Adams, Loan	10,000	Adams, Capital	55,000
Other Assets	200,000	Peters, Capital	75,000
		Blake, Capital	70,000
Total Assets	<u>\$250,000</u>	Total Liabilities & Equities	<u>\$250,000</u>

Liquidation expenses are expected to be negligible. No interest accrues on loans with partners after termination of the business.

Required

Prepare a cash distribution plan for the APB Partnership.

LO 16-3**E16-9 Confirmation of Cash Distribution Plan**

Refer to the data in exercise E16-8. During the liquidation process for the APB Partnership, the following events occurred:

- During the first month of liquidation, noncash assets with a book value of \$85,000 were sold for \$65,000, and \$21,000 of the liabilities were paid.
- During the second month, the remaining noncash assets were sold for \$79,000. The loan receivable from Adams was collected, and the rest of the creditors were paid.
- Cash is distributed to partners at the end of each month.

Required

Prepare a statement of partnership realization and liquidation with a schedule of safe payments to partners for the liquidation period.

LO 16-3**E16-10* Incorporation of a Partnership**

When Alice and Betty decided to incorporate their partnership, its trial balance was as follows:

	Debit	Credit
Cash	\$ 8,000	
Accounts Receivable (net)	22,400	
Inventory	36,000	
Equipment (net)	47,200	
Accounts Payable		\$ 17,200
Alice, Capital (60%)		62,400
Betty, Capital (40%)		34,000
Total	<u>\$113,600</u>	<u>\$113,600</u>

The partnership's books will be closed, and new books will be used for A & B Corporation. The following additional information is available:

- The estimated fair values of the assets follow:

Accounts Receivable	\$21,600
Inventory	32,800
Equipment	40,000

2. All assets and liabilities are transferred to the corporation.
3. The common stock is \$10 par. Alice and Betty receive a total of 7,100 shares.
4. The partners' profit and loss-sharing ratio is shown in the trial balance.

Required

- a. Prepare the entries on the partnership's books to record (1) the revaluation of assets, (2) the transfer of the assets to A & B Corporation and the receipt of the common stock, and (3) the closing of the books.
- b. Prepare the entries on A & B Corporation's books to record the assets and the issuance of the common stock.

LO 16-3**E16-11A Multiple-Choice on Personal Financial Statements [AICPA Adapted]**

Select the correct answer for each of the following questions.

1. On December 31, 20X7, Judy a fully vested participant in a company-sponsored pension plan. According to the plan's administrator, Judy has at that date the nonforfeitable right to receive a lump sum of \$100,000 on December 28, 20X8. The discounted amount of \$100,000 is \$90,000 at December 31, 20X7. The right is not contingent on Judy's life expectancy and requires no future performance on her part. In her December 31, 20X7, personal statement of financial condition, the vested interest in the pension plan should be reported at
 - a. \$0.
 - b. \$90,000.
 - c. \$95,000.
 - d. \$100,000.
2. On December 31, 20X7, Mr. and Mrs. McManus owned a parcel of land held as an investment. They had purchased it for \$95,000 in 20X0, and the mortgage on it had a principal balance of \$60,000 at December 31, 20X7. On this date, the land's fair value was \$150,000. In the McManuses' December 31, 20X7, personal statement of financial condition, at what amount should the land investment and mortgage payable be reported?

	Land Investment	Mortgage Payable
a.	\$150,000	\$60,000
b.	\$ 95,000	\$60,000
c.	\$ 90,000	\$ 0
d.	\$ 35,000	\$ 0

3. Rich Drennen's personal statement of financial condition at December 31, 20X6, shows net worth of \$400,000 before consideration of employee stock options owned on that date. Information relating to the stock options is as follows:
 - Options are to purchase 10,000 shares of Oglesby Corporation stock.
 - Options' exercise price is \$10 a share.
 - Options expire on June 30, 20X7.
 - Market price of the stock is \$25 a share on December 31, 20X6.
 - The exercise of the options in 20X7 would result in ordinary income taxable at 35 percent.
 After giving effect to the stock options, Drennen's net worth at December 31, 20X6, would be
 - a. \$497,500.
 - b. \$550,000.
 - c. \$562,500.
 - d. \$650,000.

"A" indicates that the item relates to Appendix 16A.

4. Nancy Emerson owns 50 percent of the common stock of Marks Corporation. She paid \$25,000 for this stock in 20X3. At December 31, 20X8, her 50 percent stock ownership in Marks had a current value of \$185,000. Marks's cumulative net income and cash dividends declared for the five years ended December 31, 20X8, were \$300,000 and \$30,000 respectively. In Nancy's personal statement of financial condition at December 31, 20X8, what amount should she report as her net investment in Marks?
- \$25,000.
 - \$160,000.
 - \$175,000.
 - \$185,000.
5. In a personal statement of financial condition, which of the following should be reported at estimated current values?

	Investments in Closely Held Business	Investments in Leaseholds
a.	Yes	Yes
b.	Yes	No
c.	No	No
d.	No	Yes

6. Personal financial statements should include which of the following statements?

	Financial Condition	Changes in Net Worth	Cash Flows
a.	No	Yes	Yes
b.	Yes	No	No
c.	Yes	Yes	No
d.	Yes	Yes	Yes

7. A business interest that constitutes a large part of an individual's total assets should be presented in a personal statement of financial condition as
- A single amount equal to the proprietorship equity.
 - A single amount equal to the estimated current value of the business interest.
 - A separate list of the individual assets and liabilities, at cost.
 - Separate line items of both total assets and total liabilities, at cost.
8. Personal financial statements should report assets and liabilities at
- Historical cost.
 - Historical cost and, as additional information, at estimated current values at the date of the financial statements.
 - Estimated current values at the date of the financial statements.
 - Estimated current values at the date of the financial statements and, as additional information, at historical cost.
9. The following information pertains to Kent's marketable equity securities:

Stock	Fair Value at December 31		Cost in 20X0
	20X3	20X2	
City Manufacturing Inc.	\$95,500	\$93,000	\$89,900
Tri Corporation	3,400	5,600	3,600
Zee Inc.		10,300	15,000

- Kent sold the Zee stock in January 20X3 for \$10,200. In his personal statement of financial condition at December 31, 20X3, what amount should he report for marketable equity securities?
- \$93,300.
 - \$93,500.
 - \$94,100.
 - \$98,900.
10. Personal financial statements should report an investment in life insurance at the
- Face amount of the policy less the amount of premiums paid.
 - Cash value of the policy less the amount of any loans against it.
 - Cash value of the policy less the amount of premiums paid.
 - Face amount of the policy less the amount of any loans against it.
11. Mrs. Taft owns a \$150,000 insurance policy on her husband's life. The policy's cash value is \$125,000, and there is a \$50,000 loan against it. The Tafts' personal statement of financial condition at December 31, 20X3, should show what amount as an investment in life insurance?
- \$150,000.
 - \$125,000.
 - \$100,000.
 - \$75,000.

LO 16-3

E16-12A Personal Financial Statements

Leonard and Michelle have asked you to prepare their statement of changes in net worth for the year ended August 31, 20X3. They have prepared the following comparative statement of financial condition based on estimated current values as required by **ASC 274**:

LEONARD AND MICHELLE		
Statement of Financial Condition		
August 31, 20X3 and 20X2		
	20X3	20X2
Assets		
Cash	\$ 3,600	\$ 6,700
Marketable securities	4,900	16,300
Residence	94,800	87,500
Personal effects	10,000	10,000
Cash surrender value of life insurance	3,200	5,600
Investment in farm business:		
Farmland	\$42,000	\$32,100
Farm equipment	22,400	9,000
Note payable on farm equipment	(10,000)	0
Net investment in farm	54,400	41,100
Total assets	<u>\$170,900</u>	<u>\$167,200</u>
Liabilities & Net Worth		
Credit card	\$ 2,400	\$ 1,500
Income taxes payable	11,400	12,400
Mortgage payable on residence	71,000	76,000
Estimated income taxes on the difference between the estimated current values of assets & liabilities and their tax bases	19,700	16,500
Net worth	<u>66,400</u>	<u>60,800</u>
Total liabilities & net worth	<u>\$170,900</u>	<u>\$167,200</u>

Additional Information

1. Leonard and Michelle's total salaries during the fiscal year ended August 31, 20X3, were \$44,300; farm income was \$6,700; personal expenditures were \$43,500; and interest and dividends received were \$1,400.
2. They purchased marketable securities in 20X1 at a cost of \$11,000 and with a market value of \$11,000 on August 31, 20X2, and sold them on March 1, 20X3, for \$10,700. Leonard and Michelle neither purchased nor sold additional marketable securities during the fiscal year.
3. The values of the residence and farmland are based on year-end appraisals.
4. On August 31, 20X3, Leonard purchased a used combine at a cost of \$14,000. He made a \$4,000 down payment and signed a five-year, 10 percent note payable for the \$10,000 balance owed. He did not purchase or sell other farm equipment during the fiscal year.
5. The cash surrender value of the life insurance policy increased during the fiscal year by \$1,600. However, Leonard had borrowed \$4,000 against the policy on September 1, 20X2. Interest at 15 percent for this loan's first year was paid when due on August 31, 20X3.
6. Leonard and Michelle paid federal income taxes of \$12,400 during the 20X3 fiscal year.
7. Mortgage payments made during the year totaled \$9,000, which included payments of principal and interest.

Required

Using the comparative statement of financial condition and additional information provided, prepare the statement of changes in net worth for the year ended August 31, 20X3. (*Hint:* It will be helpful to use T-accounts to determine several realized and unrealized amounts. An analysis of the cash, personal effects, and credit card accounts should not be required to properly complete the statement.)

Problems

LO 16-2

P16-13 Lump-Sum Liquidation

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The CDG Carlos, Dan, and Gail Partnership has decided to liquidate as of December 1, 20X6. A balance sheet on the date follows:

CDG PARTNERSHIP	
Balance Sheet	
At December 1, 20X6	
Assets	
Cash	\$ 25,000
Accounts Receivable (net)	75,000
Inventories	100,000
Property, Plant, & Equipment (net)	300,000
Total Assets	<u>\$500,000</u>
Liabilities & Capital	
Liabilities:	
Accounts Payable	\$270,000
Capital:	
Carlos, Capital	\$120,000
Dan, Capital	50,000
Gail, Capital	<u>60,000</u>
Total Capital	<u>230,000</u>
Total Liabilities & Capital	<u>\$500,000</u>

Additional Information

1. Each partner's personal assets (excluding partnership capital interests) and personal liabilities as of December 1, 20X6, follow:

	Carlos	Dan	Gail
Personal assets	\$250,000	\$300,000	\$350,000
Personal liabilities	(230,000)	(240,000)	(325,000)
Personal net worth	<u>\$ 20,000</u>	<u>\$ 60,000</u>	<u>\$ 25,000</u>

2. Carlos, Dan, and Gail share profits and losses in the ratio 20:40:40.
3. CDG sold all noncash assets on December 10, 20X6, for \$260,000.

Required

- a. Prepare a statement of realization and liquidation for the CDG Partnership on December 10, 20X6.
- b. Prepare a schedule of the net worth of each of the three partners as of December 10, 2006, after the partnership liquidation is completed.

LO 16-3**P16-14 Installment Liquidation [AICPA Adapted]**

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On January 1, 20X1, partners Art, Bru, and Chou, who share profits and losses in the ratio of 5:3:2, respectively, decide to liquidate their partnership. The partnership trial balance at this date follows:

	Debit	Credit
Cash	\$ 18,000	
Accounts Receivable	66,000	
Inventory	52,000	
Machinery & Equipment (net)	189,000	
Accounts Payable		\$ 53,000
Art, Capital		88,000
Bru, Capital		110,000
Chou, Capital		74,000
Total	<u>\$325,000</u>	<u>\$325,000</u>

The partners plan a program of piecemeal conversion of assets to minimize liquidation losses. All available cash, less an amount retained to provide for future expenses, is to be distributed to the partners at the end of each month. A summary of the liquidation transactions follows:

January 20X1

1. Collected \$51,000 on accounts receivable; the balance is uncollectible.
2. Received \$38,000 for the entire inventory.
3. Paid \$2,000 liquidation expenses.
4. Paid \$50,000 to creditors, after offset of a \$3,000 credit memorandum received on January 11, 20X1.
5. Retained \$10,000 cash in the business at the end of the month for potential unrecorded liabilities and anticipated expenses.

February 20X1

6. Paid \$4,000 liquidation expenses.
7. Retained \$6,000 cash in the business at the end of the month for potential unrecorded liabilities and anticipated expenses.

March 20X1

8. Received \$146,000 on sale of all items of machinery and equipment.
9. Paid \$5,000 liquidation expenses.
10. Retained no cash in the business.

Required

Prepare a statement of partnership liquidation for the partnership with schedules of safe payments to partners.

LO 16-3**P16-15 Cash Distribution Plan**

The Pen, Evan, and Torves Partnership has asked you to assist in winding-up its business affairs. You compile the following information.

1. The partnership's trial balance on June 30, 20X1, is



	Debit	Credit
Cash	\$ 6,000	
Accounts Receivable (net)	22,000	
Inventory	14,000	
Plant & Equipment (net)	99,000	
Accounts Payable		\$ 17,000
Pen, Capital		55,000
Evan, Capital		45,000
Torves, Capital		24,000
Total	<u>\$141,000</u>	<u>\$141,000</u>

2. The partners share profits and losses as follows: Pen, 50 percent; Evan, 30 percent; and Torves, 20 percent.
3. The partners are considering an offer of \$100,000 for the firm's accounts receivable, inventory, and plant and equipment as of June 30. The \$100,000 will be paid to creditors and the partners in installments, the number and amounts of which are to be negotiated.

Required

Prepare a cash distribution plan as of June 30, 20X1, showing how much cash each partner will receive if the partners accept the offer to sell the assets.

LO 16-3**P16-16 Installment Liquidation**

Refer to the facts in Problem 16-15. The partners have decided to liquidate their partnership by installments instead of accepting the \$100,000 offer. Cash is distributed to the partners at the end of each month. A summary of the liquidation transactions follows:

July

1. Collected \$16,500 on accounts receivable; balance is uncollectible.
2. Received \$10,000 for the entire inventory.
3. Paid \$1,000 liquidation expense.
4. Paid \$17,000 to creditors.
5. Retained \$8,000 cash in the business at the end of the month.

August

6. Paid \$1,500 in liquidation expenses.
7. As part payment of his capital, Torves accepted an item of special equipment that he developed, which had a book value of \$4,000. The partners agreed that a value of \$10,000 should be placed on this item for liquidation purposes.
8. Retained \$2,500 cash in the business at the end of the month.

September

9. Received \$75,000 on sale of remaining plant and equipment.
10. Paid \$1,000 liquidation expenses, retaining no cash in the business.

Required

Prepare a statement of partnership realization and liquidation with supporting schedules of safe payments to partners.

LO 16-3

P16-17 Installment Liquidation

The DSV Partnership decided to liquidate as of June 30, 20X5. Its balance sheet as of this date follows:

DSV PARTNERSHIP	
Balance Sheet	
At June 30, 20X5	
Assets	
Cash	\$ 50,000
Accounts Receivable (net)	95,000
Inventories	75,000
Property, Plant, & Equipment (net)	500,000
Total Assets	<u>\$720,000</u>
Liabilities & Partners' Capital	
Liabilities:	
Accounts Payable	\$405,000
Partners' Capital:	
D, Capital	\$100,000
S, Capital	140,000
V, Capital	<u>75,000</u>
Total Capital	<u>315,000</u>
Total Liabilities & Capital	<u>\$720,000</u>

Additional Information

- The personal assets (excluding partnership loan and capital interests) and personal liabilities of each partner as of June 30, 20X5, follow:

	D	S	V
Personal assets	\$250,000	\$450,000	\$300,000
Personal liabilities	<u>(270,000)</u>	<u>(420,000)</u>	<u>(240,000)</u>
Personal net worth	<u>\$ (20,000)</u>	<u>\$ 30,000</u>	<u>\$ 60,000</u>

- The DSV Partnership was liquidated during the months of July, August, and September. The assets sold and the amounts realized follow:

Month	Assets Sold	Carrying Amount	Amount Realized
July	Inventories	\$ 50,000	\$ 45,000
	Accounts receivable (net)	60,000	40,000
	Property, plant, & equipment	400,000	305,000
August	Inventories	25,000	18,000
	Accounts receivable (net)	10,000	4,000
September	Accounts receivable (net)	25,000	10,000
	Property, plant, & equipment	100,000	45,000

Required

Prepare a statement of partnership realization and liquidation for the DSV Partnership for the three-month period ended September 30, 20X5. D, S, and V share profits and losses in the ratio 50:30:20, respectively. The partners wish to distribute available cash at the end of each month after reserving \$10,000 of cash at the end of both July and August to meet unexpected liquidation expenses. Actual liquidation expenses incurred and paid each month amounted to \$2,500. Support each cash distribution to the partners with a schedule of safe installment payments.

LO 16-3

P16-18 Cash Distribution Plan

Refer to the information in problem 16-17. Assume the following cash amounts were received during the months of July, August, and September from the sale of DSV Partnership's noncash assets:

July	\$390,000
August	22,000
September	55,000

The partnership wishes to keep \$10,000 of cash on hand at the end of both July and August to pay for unexpected liquidation expenses.

It paid liquidation expenses of \$2,500 at the end of each month, July, August, and September.

Required

- Prepare a statement as of June 30, 20X5, showing how cash will be distributed among partners as it becomes available.
- Prepare schedules showing how cash is distributed at the end of July, August, and September 20X5.

LO 16-1–16-3

P16-19 Matching

Match the terms on the left with the descriptions on the right. Each description may be used only once (or not at all).

Terms	Descriptions of Terms
1. Dissolution	A. Sale of partnership assets, payment of its creditors, and distribution of any remaining assets to partners.
2. Partner's loss absorption potential	B. Allocation to other partners in their profit and loss-sharing ratio if the partner is personally insolvent.
3. Liquidation	C. Schedule that shows how cash is to be distributed as it becomes available during liquidation process.
4. Statement of partnership realization and liquidation	D. Amount computed by dividing a partner's capital balance by that partner's loss-sharing ratio.
5. Installment liquidation	E. Revaluation of a partnership's assets and liabilities to their market values.
6. Cash distribution plan	F. Change in the legal relationship between partners.
7. Incorporation of a partnership	G. End of the normal business function of the partnership.
8. Partner's deficit in capital	H. Liquidation in which all assets are converted into cash over a short time period, enabling all creditors to be paid, with any remaining cash being distributed according to the partner's capital balance.
9. Lump-sum liquidation	I. Cash payments to partners computed on the assumption that all noncash assets will be sold for nothing.
10. Safe payments to partners	J. Presentation, in worksheet form, of the effects of the liquidation process on the balance sheet accounts of the partnership.
	K. Liquidation in which cash is periodically distributed to partners during the liquidation process.

LO 16-1

P16-20 Partnership Agreement Issues [AICPA Adapted]

A partnership involves an association between two or more persons to carry on a business as co-owners for profit. Items 1 through 10 relate to partnership agreements.

The statement of facts for Parts A and B are followed by numbered sentences that state legal conclusions relating to those facts. Determine whether each legal conclusion is correct or not and mark it with the letter Y for yes, correct, or N for no, not correct.

Part A

Adams, Webster, and Coke were partners in a construction business. Coke decided to retire and found Black, who agreed to purchase his interest. Black was willing to pay Coke \$20,000 and promised to assume Coke's share of all firm obligations.

Required (Use Y for yes and N for no)

1. Unless the partners agree to admit Black as a partner, she could not become a member of the firm.
2. The retirement of Coke would cause a dissolution of the firm.
3. The firm's creditors are third-party beneficiaries of Black's promise to Coke.
4. If Black purchased Coke's interest and promised to pay his share of the firm's debts, Coke would be released from all liability for those debts.
5. If the other partners refused to accept Black as a partner, Coke could retire, thereby causing a dissolution.

Part B

Carson, Crocket, and Kitt were partners in an importing business. They needed additional capital to expand and located White who agreed to purchase a one-quarter interest in the partnership by contributing \$50,000 in capital. Before White became a partner, several creditors had loaned money to the partnership. The partnership subsequently failed, and the creditors are now attempting to assert personal liability against White.

Required (Use Y for yes and N for no)

6. White is personally liable on all of the firm's debts contracted subsequent to his entry into the firm.
7. Creditors of the partnership prior to White's admission automatically continue to be creditors of the partnership after the admission of the new partner.
8. Creditors of the partnership that existed prior to White's entry can assert rights against his capital contribution.
9. White has personal liability for firm debts existing prior to his entry into the firm.
10. White must remain in the partnership for at least one year to be subject to personal liability.