

CHAPTER FIVE : ACCOUNTING FOR PARTNERSHIPS

5.1. Definition Of Partnership

- ➡ An association of two or more persons to carry on as co-owners of a business for profit.
 - ➡ A partnership is created by a contract, known as the **partnership agreement** or **articles of partnership**.

Formation

- A partnership agreement may be oral or written. However, to avoid misunderstandings, the partnership agreement should be in writing. The written agreement by which a partnership is formed is called the *articles of partnership* or **partnership agreement**.

The article of partnership contains the following:

- ➡ Name of the business, location, purpose and duration of the partnership.
- ➡ Name, address and duties of each partner.
- ➡ Initial investments to be made by partners
- ➡ Methods of income or loss distribution
- ➡ Amount and timing of withdrawal of money
- ➡ Procedures for admission and withdrawal of partners
- ➡ Liquidation procedures.

5.2.Characteristics of a partnership

A) Voluntary Association

- ➡ A partnership is a voluntary association of individuals rather than a legal entity in itself.

B) Limited life

- ➡ A partnership dissolves whenever a partner ceases to be a member of the firm. **E.g.**
 - ✚ If a partner withdraws due to bankruptcy
 - ✚ Incapacity, or death and
 - ✚ Admitting a new partner.

C) Unlimited liability/ No limitation on legal liability/

- ✚ Each partner is individually liable to creditors for debts incurred by the partnership.

D) Limited ability to raise capital (funds)

- ✚ The ability to raise capital (funds) for the company is limited to what the partners can provide from personal resources or through borrowing.

E) Not taxable

- ✚ For federal income tax purposes, a partnership is not taxed.

F) Co-ownership of partnership property

- ✚ The property invested in a partnership by a partner becomes the joint property of all the partners.

G) Mutual agency

- ✚ Each partner is an agent of the partnership. **For example**, any partner can enter into a contract on behalf of all the members of the partnership.

H) Participation in income - Net income and net loss are distributed among the partners according to their partnership agreement.

- ✚ If the partnership agreement **does not provide for distribution of income and losses**, then income and losses are divided equally among the partners.

Advantages and Disadvantages of a Partnership

Advantages	Disadvantages
Combining skills and resources of two or more individuals	Mutual agency
Ease of formation	Limited life
Freedom from governmental regulations and restrictions	Unlimited liability
Ease of decision making	

5.3. Forming and Dividing Income of a Partnership

5.3.1. Forming a Partnership

- ➡ The investments of each partner are recorded in separate entries.
- ➡ The assets contributed by a partner are debited to the partnership asset accounts.
- ➡ If any liabilities are assumed by the partnership, it is credited.
- ➡ The partner's capital account is credited for the net amount.

To illustrate, assume that Joseph Stevens and Earl Foster, owners of competing hardware stores, agree to combine their businesses in a partnership. Stevens agrees to contribute the following:

Cash	\$ 7,200	Office equipment	\$2,500
Accounts receivable	16,300	Allowance for doubtful accounts	1,500
Merchandise inventory	28,700	Accounts payable	2,600
Store equipment	5,400		

The entry to record the assets and liabilities contributed by Stevens is as follows:

Apr.	1	Cash	7,200	
		Accounts Receivable	16,300	
		Merchandise Inventory	28,700	
		Store Equipment	5,400	
		Office Equipment	2,500	
		Allowance for Doubtful Accounts		1,500
		Accounts Payable		2,600
		Joseph Stevens, Capital		56,000

- ➡ The noncash assets are recorded at its current market value.
- ➡ **Example,** the store equipment contributed by Stevens may have had a book value of \$3,500 in Stevens' ledger (cost of \$10,000 less accumulated depreciation of \$6,500).
- ➡ However, it is recorded at its current market value of \$5,400.
- ➡ The contributions of Foster would be recorded in an entry similar to the entry for Stevens.

Dividing Net Income or Net Loss

- ➡ If a partnership agreement does not mention the distribution of income and losses, the law requires that they be shared equally by all partners.
- ➡ Also, if a partnership agreement specifies only the distribution of income, but is silent as to losses, the law requires that losses be distributed in the same ratio as income.
- ➡ Most partnership agreements, however, do specify how income or losses are to be divided.

Common methods of dividing partnership income are based on:

- 1) Services of the partners
- 2) Services and investments of the partners

a) Services of Partners

- ➡ Dividing income based on the services provided by each partner to the partnership.
- ➡ These services are often recognized by partner salary allowances.
- ➡ Such allowances reflect differences in
 - ✚ Partners' abilities and
 - ✚ Time devoted to the partnership.

To illustrate, assume that the partnership agreement of Jennifer Stone and Crystal Mills provides for monthly salary allowances. Stone is to receive a monthly allowance of \$5,000 (\$60,000 annually), and Mills is to receive \$4,000 a month (\$48,000 annually). Any net income remaining after the salary allowances is to be divided equally. Assume also that the net income for the year is \$150,000.

Net income			<u>\$150,000</u>
Division of net income:			
	J. Stone	C. Mills	Total
Annual salary allowance	\$60,000	\$48,000	\$108,000
Remaining income	<u>21,000</u>	<u>21,000</u>	<u>42,000</u>
Net income	<u>\$81,000</u>	<u>\$69,000</u>	<u>\$150,000</u>

The net income division is recorded as a closing entry, even if the partners do not withdraw the amounts of their salary allowances. The entry for closing Income Summary and dividing net income is as follows:

Dec. 31	Income Summary		150,000	
	Jennifer Stone, Capital			81,000
	Crystal Mills, Capital			69,000

- ➡ If Stone and Mills had withdrawn their salary allowances monthly, the withdrawals would have been debited to their drawing accounts during the year.
- ➡ At the end of the year, the debit balances of \$60,000 and \$48,000 in their drawing accounts would be transferred as reductions to their capital accounts.

b) Services of Partners and Investments

- ➡ Partners may agree that the most equitable plan of dividing income is to provide for
 - 1) Salary allowances and
 - 2) Interest on capital investments.
 - 3) Any remaining net income is then divided as agreed upon.

For example, assume that the partnership agreement for Stone and Mills divides income as follows:

- a) Monthly salary allowances of \$5,000 for Stone and \$4,000 for Mills.
- b) Interest of 12% on each partner's capital balance on January 1.

c) Any remaining net income divided equally between the partners.

Stone had a credit balance of \$160,000 in her capital account on January 1 of the current fiscal year, and Mills had a credit balance of \$120,000 in her capital account. The \$150,000 net income for the year is divided per the following schedule:

Net income			<u>\$150,000</u>
Division of net income:			
	J. Stone	C. Mills	Total
Annual salary allowance	\$60,000	\$48,000	\$108,000
Interest allowance	19,200 ¹	14,400 ²	33,600
Remaining income	4,200	4,200	8,400
Net income	<u>\$83,400</u>	<u>\$66,600</u>	<u>\$150,000</u>
¹ 12% × \$160,000			
² 12% × \$120,000			

The entry for closing Income Summary and dividing net income is as follows:

Dec.	31	Income Summary Jennifer Stone, Capital Crystal Mills, Capital		150,000	83,400 66,600
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C) Allowances Exceed Net Income

- In the preceding example, the net income is \$150,000. The total of the salary (\$108,000) and interest (\$33,600) allowances is \$141,600. Thus, the net income exceeds the salary and interest allowances.
- If the net income is less than total allowances, the remaining balance will be a negative amount.
- This amount must be divided among the partners as though it were a net loss.

To illustrate, assume the same salary and interest allowances as in the preceding example, but that the net income is \$100,000. In this case, the total of the allowances of \$141,600 exceeds the net income by \$41,600 (\$100,000- \$141,600). This amount is divided equally between Stone and Mills. Thus, \$20,800 (\$41,600/2) is deducted from each partner's share of the allowances. The final division of net income between Stone and Mills is shown as follows:

Net income			<u>\$100,000</u>
Division of net income:			
	J. Stone	C. Mills	Total
Annual salary allowance	\$60,000	\$48,000	\$108,000
Interest allowance	19,200	14,400	33,600
Total	\$79,200	\$62,400	\$141,600
Deduct excess of allowances over income	20,800	20,800	41,600
Net income	<u>\$58,400</u>	<u>\$41,600</u>	<u>\$100,000</u>

The entry for closing Income Summary and dividing net income is as follows:⁴

Dec.	31	Income Summary Jennifer Stone, Capital Crystal Mills, Capital		100,000	58,400 41,600
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Partnership Dissolution

- ➔ Many partnerships provide for admitting new partners and for partner withdrawals by amending the existing partnership agreement.
- ➔ In this way, the company may continue operating without having to form a new partnership and prepare a new partnership agreement.

a) Admitting a Partner

A person may be admitted to a partnership by either of the following:

- a) Purchasing an interest from one or more of the existing partners.
 - b) Contributing assets to the partnership.
- ➔ When a new partner is admitted by purchasing an interest from one or more of the existing partners:
 - The total assets and
 - The total owners' equityof the partnership is not affected.
 - ➔ The capital (equity) of the new partner is recorded by transferring capital (equity) from the existing partners.
 - ➔ When a new partner is admitted by contributing assets to the partnership:
 - The total assets and
 - The total owners' equityof the partnership is increased.
 - ➔ The capital (equity) of the new partner is recorded as the amount of assets contributed to the partnership by the new partner.

b) Purchasing an Interest from Existing Partners

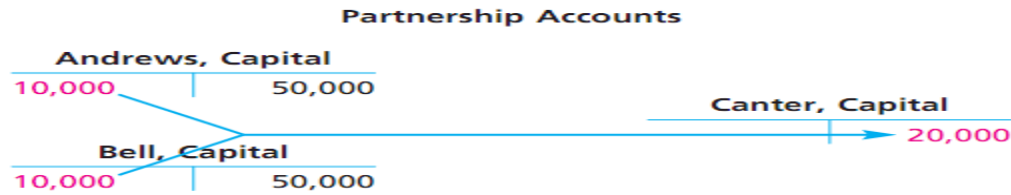
- ➔ The purchase and sale of a partnership interest occurs between the new partner and the existing partners acting as individuals.
- ➔ The only entry needed is to transfer owner's equity amounts from the capital accounts of the selling partners to the capital account established for the incoming partner.

To illustrate, assume that on June 1, Tom Andrews and Nathan Bell each sell one fifth of their partnership equity of Bring It consulting to Joe Canter for \$10,000 in cash. On June 1, the partnership has net assets of \$100,000 and both existing partners' have capital balances of \$50,000 each. This transaction is between Andrews, Bell, and Canter.

The only entry required by Bring It Consulting is to record the transfer of capital (equity) from Andrews and Bell to Canter, as shown below.

June	1	Tom Andrews, Capital Nathan Bell, Capital Joe Canter, Capital		10,000 10,000	20,000
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The effect of the transaction on the partnership accounts is shown in the following diagram:



- After Canter is admitted to Bring It Consulting, the total owners' equity is still \$100,000. Canter has a one-fifth (20%) interest and a capital balance of \$20,000.
- Andrews and Bell each own two-fifths (40%) interest and have capital balances of \$40,000 each.
- Even though Canter has a one-fifth (20%) interest in the partnership:
 - He may not be entitled to a one-fifth share of the partnership net income.
 - The division of the net income or net loss is made according to the new or amended partnership agreement.
- The preceding entry is not affected by the amount paid by Canter for the one-fifth interest. **For example**, if Canter had paid \$15,000 to Andrews and Bell instead of \$10,000, the entry would still be the same. This is because the transaction is between Andrews, Bell, and Canter, rather than the partnership.

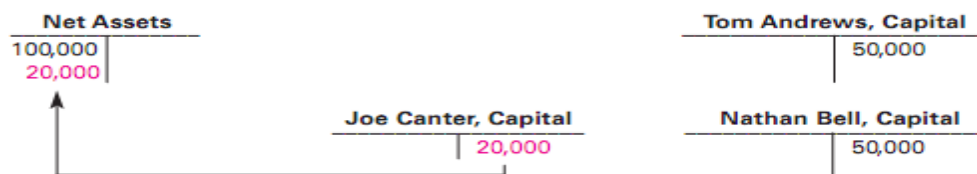
Contributing Assets to a Partnership

- When a new partner is admitted by contributing assets to the partnership, the total assets and the total owners' equity of the partnership are increased. This is because the transaction is between the new partner and the partnership.

To illustrate, assume that instead of purchasing a one-fifth ownership in Bring It Consulting directly from Tom Andrews and Nathan Bell, Joe Canter contributes \$20,000 cash to Bring It Consulting for ownership equity of \$20,000. The entry to record this transaction is as follows:

June	1	Cash		20,000	
		Joe Canter, Capital			20,000

The effect of the transaction on the partnership accounts is shown in the following diagram:



- After the admission of Canter, the net assets and total owners' equity of Bring It Consulting increase to \$120,000, of which Joe Canter has a \$20,000 interest.

Revaluation of Assets

- Before a new partner is admitted, the balances of a partnership's asset accounts should be stated at current values. If necessary, the accounts should be adjusted.
- Any net adjustment (increase or decrease) in asset values is divided among the capital accounts of the existing partners similar to the division of income.

To illustrate, assume that in the preceding example the balance of the merchandise inventory account is \$14,000 and the current replacement value is \$17,000. If Andrews and Bell share net income equally, the revaluation is recorded as follows:

June	1	Merchandise Inventory		3,000	
		Tom Andrews, Capital			1,500
		Nathan Bell, Capital			1,500

Partner Bonuses

- A new partner may pay existing partners a bonus to join a partnership. In other cases, existing partners may pay a new partner a bonus to join the partnership.
- Bonuses are usually paid because of higher than normal profits the new or existing partners are expected to contribute in the future. For example, a new partner may bring special qualities or skills to the partnership.
- Existing partners receive a bonus when the ownership interest received by the new partner is less than the amount paid. In contrast, the new partner receives a bonus when the ownership interest received by the new partner is greater than the amount paid.

To illustrate, assume that on March 1 the partnership of Marsha Jenkins and Helen Kramer is considering a new partner, Alex Diaz. After the assets of the partnership have been adjusted to current market values, the capital balances of Jenkins and Kramer are as follows:

Marsha Jenkins, Capital	\$20,000
Helen Kramer, Capital	24,000
Total owners' equity <i>before</i> admitting Diaz	<u>\$44,000</u>

Jenkins and Kramer agree to admit Diaz to the partnership for \$31,000. In return, Diaz will receive one-third equity in the partnership and will share equally with Jenkins and Kramer in partnership income or losses. In this case, Diaz is paying Jenkins and Kramer a \$6,000 bonus to join the partnership, computed as follows:

Marsha Jenkins, Capital	\$20,000	
Helen Kramer, Capital	24,000	
Diaz's contribution	<u>31,000</u>	
Total owners' equity <i>after</i> admitting Diaz	\$75,000	
Diaz's equity interest after admission	$\times \frac{1}{3}$	
Alex Diaz, Capital	<u>\$25,000</u>	
Diaz's contribution	\$31,000	
Alex Diaz, Capital	<u>25,000</u>	
Bonus paid to Jenkins and Kramer	<u>\$ 6,000</u>	

The \$6,000 bonus paid by Diaz increases Jenkins's and Kramer's capital accounts. It is distributed to the capital accounts of Jenkins and Kramer according to their income sharing ratio. Assuming that Jenkins and Kramer share profits and losses equally, the entry to record the admission of Diaz to the partnership is as follows:

Mar.	1	Cash		31,000	
		Alex Diaz, Capital			25,000
		Marsha Jenkins, Capital			3,000
		Helen Kramer, Capital			3,000

➔ Existing partners may agree to pay the new partner a bonus to join a partnership.
To illustrate, assume that after adjusting assets to market values, the capital balances of Janice Cowen and Steve Dodd are as follows:

Janice Cowen, Capital	\$ 80,000
Steve Dodd, Capital	40,000
Total owners' equity <i>before</i> admitting Chou	<u>\$120,000</u>

Cowen and Dodd agree to admit Ellen Chou to the partnership on June 1 for an investment of \$30,000. In return, Chou will receive a one-fourth equity interest in the partnership and will share in one-fourth of the profits and losses. In this case, Cowen and Dodd are paying Chou a \$7,500 bonus to join the partnership, computed as follows:

Janice Cowen, Capital	\$ 80,000	
Steve Dodd, Capital	40,000	
Chou's contribution	30,000	
Total owners' equity <i>after</i> admitting Chou	<u>\$150,000</u>	
Chou's equity interest after admission	$\times \frac{1}{4}$	
Ellen Chou, Capital	<u>\$ 37,500</u>	
Ellen Chou, Capital	\$ 37,500	←
Chou's contribution	30,000	
Bonus paid to Chou	<u>\$ 7,500</u>	

The \$7,500 bonus paid to Chou decreases Cowen's and Dodd's capital accounts. It is distributed to the capital accounts of Cowen and Dodd according to their income-sharing ratio.

Assuming that the income-sharing ratio of Cowen and Dodd was 2:1 before the admission of Chou, the entry to record the admission of Chou to the partnership is as follows:

June	1	Cash		30,000	
		Janice Cowen, Capital		5,000 ¹	
		Steve Dodd, Capital		2,500 ²	
		Ellen Chou, Capital			37,500

¹ \$7,500 $\times$ 2/3
² \$7,500 $\times$ 1/3

Withdrawal of a Partner

A partner may retire or withdraw from a partnership. In such cases, the withdrawing partner's interest is normally sold to the:

- Existing partners or
 - Partnership
- ➔ If the existing partners purchase the withdrawing partner's interest, the purchase and sale of the partnership interest is between the partners as individuals. The entry on the partnership's records is to
- ▶ Debit the capital account of the partner withdrawing and
 - ▶ Credit the capital account of the partner or partners buying the additional interest.
- ➔ If the partnership purchases the withdrawing partner's interest, the assets and the owners' equity of the partnership are reduced by the purchase price.

- Before the purchase, the asset accounts should be adjusted to current values. The net amount of any adjustment should be divided among the capital accounts of the partners according to their income-sharing ratio.
- The entry to record the purchase
 - ▶ Debits the capital account of the withdrawing partner and
 - ▶ Credits Cash for the amount of the purchase.
- If not enough partnership cash is available to pay the withdrawing partner, a liability may be created (credited) for the amount owed the withdrawing partner.

Death of a Partner

- When a partner dies, the partnership accounts should be closed as of the date of death.
- The net income for the current period should then be determined and divided among the partners' capital accounts.
- The asset accounts should also be adjusted to current values and the amount of any adjustment divided among the capital accounts of the partners.
- After the income is divided and any assets revalued, an entry is recorded to close the deceased partner's capital account.
- The entry debits the deceased partner's capital account for its balance and credits a liability account, which is payable to the deceased's estate. The remaining partner or partners may then decide to continue the business or liquidate it.

Liquidating Partnerships

- When a partnership goes out of business, it sells the assets, pays the creditors, and distributes the remaining cash or other assets to the partners.
- This winding-up process is called the **liquidation** of the partnership.
- Although liquidating refers to the payment of liabilities, it includes the entire winding-up process.
- When the partnership goes out of business and the normal operations are discontinued, the accounts should be adjusted and closed.
- The only accounts remaining open will be the asset, contra asset, liability, and owners' equity accounts.

The steps in the liquidation process are as follows:

- **Step 1.** Sell the partnership assets. This step is called **realization**.
- **Step 2.** Distribute any gains or losses from realization to the partners based on their income-sharing ratio.
- **Step 3.** Pay the claims of creditors using the cash from step 1 realization.
- **Step 4.** Distribute the remaining cash to the partners based on the balances in their capital accounts.

To illustrate, assume that Farley, Greene, and Hall share income and losses in a ratio of 5:3:2 (5/10, 3/10, 2/10). On April 9, after discontinuing business operations of the partnership and closing the accounts, the following trial balance in summary form was prepared:

Cash	11,000	
Noncash Assets	64,000	
Liabilities		9,000
Jean Farley, Capital		22,000
Brad Greene, Capital		22,000
Alice Hall, Capital		22,000
Total	<u>75,000</u>	<u>75,000</u>

Based on these facts, we show the accounting for liquidating the partnership by using three different selling prices for the noncash assets.

a) Gain on Realization

➔ Assume that Farley, Green, and Hall sell all noncash assets for \$72,000. Thus, a gain of \$8,000 (\$72,000 - \$64,000) is realized. The partnership is liquidated during April as follows:

➔ **Step 1.** Sale of assets: \$72,000 is realized from sale of all the noncash assets.

➔ **Step 2.** Division of gain: The gain of \$8,000 is distributed to Farley, Green, and Hall in the income-sharing ratio of 5:3:2. Thus, the partner capital accounts are credited as follows:

Farley	\$4,000 (\$8,000 × 50%)
Green	2,400 (\$8,000 × 30%)
Hall	1,600 (\$8,000 × 20%)

➔ Step 3. Payment of liabilities: Creditors are paid \$9,000.

➔ Step 4. Distribution of cash to partners: The remaining cash of \$74,000 is distributed to the partners according to their capital balances as follows:

Farley	\$26,000
Green	24,400
Hall	23,600

Statement of Partnership Liquidation: Gain on Realization

Farley, Green, and Hall Statement of Partnership Liquidation For Period April 10–30, 2010												
		Cash	+	Noncash Assets	=	Liabilities	+	Capital				
								Farley (50%)	+	Green (30%)	+	Hall (20%)
Steps 1–2	→ Balances before realization	\$ 11,000		\$64,000		\$9,000		\$22,000		\$22,000		\$22,000
	→ Sale of assets and division of gain	+72,000		–64,000				+ 4,000		+ 2,400		+ 1,600
	Balances after realization	\$83,000		\$ 0		\$9,000		\$26,000		\$24,400		\$23,600
Step 3	→ Payment of liabilities	– 9,000				–9,000						
	Balances after payment of liabilities	\$74,000		\$ 0		\$ 0		\$26,000		\$24,400		\$23,600
Step 4	→ Cash distributed to partners	–74,000						–26,000		–24,400		–23,600
	Final balances	\$ 0		\$ 0		\$ 0		\$ 0		\$ 0		\$ 0

The entries to record the steps in the liquidating process are as follows:

1) Sale of assets

	Cash		72,000	
	Noncash Assets			64,000
	Gain on Realization			8,000

2) Division of gain:

		Gain on Realization		8,000	
		Jean Farley, Capital			4,000
		Brad Green, Capital			2,400
		Alice Hall, Capital			1,600

3) Payment of liabilities

		Liabilities		9,000	
		Cash			9,000

4) Distribution of cash to partners

		Jean Farley, Capital		26,000	
		Brad Green, Capital		24,400	
		Alice Hall, Capital		23,600	
		Cash			74,000

- As shown in above, the cash is distributed to the partners based on the balances of their capital accounts.
- These balances are determined after the gain on realization has been divided among the partners and the liabilities paid.
- The income-sharing ratio should not be used as a basis for distributing the cash to partners.

b) Loss on Realization

- Assume that Farley, Green, and Hall sell all noncash assets for \$44,000. Thus, a loss of \$20,000 (\$64,000 - \$44,000) is realized. The liquidation of the partnership is as follows:
- Step 1. Sale of assets: \$44,000 is realized from the sale of all the noncash assets.
- Step 2. Division of loss: The loss of \$20,000 is distributed to Farley, Green, and Hall in the income-sharing ratio of 5:3:2. Thus, the partner capital accounts are debited as follows:

Farley	\$10,000 (\$20,000 × 50%)
Green	6,000 (\$20,000 × 30%)
Hall	4,000 (\$20,000 × 20%)

- Step 3. Payment of liabilities: Creditors are paid \$9,000.
- Step 4. Distribution of cash to partners: The remaining cash of \$46,000 is distributed to the partners according to their capital balances as follows:

Farley	\$12,000
Green	16,000
Hall	18,000

The steps in liquidating the partnership are summarized in the statement of partnership liquidation shown in Exhibit 6.

Statement of Partnership Liquidation: Loss on Realization

Farley, Green, and Hall Statement of Partnership Liquidation For Period April 10–30, 2010												
						Capital						
		Cash	+	Noncash Assets	=	Liabilities	+	Farley (50%)	+	Green (30%)	+	Hall (20%)
Steps 1–2	→ Balances before realization	\$11,000		\$64,000		\$9,000		\$22,000		\$22,000		\$22,000
	→ Sale of assets and division of loss	+44,000		–64,000				–10,000		– 6,000		– 4,000
	Balances after realization	\$55,000		\$ 0		\$9,000		\$12,000		\$16,000		\$18,000
Step 3	→ Payment of liabilities	– 9,000				–9,000						
	Balances after payment of liabilities	\$46,000		\$ 0		\$ 0		\$12,000		\$16,000		\$18,000
Step 4	→ Cash distributed to partners	–46,000						–12,000		–16,000		–18,000
	Final balances	<u>\$ 0</u>		<u>\$ 0</u>		<u>\$ 0</u>		<u>\$ 0</u>		<u>\$ 0</u>		<u>\$ 0</u>

The entries to record the steps in the liquidating process are as follows:

2. Sale of assets

Cash	44,000	
Loss on Realization	20,000	
Noncash Assets		64,000

3. Division of gain:

Jean Farley, Capital	10,000	
Brad Green, Capital	6,000	
Alice Hall, Capital	4,000	
Loss on Realization		20,000

4. Payment of liabilities

Liabilities	9,000	
Cash		9,000

5. Distribution of cash to partners

Jean Farley, Capital	12,000	
Brad Green, Capital	16,000	
Alice Hall, Capital	18,000	
Cash		46,000

c) Loss on Realization—Capital Deficiency

- The share of a loss on realization may be greater than the balance in a partner's capital account.
- The resulting debit balance in the capital account is called a **deficiency**. It represents a claim of the partnership against the partner.

To illustrate, assume that Farley, Green, and Hall sell all noncash assets for \$10,000. Thus, a loss of \$54,000 (\$64,000 - \$ 10,000) is realized. The liquidation of the partnership is as follows:

- Step 1. Sale of assets: \$10,000 is realized from the sale of all the noncash assets.
- Step 2. Division of loss: The loss of \$54,000 is distributed to Farley, Green, and Hall in the income-sharing ratio of 5:3:2. The partner capital accounts are debited as follows:

Farley	\$27,000 (\$54,000 × 50%)
Green	16,200 (\$54,000 × 30%)
Hall	10,800 (\$54,000 × 20%)

- ➔ Step 3. Payment of liabilities: Creditors are paid \$9,000.
- ➔ Step 4. Distribution of cash to partners: The share of the loss allocated to Farley, \$27,000 (50% * \$54,000), exceeds the \$22,000 balance in her capital account. This \$5,000 deficiency represents an amount that Farley owes the partnership. Assuming that Farley pays the deficiency, the cash of \$17,000 is distributed to the partners according to their capital balances as follows:

Farley	\$ 0
Green	5,800
Hall	11,200

Statement of Partnership Liquidation: Loss on Realization—Capital Deficiency

Farley, Green, and Hall Statement of Partnership Liquidation For Period April 10–30, 2010												
					Capital							
		Cash	+	Noncash Assets	=	Liabilities	+	Farley (50%)	+	Green (30%)	+	Hall (20%)
Steps 1–2	Balances before realization	\$11,000		\$64,000		\$9,000		\$22,000		\$22,000		\$22,000
	Sale of assets and division of loss	+10,000		–64,000				–27,000		–16,200		–10,800
	Balances after realization	\$21,000		\$ 0		\$9,000		\$ (5,000)		\$ 5,800		\$11,200
Step 3	Payment of liabilities	– 9,000				–9,000						
	Balances after payment of liabilities	\$ 12,000		\$ 0		\$ 0		\$ (5,000)		\$ 5,800		\$11,200
Step 4	Receipt of deficiency	+ 5,000						+ 5,000				
	Balances	\$ 17,000		\$ 0		\$ 0		\$ 0		\$ 5,800		\$11,200
	Cash distributed to partners	– 17,000								– 5,800		–11,200
	Final balances	\$ 0		\$ 0		\$ 0		\$ 0		\$ 0		\$ 0

The entries to liquidate the partnership are as follows:

1- Sale of assets

Cash	10,000	
Loss on Realization	54,000	
Noncash Assets		64,000

2- Division of loss

Jean Farley, Capital	27,000	
Brad Green, Capital	16,200	
Alice Hall, Capital	10,800	
Loss on Realization		54,000

3- Payment of liabilities

Liabilities	9,000	
Cash		9,000

4- Receipt of deficiency

Cash	5,000	
Jean Farley, Capital		5,000

5- Distribution of cash to partners

	Brad Green, Capital	5,800	
	Alice Hall, Capital	11,200	
	Cash		17,000

- If the deficient partner does not pay the partnership their deficiency, there will not be sufficient partnership cash to pay the remaining partners in full.
- Any uncollected deficiency becomes a loss to the partnership and is divided among the remaining partners' capital balances based on their income-sharing ratio.
- The cash balance will then equal the sum of the capital account balances.
- The cash can then be distributed to the remaining partners, based on the balances of their capital accounts.

To illustrate, assume that in the preceding example Farley could not pay her deficiency. The deficiency would be allocated to Green and Hall based on their income sharing ratio of 3:2. The remaining cash of \$12,000 would then be distributed to Green (\$2,800) and Hall (\$9,200) as shown below.

	Capital Balances Before (Deficiency)	Allocated (Deficiency)	Capital Balances After Deficiency
Farley	\$(5,000)	\$5,000	\$ 0
Green	5,800	(3,000)*	2,800
Hall	11,200	(2,000)**	9,200
Total	<u>\$12,000</u>		<u>\$12,000</u>

*\$3,000 = $[\$5,000 \times (3/5)]$ or $(\$5,000 \times 60\%)$

**\$2,000 = $[\$5,000 \times (2/5)]$ or $(\$5,000 \times 40\%)$

- The entries to allocate Farley's deficiency and distribute the cash are as follows:

1. Allocation of deficiency:

	Brad Green, Capital	3,000	
	Alice Hall, Capital	2,000	
	Jean Farley, Capital		5,000

2. Distribution of cash to partners:

	Brad Green, Capital	2,800	
	Alice Hall, Capital	9,200	
	Cash		12,000