**UNIT 6: LIQUIDATION OF A PARTNERSHIP**

**6.1 Introduction**

Liquidation refers to the process of winding-up the operation of the business. Liquidation may result form the sale of the business by mutual agreement of the partners, from the death of a partner, or from bankruptcy. In contrast to the dissolution of a partnership, liquidation ends both the legal and economic life of the entity. The liquidation of a partnership terminates the business.

**6.2 The partnership liquidation process**

The liquidation process involves four steps. These are:

1. **Adjust and close accounts and prepare trial** **balance.** When the ordinary business activities are discontinued, as the partnership goes out of the business, the accounts should be adjusted and closed according to the customary procedures of the periodic summary. Then a post closing trial balance is prepared that contains only assets, liabilities, and owner’s equity.
2. **Sale of the non-cash assets and allocation of gain/loss on realization**

 Once the operation of the business is terminated, the non-cash assets should be converted to cash through sale. The sale of non-cash assets for cash is called realization. The non-cash assets may be sold in a single transaction, or on piecemeal basis. When assets are sold on piecemeal basis, the liquidation process may extend over a considerable period of time.

If the cash proceed from sale is greater than book value, the difference is gain on realization. After recording the sale of the non-cash assts, gain or loss on realization is allocated between/among partners according to their income sharing ratios.

**3. Payment of partnership Liabilities**

After the non-cash assets are sold, the available cash is used to pay the partnership creditors before any cash is distributed to partners. The accounting entry debits liabilities (or liability account) and credit cash.

**4. Distribute the remaining cash to partners**

After all debt claims are settled, the remaining cash will be distributed to the partners according to their capital balances. Note that the remaining cash is not distributed to the partners on the basis of their income-sharing ratio.

Each of the above step must be performed in sequence because creditors must be paid before partners receive any cash distributions. Each step also must be recorded by an accounting entry.

**6.3 illustration on liquidation**

The following section illustrates the liquidation process

**Example**

Assume that HM partnership is liquidated when its ledger shows the following assets, liabilities and owners’ equity accounts:

|  |  |
| --- | --- |
| **Assets** | **Liabilities & Owner’s equity** |
| Cash  |  Br. 6,000 | Accounts payable  | Br. 15,000 |
| Accounts receivable  |  13,000 | Hanna, capital  |  38,000 |
| Inventory  |  20,000 | Meseret, capital  |  21,000 |
| Equipment  |  45,000 |  Total  | Br. 74,000 |
| Accumulated depreciation (equipment )Total |  (10,000)Br. 74,000 |  |  |

Accounts have been adjusted and closed

Hanna and Meseret share income on a 6:4 basis. Assume further that all non-cash assets are sold in a single transaction. All non-cash assets are sold for Br. 80,000. The liquidation process started on November 3 and ended on Nov.26, 2003.

**Required**

1. Prepare statement of partnership liquidation.
2. Prepare the entry to record transactions in the liquidation process.

**Solution**

**a. Statement of partnership liquidation**

The statement of partnership liquidation is organized around the basic accounting equation. It is prepared to show the liquidation process and to determine the distribution of cash to partners. The statement of partnership liquidation for HM partnership is shown below:

|  |  |
| --- | --- |
| **Items**  | Cash + Non cash = Liabilities + Hanna + Meseret Assets Capital Capital  |
| Balances before realization  | 6000 + 68000 = 15000 + 38000 + 21000 |
| Sale of non-cash assets and allocation of gain  | 80000 + (68000) = - 7200 + 4800 |
| New balances  | 86000 + - 0 - = 15000 + 45200 + 25800 |
| Pay liabilities  | (15000) + - 0 - = (15000) - -  |
| New balances  | 71000 + -0- = -0- + 45200 + 25800 |
| Cash distribution to partners  | (71000) + - = - (45200) + (25800) |
| Final balances  |  -0- -0- -0- -0- -0- |

Note that Gain on realization is Br. 12,000 (i.e. 80,000 – 68,000 = 12,000). The amount of gain is divided between the two partners based on their income sharing ratio of 6:4 i.e. allocation of gain to:

 Hanna = 12,000 x 6/10 = 7,200

 Meseret = 12,000 X 4/10 = 4,800

The amount of gain increases the partners’ capital accounts. Cash distribution to partners is based on the partners’ capital balances. For example, after the liabilities have been paid, the remaining cash is Br. 71,000. At this time, Hanna has a balance of Br. 45,200 and Meseret has Br. 25,800. Since the sum of the capital balances of the partners is equal to the remaining cash of Br. 71,000, the Br. 71,000 can be distributed to partners according to their capital balances i.e. Br. 45,200 is distributed to Hanna and Br. 25,800 is distributed to Meseret.

b. The following entries can be made to record the foregoing events:

1) To record the realization of non-cash assets

 Cash……………………………………………………… 80,000

 Accumulated Depreciation – Equipment……………….. 10,000

Accounts Receivable …………………………………. 13,000

Inventory……………………………………………….. 20,000

Equipment……………………………………………… 45,000

Gain on realization………………………………….….. 12,000

2) To record the allocation of gain to the partners’ capital accounts

Gain on Realization……………………………………. 12,000

Hanna, capital………………………………………….. 7,200

Meseret, capital………………………………………… 4,800

3) To record the payment of liabilities

Accounts payable…………………………………….. 15,000

Cash……………………………………………………… 15,000

4) To record the distribution of the remaining cash to partners

Hanna, capital……………………………………………. 45,200

Meseret, capital………………………………………….. 25,800

 Cash……………………………………………… 71,000

There is slight difference in the statement of partnership liquidation and journal entries if the realization of non-cash assets results in a loss. For example, assume that the non-cash assets are sold for Br. 50,000. In this case, loss on realization is equal to Br. 18,000 (i.e. 68,000 – 50,000 = 18,000). The statement of partnership liquidation is prepared as follows:

**HM Partnership**

**Statement of Partnership Liquidation**

**For the period from November 3 and November 26,2003**

|  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- |
| **Items** | **Cash** | **+ Non-cash Assets** | **+ Liabilities** | **+ Hanna** **Capital** | **+ Meseret** **Capital** |
| Balance before realization  | 6000 + | 68000 | = 15000 | 38000 |  21000 |
| Sale of non-cash assets and allocation of loss  | 50000 + | (68000) | = -  | (10800) |  (7200) |
| New balances  | 56000 + | -0- | = 15000 |  27200 |  13800 |
| Pay liabilities  | (15000) + |  -  | = (15000) |  -  |  -  |
| New balances  | 41000 + | -0- | = -0- |  27200 |  13800 |
| Cash distribution to partners  | (41000) +  |  -  | = - | (27200) | (13800) |
| Final balances  | -0- + | -0- | = -0- | -0- | -0- |

From the above statement, although non-cash assets are sold at loss of Br. 18,000, the capital accounts of the partners are able to bear the share of the loss. After the division of loss (Br. 18,000) between partners, their capital balances are positive. Similarly, after the liabilities of Br. 15,000 are paid, the remaining cash balance of Br. 41,000 is distributed to partners according to their capital balances (Hanna, Br. 27200; and Meseret Br. 13,800). This leaves the partners capital balances zero.

The accounting entries required to record the above transactions are presented below:

(1) To record the realization of non-cash assets

Cash……………………………………………………………….. 50,000

 Loss on Realization………………………………………………..18,000

Accumulated depreciation – Equipment…………………………..10,000

Accounts Receivable……………………………………………….. …13,000

Inventory……………………………………………………………….20,000

Equipment……………………………………………………………...45,000

2. To record the allocation of loss to partners

 Hanna, capital…………………………………………..10,800

Meseret, capital………………………………………… 7,200

Loss on Realization…………………………………………18,000

3. To record the payment of liabilities

Accounts payable………………………………………..15,000

Cash………………………………………………………..15,000

4. To record the distribution of cash to partners

 Hanna, capital……………………………………….27,200

Meseret, capital……………………………………..13,800

Cash…………………………………………………..41,000

In the above case, although the realization of non-cash assets results in a loss, the capital accounts of the partners were able to bear the loss. That is, each partner’s capital account shows a positive balance after the division of loss (Hanna, Br. 27200; and Meseret, capital, Br. 13800). There is a case in which one or more partner’s capital accounts are unable to bear the loss due to realization of non-cash assets. In other words, the allocation of loss on realization may result in debit (negative) capital balance for one or more partners.

For example, assume that the non-cash assets were sold for Br. 10,000 instead of Br. 80,000. This results in a Br. 58,000 (i.e. 68,000 – 10,000 = 8,000) loss on realization. This loss is allocated as follows:

Hanna = 58,000 X 60% = 34,800

Meseret = 58,000 X 40% = 23,200

It is readily apparent that the part of the loss allocated to Meseret Br. 23,200 exceeds the Br. 21,000 balance in Meseret’s capital account. This results in capital deficiency of Br. 3,000 (i.e. 23,200 – 21,000 = 2,200). This deficiency of Meseret (Br. 2,200) is a potential deficiency to Hanna and must be tentatively absorbed by Hanna. The capital balance remaining represents Meseret’s claim on the partnership cash. The computations may be summarized in the following manner:

|  |  |  |  |
| --- | --- | --- | --- |
|  | **Hanna** **Capital**  | **Meseret** **Capital**  |  **Total**  |
| Balances before realization  | 38,000 | 21,000 | 59,000 |
| Division of loss on realization  | (34,800) | (23,200) | (58,000) |
| Balances after realization  | 3,200 | (2,200) | 1,000 |
| Allocation of potential additional deficiency  | (2,200) | 2,200 | - |
| Claim to partnership cash  | 1,000 | - | 1,000 |

**HM partnership**

**Statement of Partnership Liquidation**

**For the period from November 3 and November 26,2003**

|  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- |
| **Items**  | **Cash +** | **Non-Cash Assets** | **= Liabilities**  | **+ Hanna**  **capital**  | **+ Meseret**  **capital**  |
| Balances before realization | 6000 + | 68000 | =15000 | + 38000 | + 21000 |
| Sales of non-cash assets and allocation of loss  | 10000 +  | (68000) | = -  | + (34800) | + (23,200) |
| New balances  | 16000 + | -0- | 15000 | + 3200 | + (2200) |
| Pay liabilities  | (15000) + |  -  | (15000) | + -  | + - |
| New balances  | 1000 + | -0- | -0- | + 3200 | + (2200) |
| Cash distribution to partners  | (1000) +  |  -  |  - | + (1000)  |  -  |
| New balances  | -0- | -0- | -0- | + 2200 | + (2200) |

**Accounting Entries**

1) To record the realization of non-cash assets

Cash………………………………………………………… 10,000

Loss on realization………………………………………….. 58,000

Accumulated depreciation – equipment ……………………. 10,000

 Equipment………………………………………………..… 45,000

 Accounts receivable…………………………………… 13,000

 Inventory……………………………………………….. 20,000

2) To record the allocation of loss to partners:

Hanna, capital……………………………………………………34,800

Meseret, capital………………………………………………….23,200

 Loss on realization…………………………………………………58,000

3) To record the payment of liabilities

Accounts payable……………………………………………….15,000

Cash……………………………………………………………….15,000

4) To record the distribution of cash to partners

Hanna, capital…………………………………………………..1,000

Cash……………………………………………………………….1,000

A partnership has unlimited liability in the sense that deficient partner is obliged to contribute from his/her personal assets. A deficient partner is a partner whose capital balance is debit (negative). The deficient partner may not have personal asset. In this case, partners with positive capital will bear the deficiency.

For the foregoing example, let’s consider the following assumptions:

**Assumption A**: Meseret pays the entire amount of the Br. 2,200 deficiency to the partnership.

**Assumption B**: Meseret pays Br. 1,500 of the deficiency to the partnership, and the remainder is considered to be uncollectible.

**Assumption C**: Meseret is unable to pay any part of the Br. 2,200 deficiency.

The various steps in the final settlements and the entries for the partnership under three different assumptions as to the final settlement are illustrated below:

**Assumption A: Meseret pays the entire amount of Br. 2200 deficiency to the partnership**

The receipt of Br. 2200 paid by Meseret to the partnership, and the distribution of the Br. 2200 to the partner (Hanna) are illustrated in the following partnership statement.

**HM Partnership**

**Statement of Partnership Liquidation**

**For period November 3-26,2003**

|  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- |
| **Items**  |  **Cash**  | **+ Non cash**  **assets**  | **= Liabilities**  | **+ Hanna**  **capital**  | **+ Meseret**  **capital**  |
| New balances  | -0- | + -0- | = -0- | + 2200 | + (2200) |
| Receipt of deficiency  | 2200 | + - |  - |  -  |  2200 |
| New balances  | 2200 | + -0- | -0- | +2200 |  + -0- |
| Distribution of cash to Hanna  | (2200) |  -  |  -  | (2200) |  -  |
| Final balances  | -0- | -0- | -0- | -0- |  -0- |

The entries to record the final settlement are as follows:

5) To record the receipt of deficiency

 Cash……………………………………………………….. 2200

Meseret, capital…………………………………………….. 2200

6) To distribute cash to Hanna

 Hanna, capital………………………………………………..2200

Cash………………………………………………………..2200

**Assumption B: Meseret pays Br. 1500 of the deficiency to the partnership, and the remainder is considered to be uncollectible.**

The receipt of Br. 1500 paid by Meseret to the partnership, the allocation of the Br. 700 loss, and the payment of the Br. 1500 to Hanna are indicated in the following statement of partnership liquidation.

**HM partnership**

**Statement of partnership Liquidation**

**For period November 3-26,2003**

|  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- |
| **Items**  | **Cash**  | **+ Non cash**  **assets**  | **= Liabilities**  | **+ Hanna**  **capital**  | **+ Meseret**  **capital**  |
| New balances  | - | + -0- | = -0- | + 2200 | + (2200) |
| Receipt of deficiency  | -1500 | + - |  - |  -  |  1500 |
| New balances  | 1500 | + -0- | = -0- | +2200 |  + (700) |
| Allocation of Loss  |  - |  - |  - | (700) |  + 700 |
| New balances  | 1500 | +-0- | = -0-  | 1500 |  + -0- |
| Distribution of cash to Hanna  | (1500) |  -  |  -  | (1500) |  -  |
| Final balances  | -0- | -0- | -0- | -0- |  -0- |

Note that the Br. 700 loss was borne by Hanna. The entries to record the final settlement are as follows:

(5) To record the receipt of part of deficiency

Cash…………………………………………………………… 1500

Meseret, capital…………………………………………………..1500

(6) To record the allocation of loss to Hanna

Hanna, capital………………………………………………………...700

Meseret, capital……………………………………………………700

(7) To record the distribution of cash to Hanna

Hanna, capital……………………………………………………….1500

Cash……………………………………………………………….1500

**Assumption C: Meseret is unable to pay any part of the Br. 2200 deficiency**.

The allocation of Br. 2200 loss to Hanna is indicated in the following statement of partnership liquidation.

|  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- |
| **Items**  | **Cash**  | **+ Non cash**  **Assets**  | **= Liabilities**  | **+ Hanna**  **Capital**  | **+ Meseret**  **Capital**  |
| New balances  | -0- | + -0- | = -0- | + 2200 | + (2200) |
| Division of loss  |  - | + - |  - |  (2200)  |  2200 |
| Final balances  | -0- | -0- | -0- | -0- | -0- |

The entry required to record the final step in the liquidation is shown below:

(5) To record the allocation of loss to Hanna

Hanna, capital……………………………………………………..2200

Meseret, capital………………………………………………….2200

Note that Assumption A, B, and C are independent in the sense that all do not occur at the same time. Either assumption A, B, or C occurs at a time.

**Check your progress 6-1**

1. Bale Company at December 31 has cash Br. 20,000, non cash assets Br. 100,000, liabilities Br. 55,000, and the following capital balances: Bayisa Br. 40,000 and Lemma Br. 25,000. The firm is liquidated and Br. 110,000 in cash is received for the non-cash assets. Bayisa and Lemma share income at 55% and 45% respectively. The liquidation process took 15 days (November 16-30, 2003).

**Required**

a. Prepare the statement of partnership liquidation.

b. Prepare the entry to record:

1. The sale of non-cash assets

ii. The allocation of gain or loss to the partner

iii. Payment of creditors

iv. Distribution of cash to the partners.

2. Prior to the distribution of cash to the partners, the accounts of MEL Company show the following balances. Cash Br. 30,000, M capital Br. 18,000 (Cr.), E capital (Cr.) Br. 16,000, and L capital (Dr.) Br. 4,000. The income sharing ratios are 5:3:2 respectively.

**Required**

a) Prepare the entry to record:

1. L’s payment of Br. 4000 in cash to the partnership

ii. The distribution of cash to partners with credit balances

b) Prepare the entry to record:

i) The absorption of L’s capital deficiency by the other partners

ii) The distribution of cash to the partners with credit balances

##### **6.4 Partnership Liquidation when Loan payable Exists**

The right of offset may be applied in partnership liquidation. The right of offset states that if a partner’s capital account has a debit balance, any credit balance in that partner’s loan account must be offset against the deficit in the capital account. However, if a partner with loan account receives any cash, the payment is recorded by a debit to the loan account to the extent of the balance of that account.

Assume that A, B and C who share net income or losses in 4: 4:2 ratio, decide to liquidate the partnership. The balance sheet on December 31,2004, just prior to liquidation, is shown below:

**ABC Partnership**

**Balance sheet**

December 31, 2004

Assets Liabilities and capital

Cash 20,000 Liabilities 10,000

Other assets 85,000 Loan payable to B 30,000

 A, Capital 32,000

 B, Capital 15,000

 \_\_\_\_\_\_\_ C, Capital 35,000

**Total** 105,000 **Total**  105,000

Assume that the non cash assets are sold for Br. 60,000. The liquidation process took place from January 1 to April 1,2005.

Loss on realization = 85,000 – 60,000 = 25,000

Statement of Realization and liquidation is prepared as follows:

**ABC Partnership**

**Statement of Realization and liquidation**

January 1 through April 1,2005

 Other

 Cash Assets Liab. Loan A B C

Balances before realization 20,000 85,000 10,000 20,000 32,000 8,000 35,000

Realization of other Assets 60,000 (85,000) --- ---- (10,000) (10,000) (5,000)

Balances 80,000 ---- 10,000 20,000 22,000 2,000 30,000

Payment to creditors (10,000) --- (10,000) --- --- -- -- \_\_\_

Balances 70,000 --- -- 20,000 22,000 (2,000) 30,000

Offset B’ Capital deficit

Against B’s loan -- --- --- (2000) ---- 2000 ---\_\_

Balances 70,000 --- --- 18,000 22,000 --- 30,000

Payment to partners (70,000) --- --- (18,000) (22,000) --- (30,000)

Balances --- --- -- --- --- -- ---

**6.5 summary**

Partnership dissolution may be followed by liquidation. Liquidation involves termination of the operation of the partnership. When a partnership is liquidated accounts should be adjusted and closed; non-cash assets are converted to cash; all creditors are paid; and the remaining cash should b e distributed to the partners.

The sale of non-cash assets (realization) may result in gain or loss. Any gain or loss arising from realization is divided between/among partners according to their income sharing agreement. Gain on realization increase’s the partners’ capital accounts while loss on realization reduces the accounts.

After all creditors are paid the remaining cash is distributed to the partners according to their capital balances.