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Teaching and educational note

Applying accounting principles to a partnership dissolution

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Abstract

This teaching case shows how a partnership used a consultant to help resolve certain accounting issues associated with its dissolution. Focusing on accounting theory, partnership accounting and contracts, this case can help develop critical thinking skills and can be used in several accounting courses (including advanced financial accounting and accounting theory) at both the graduate and upper division undergraduate levels. The case demonstrates that lawyers and others who form partnerships should develop well-crafted operating agreements that cover normal and unusual business transactions as well as the firm's dissolution. Specifically, they should identify and assess all matters relevant to the dissolution process, including the compensation scheme and other contractual issues. The case emphasizes the importance of accurate and timely accounting information – both during a firm's life and at its dissolution. The case requires students to balance GAAP and the fair/equitable treatment of the partners involved.
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1. Introduction

Partners in professional service firms, experts in their field, may not recognize the many issues that a partnership operating agreement (OA) should address, especially the distribution of firm assets upon dissolution. An OA should be written and should describe: (1) the business; (2) the partners‘ rights and responsibilities; (3) partners' required initial investment and asset valuation criteria; (4) profit- and loss-sharing arrangements; (5) capital contribution/withdrawal provisions; and (6) distribution of assets upon firm dissolution. Ignoring possible dissolution invites almost certain disagreement and the risk of litigation. This teaching case provides the facts and recommendations developed by applying generally accepted accounting principles (GAAPs) to a law firm's OA when the OA was silent regarding dissolution.

2. Background and problem statement

Jack Jacobs, senior partner in the ABC law firm, met with Arnold Rose, an accounting consultant experienced in dissolutions, mergers, and acquisitions, to help determine ABC's final distributions. Since ABC's faulty OA did not provide guidelines for capital distribution at dissolution, Rose warned Jacobs that all partners of the firm might not welcome his recommendations. For example, the final accounting must consider how to deal with current and former partners' negative capital balances, an issue that generated different, deeply ingrained expectations among the partners about who should be responsible for them. Jacobs offered to ease Rose's task by setting out the major problems the firm was facing in dissolution and to meet individually with ABC's other partners in order to discover their perspectives on the key issues to address. In return, Rose offered Jacobs a broad outline of how he would proceed:

- Apply GAAP to properly classify assets, liabilities, equity, revenues, and expenses to facilitate the preparation of accurate financial statements.
- Determine what the OA says about dissolution issues and ascertain what provisions exist.
- Apply GAAP to help resolve income measurement issues associated with final dissolution accounting, where the OA is silent.
- Apply partnership dissolution accounting to decide how to "split up the pie," i.e., who owes what (liabilities), how liabilities will be paid (assets), and what is left to distribute (equity).
- Based on the OA and GAAP, reconcile differences between the partnership accountant's and the accounting consultant's financial dissolution plans.

Rose, a certified public accountant (CPA), assured Jacobs that his conclusions would be objective and fair, and that he would do what he could to make the dissolution process move along smoothly. Jacobs had confidence in Rose and considered him a trustworthy professional.

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